

# Law of partnership - fiduciary duty analysis



Analyse within the Law of Partnership – Fiduciary DutyDefinition

Partnership is a longstanding legal concept which has become regulated by statute. Recently, the introduction of Limited Liability Partnerships has added a new species of partnership to the legal lexicon and demands a dramatic reworking of the way in which partnerships are viewed.

The classic definition of partnership is provided by s. 1 of the Partnership Act 1890:

“ Partnership is the relation which subsists between persons carrying on a business in common with a view to profit.”

The relationship between partners must be contrasted with the relationship between employer and employee. The latter may also be said to be “ carrying on a business etc.” but one is subordinate to the authority of the other. Partners possess a number of co-existent rights:

- To be involved in decisions affecting the business;
- To share in the profits and losses;
- To examine the accounts;
- To be entitled to the good faith of the other partner(s);
- To veto the introduction of a new partner.

Traditionally, a definition of partnership would involve a contrast with a company drawing the distinction that, unlike a company, a partnership could not benefit from the protection of limited liability. However, as will be seen

below, such a distinction is no longer universally valid following the Limited Liability Partnerships Act 2000.

### Fiduciary Duty

Partnership is a particular type of contract (albeit governed by the partnership legislation). There is therefore considerable involvement of the common law and equitable principles. The major consequence of entering into a partnership is that the partners owe a fiduciary duty to one another. Since the law of fiduciaries and constructive trusts is a creature of equity and the categories of equity are never closed it is impossible to provide a comprehensive and definitive list of such duties but a number of clear principles have emerged. The partners owe one another a duty of good faith. For example, in *Floydd v Cheney*<sup>[1]</sup>, an architect engaged an assistant with a view to partnership. The assistant removed certain documents and photographed others in the absence of the architect who then sued for the return of the documents and negatives and sought an injunction restraining the use of confidential information. There was a dispute as to whether this was a partnership or a master/servant relationship. However, Megarry J held that even if this was a partnership, there existed a duty of good faith which prevented the assistant from acting as he did.

A partnership relationship is one of 'utmost trust' ( *uberrimae fidei* ).

Therefore each partner must deal honestly and openly with his fellows and disclose all relevant information to them. A failure to disclose is a breach of this duty; there is no need to establish fraud. This is also partly embodied in statute. Section 28 of the Partnership Act 1980 provides:

“ Partners are bound to render true accounts and full information of all things affecting the partnership to any partner or his legal representatives.”

A trustee must not profit from his trust and this applies to partners as fiduciaries. This a partner must not make unauthorised personal profit. This principle is also embodied in s. 29 of the Act which requires a partner to account to the firm for any benefit derived by him without the consent of the other partners from any transaction concerning the partnership or involving the use of partnership property. Thus the rule in *Keech v Sandford*<sup>[2]</sup> (which provided that where a trustee of a trust which holds a lease obtained a renewal of the lease for his own benefit, he held the lease as a constructive trustee for the beneficiaries) applies to partners where they obtain such a benefit as a result of their position as a partner. A partner must not put himself in a position of conflict of interest and duty toward his partners. This is codified by s. 30 of the Act which provides that where a partner has carried on a business of the same nature and in competition with the partnership, he must account to the other partners for the profits of that business. Because, as has been seen, partnership is a species of contract, the written terms of the partnership deed (if any) and indeed those imposed by the Act can be varied by express or implied agreement.

### Limited Liability Partnerships

For many years pressure had been growing in the commercial world and particularly among those providing professional services for the introduction of a form of partnership that would provide a limitation of liability akin to that enjoyed by directors of a limited company. This was driven in particular by

an increase in litigation and the consequent threat to firms and therefore to their partners personally. This led to the passage of the Limited Liability Partnerships Act 2000 and the creation of Limited Liability Partnerships. LLPs are therefore entirely a creature of statute and a new form of legal entity. They continue to enjoy the organisational flexibility of partnerships. In matters relating to taxation (partners are Schedule D as before) they are similar to traditional partnerships but in many other respects it is appropriate to think of them in terms of the company model. Indeed the only way in which an LLP can be created is by submitting an incorporation document to Companies House. While there is no need to submit a partnership deed (contrast the filing of Articles of Association in respect of companies), partners in LLPs are well advised to subscribe to a deed which will regulate the operation of the partnership and protect their interests in the event of a dispute. An LLP is therefore a corporate body with a separate identity from the partners. In general, partners in an LLP will have full entitlement to limited liability. (There is an exception in circumstances in which an LLP continues to trade after being reduced to only one “designated member” such that, after a prescribed interval, the remaining partner will become jointly and severally liable with the LLP.) Similarly, in the event of insolvency, partners are not in most circumstances personally liable to any extent over and above the aggregate of their capital share in the LLP and any contribution they have agreed to make. An LLP is analogous to a limited company in that it has no existence until the formalities of incorporation are complete. However, many of the restrictions upon the freedom of action of company directors – particularly interaction with the corporate body – do not apply. Nonetheless, unlike partnerships, Companies House imposes a

number of formal requirements such as the filing of an annual return and audited accounts. Both partnerships and LLPs involve a venture for profit. There is no restriction upon the type of venture to be undertaken (although LLPs are not suitable for use by charities). In a traditional partnership, the central feature is the relationship between the members whereas with an LLP it is the act of association that creates the entity. This can be seen from the fact that in a partnership every member is an agent of the partnership and an agent of the other partners whereas in an LLP every partner is an agent of the LLP itself but not of the other partners. This has led commentators <sup>[3]</sup> to conclude:

“ Overall, LLPs are a curious mix of the law of partnership and the law of companies.”

Those authors (at p. 165) speculate as to the operation of duties within the new form of partnership:

“ Partners will owe a duty to the LLP as a body corporate in common law but it seems unclear whether they owe a duty of good faith to each other.”

### LLPs and Fiduciary Duty

The fiduciary duties of a partner to an LLP are helpfully explored by Whittaker and Machell <sup>[4]</sup>. They observe that “ the core obligation of a fiduciary is that of single-minded loyalty to his principal”. This core obligation is represented by several separate duties or restrictions including but not limited to the following:

- To act at all times in good faith;

- Not to misapply the money or property of the LLP;
- Not to put himself in a position of conflict of interest with the LLP;
- To disclose all relevant information (including any material breach by him of his fiduciary duties to the LLP;
- Not to compete with the LLP;
- Not to misuse his position in the LLP for his own advantage.

The authors suggest (at p. 137):

“ that the fiduciary obligations set out above will exist unless they are expressly (and properly) excluded by the LLP agreement or it is clear from a consideration of all the circumstances that particular duties are inapplicable.”

The Act contains a number of “ default rules” which specify such duties and, regulate, for example, the circumstances in which a member may be expelled from an LLP but it should be noted that these rules are not a comprehensive statement of a member’s fiduciary duties which will continue in their totality to be regulated by equitable principles where any partnership deed does not make express provision.

#### Partnerships in Other Jurisdictions

Partnership is recognised as a legal relationship throughout Europe and, provided that it has been formed in accordance with the laws of a member state and has its registered office (in the case of LLPs) or principal place of business (in respect of traditional partnerships) within the EC, a partnership will be treated for the purposes of European law in the same way as a

natural person who is a national of a member state. In most European jurisdictions there are three basic types of commercial partnership: the undisclosed or “secret” partnership; the general partnership and the limited partnership. In France, partners in a secret partnership can authorise each other to disclose their partnership relationship to third parties thus rendering it a *société en participation ostensible* with the result that they become jointly and severally liable for the firm’s obligations. By contrast, in Austria, where the partnership will consist of a principal and a single dormant partner, the latter will not be liable even if he manages the business. The formalities for creation of general partnerships vary according to jurisdiction. In countries such as Belgium, Bulgaria and Greece, it is necessary to have a written agreement for registration purposes whereas in other countries an oral agreement will suffice. In France and Belgium, there are two types of limited partnership ( *société en commandite simple* and *société en commandite par actions* ). The latter is more analogous to a limited company. In the former, the limited partners may not participate in the management of the partnership on pain of losing their limited status. This contrasts sharply with the operation of English LLPs discussed above which is more akin to that in Austria which allows limited partners to participate in internal management.

### Proposals for Reform

Finally, it should be noted that the Limited Liability Partnerships Act 2000 created an additional category of partnership rather than reforming the existing rules. In the Preface to the First Edition of *Partnership Law* , Geoffrey Morse observed:



“ It is to the everlasting credit of the Victorian judges that they created a business form which has proved to be both strong and flexible enough to adapt itself to EEC-wide firms of accountants when it was designed for small parochial businesses in Victorian England.”

Nonetheless, as has been seen by the need to develop LLPs, modern circumstances demand continual evolution. In November 2003, the Law Commission and the Scottish Law Commission published a report on such reform accompanied by a detailed draft Partnership Bill. Central to their proposals is a redefinition of partnership which moves away from the relationship between persons carrying on business together to “ an association formed when two or more persons start to carry on business together *under a partnership agreement* [emphasis supplied]”. This gives primacy to the existence of an agreement. A written agreement has never been an essential prerequisite of a partnership (even under the 2000 Act) and the Commissions shied away from imposing a statutory model agreement but it is nonetheless proposed to abolish partnerships at will providing that there should at the very least be express agreement.

### Bibliography

Adams, T. et al, *Business Law and Practice 2004-2005*

Banks, R., *Lindley & Banks on Partnership* , (18<sup>th</sup> Ed., 2002)

Morse G. et al, *Palmer's Limited Liability Partnership Law* (2002)

Morse, G., *Partnership Law* , (5<sup>th</sup> Ed., 2001)

Whittaker, J.& Machell, J., *The Law of Limited Liability Partnerships* , (2<sup>nd</sup> Ed., 2004)

*Encyclopaedia of Forms & Precedents* , Partnership, Volume 30(1)

1

---

### Footnotes

[1] [1970] Ch 602

[2] (1726) Sel Cas t King 61

[3] For example, Adams, T. et al, *Business Law and Practice 2004-2005* , p. 166

[4] *The Law of Limited Liability Partnerships* , (2<sup>nd</sup> Ed., 2004) p. 134 *et seq*