

Chapter 2: Nature of Partnership

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Aims of this Chapter

This chapter will enable you to achieve the following learning outcomes from the ILEX syllabus:

- 1 Understand the key practical, financial and fiscal implications in choice of business medium
- 2 Understand the practices and procedures relating to the formation and management of a partnership

2.1 Introduction

Partnership is a relationship, like marriage. The relationship is created when certain conditions are satisfied. This chapter examines these conditions.

2.2 Definition of partnership

Partnership is defined by **s1(1) PA 1890** as:

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

Although the definition might seem clear enough it does require considerable elucidation. It is possible to identify four characteristics that must be present before a partnership can exist. There must be (1) a business (2) carried on in common (3) by two or more persons (4) with a view of profit.

2.3 A business

Business is stated by **s45 PA 1890** to include *every trade, occupation or profession*. This statutory statement is problematic because not every occupation can be called a business. For example, a landowner who simply manages his estate and collects the rents does not carry on a business, but if he deals in land (rather than just selling it off) this would constitute a business. The receipt of income from property is an incident of ownership. For a business to exist, the enterprise must be one which is recognised as a commercial or professional calling, for example, solicitors or plumbers.

The term “business” connotes some continuing activity and generally involves a series of commercial transactions which, if successful, result in a profit for the participants. However, a single transaction or venture may constitute a business or trade, such as a one-off purchase of goods or services: ***Mann v D’Arcy [1968]***. The existence of a business is not an essential prerequisite for a partnership. In ***Khan and Another v Miah and Another [2000]*** it was held that a partnership may exist before trading is actually commenced. The partners had to prepare for business by acquiring premises, securing planning

consent and putting their affairs in order, to enable them to carry on business as restaurateurs. The court held that the process of committing capital and the effort of preparing for business was a joint venture which is part and parcel of being in partnership. The fact was that, prior to starting to trade, the partners were involved in commercial activity with a view of profit.

2.4 Carried on in common

The concept of common activity raises difficulties. The requirement might be said to be that the business is carried on by or on behalf of the partners. A person might be said to carry on business if he participates in the management of the business, as an owner might participate, but **s24 PA 1890** recognises that individual partners might agree to forgo their right to participate in management. Ultimately, it is necessary to look at all the facts to determine whether or not a business is carried on by or on behalf of the partners.

Effectively, there is a requirement for participation in the business. One has to look at the conduct of the alleged partners and ascertain whether or not they comport themselves as partners. In circumstances in which individuals behave as though they are not partners, the crediting of a share of the profits of the business to the accounts of those individuals will not be sufficient to make them partners: **Saywell v Pope [1979]**. Accordingly, the receipt of a share of profits does not automatically make a person a partner.

The fact that two or more persons participate jointly in a business and share net profits is not sufficient alone to make them partners. It is necessary to consider the ultimate beneficial entitlement to the profits generated. In **Re Fisher & Sons [1912]** a partnership did not exist when executors continued the business of the deceased, because the profits generated did not belong to the personal representatives.

2.5 By two or more persons

Individuals and artificial persons (companies and limited liability partnerships) may be partners.

2.6 Carried on with a view of profit

A partnership can exist only if a business is carried on with the intention to make a profit. **PA 1890** does not state that there must be an intention to share profits between partners. The sharing of profits is not essential to the existence of a partnership, but there may be enough other factors present to establish a partnership in the absence of an alleged partner sharing the profits. **Stekel v Ellice [1973]** established that a person receiving a salary could still be a partner if other factors made such a designation appropriate.

On the other hand, the sharing of profits is *prima facie* evidence that a partnership subsists. **s2(3) PA 1890** states:

The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business.

The provision then goes on to list a number of instances whereby a receipt of a share of profits does not, by itself, make a person a partner. The fact that the receipt of profits is only *prima facie* evidence means that it is necessary

to look at all the circumstances of each case. If there are other factors which tend to suggest there is no partnership, these factors may be sufficient to rebut the *prima facie* evidence of partnership (which exists in the form of the receipt of a share of profits): ***Cox v Hickman [1860]***. In other words, the sharing of profits is only one of several factors to be taken into account in deciding whether a particular arrangement is a partnership. Whether a person may be held to be a partner clearly depends upon the facts of the case and the intention of the parties.

In all but the most exceptional of cases it will be clear whether or not the intended or actual relationship is one of partnership. The question of whether or not a person is a partner usually arises in the context of a creditor seeking to fix liability for a debt on a person on the basis that he is a partner, and thus responsible for the debts of the firm, because those who are obviously partners cannot meet the debt.

In the context of normal commercial lending to a partnership the risk of the lender being held to be a partner is minimal, but it increases when terms are agreed which entitle the lender to a share of profits or to participate in some way in the decision-making processes of the business. **s2(3)(d) PA 1890** provides specifically that the advance of money by way of loan to a person engaged in business on terms that the lender receives a rate of interest which varies with profits, or a share of profits, does not by itself make the lender a partner. The provision goes on to state that the contract for the loan must be in writing signed by or on behalf of all parties before the lender may rely upon this provision. A loan on such terms coupled with other factors, which might be termed “badges of partnership”, such as the right to be consulted prior to management decisions being taken, may be sufficient to tip the balance against the proposition that the lender is not a partner, especially when the commercial reality is that the lender’s point of view must be adopted by the actual partners.

These rules, designed to determine the existence of a partnership, are of equal importance on the retirement of a partner who sells his share to the remaining partners. It is not unknown for the consideration for the purchase of the outgoing partner’s share of the goodwill to be a percentage of future profits generated by the business after completion of the sale. **s2(3)(e)** provides that a seller receiving a portion of the profits of a business in consideration of the sale by him of the goodwill of the business is not sufficient in itself to make the seller a partner. However, prudence dictates that the seller should reserve some sort of powers/rights to protect the payment of future consideration; care is needed to make sure such rights do not add sufficient weight to the relationship between the seller and purchaser to make them partners, especially since the object is to effect a retirement from a partnership in the first place.

It should also be noted that a lender who is entitled to a share of net profits, or a person who sells goodwill in consideration of a share of profits generated by a partnership, is a postponed creditor. If the partnership becomes insolvent then the status of certain creditors is reduced to that of deferred creditor and they cannot recover anything in respect of their debt until all the other “ordinary” creditors have been paid in full: **s3 PA 1890**.

2.7 Summary

(1) Partnership is a relationship which exists when the conditions set out in **s1 PA 1890** are satisfied. **s1** defines a partnership as *the relation which subsists between persons carrying on a business in common with a view of profit*. There must be:

- a business;
 - carried on in common;
 - by two or more persons;
 - with a view of profit.
- (2) A business includes every trade, occupation or profession. The following points should be noted:
- not every occupation is a business and, if it is not, it cannot form the basis of a partnership;
 - for an enterprise to be a business it must be a recognised commercial or professional calling;
 - the term “business” connotes a continuing activity and generally involves a series of commercial transactions;
 - a partnership may come into existence before trading has commenced.
- (3) Factors to be taken into account to ascertain whether a business is carried on “in common”, and therefore whether persons participate in a business, include:
- participation in management;
 - sharing of and beneficial entitlement to profits;
 - the conduct and intentions of the persons involved.
- (4) Those who may participate in a partnership include individuals and artificial persons such as companies and limited liability partnerships.
- (5) An intention to make profits is a prerequisite for the existence of a partnership. The following points should be noted:
- the sharing of profits is not essential to the existence of a partnership provided substantial other factors exist to support the existence of a partnership;
 - sharing of profits is *prima facie* evidence of the existence of a partnership.
- (6) The receipt of a share of profits does not, by itself, make a person a partner. One has to look at the circumstances of each case to determine whether a person is a partner.



Check for yourself . . .

Now that you have finished reading this chapter, you should be able to meet all the ILEX assessment criteria listed in this table. If you are not sure about anything, look back at the chapter and re-read the relevant part. The right-hand column of the table has been left blank so that you can tick off each item when you feel confident about it. You may wish to wait until you have studied **Chapter 3** before you tick off the final two of these items.

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Published in 2011 by:
ILEX Tutorial College Ltd
College House
Manor Drive
Kempston
Bedford
United Kingdom
MK42 7AB

British Library Cataloguing in Publication Data

A catalogue record for this manual is available from the British Library.
ISBN 978-1-84256-568-4