

Partnership Protection

Expert knowledge means success



Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

One of the key considerations for a business is whether it should operate as a sole trader, partnership or limited company.

If the choice is partnership, the Partnership Agreement is an essential document for the protection and guidance of the parties during the future course of the business.

A Partnership Agreement should set out the rules governing how the partnership operates. In the absence of an agreement there will be a large element of uncertainty and the Partnership Act will apply - perhaps leading to results completely different from what was intended.

A written Partnership Agreement avoids uncertainty and helps to:

- Increase security by providing a period of notice if one partner wishes to end the arrangement - otherwise the partnership and the business can end at any time at the whim of a partner.
- Ensure continuity of business - in the event of one partner leaving, the firm's name and assets can be used if wanted by the remaining partner(s).
- Place restrictions on an ex-partner in relation to competitive activities.
- Determine what should happen upon the death of a partner and what provision should be made for the firm to continue and how the deceased share of assets and earnings should be funded and distributed to their estates.
- Provide protection for all individual partners in relation to the activities of fellow partners in the day-to-day operation of the business.

While a written agreement isn't required by law, a Partnership Agreement can provide the framework for defining each partner's duties and obligations, as well as settling the conflicts, disagreements and other difficult-to-resolve issues that often happen in most business relationships.

Partnerships and continuity

Under the Partnership Act 1890, a partnership is defined as 'the relationship which subsists between two or more persons carrying on a business in common with a view of profit', other than by forming a limited company.

If there is no formal Partnership Agreement, the provisions of the 1890 Act will apply, and on death of one of the partners the partnership will be dissolved, with the estate of the deceased partner usually having a right to a share of the dissolution profits.

This is clearly unsatisfactory in most cases, so a Partnership Agreement will normally be drawn up which ensures that the surviving partners can purchase the deceased partner's share.

In fact a partnership may also be dissolved by:

- termination of the venture
- the passing of time
- the death or bankruptcy of a partner
- an event which makes it unlawful to continue the venture/business
- by order of the Court
- by notice given by a partner if the partnership is for an indefinite period

Clearly a Partnership Agreement needs to be in place to deal with any possible dissolution regardless of the cause.

Three main forms of agreement are available to protect a partnership on the death of a partner as follows:

- **The buy and sell agreement**
The partners all agree that, on the death of a partner, the surviving partners will buy the deceased partner's share of the business. They will make the purchase in such proportions that the same ownership ratio is maintained between the survivors. Each partner will effect and maintain a life policy on his life under trust for the benefit of the other partner(s) with two (or more) of the partners as trustees, assuring the sum required to meet the value of the deceased partner's share on death.



- **The cross-option (or double option) agreement**
In this method there is also an agreement between the partners backed up by policies under trust, but one that gives options rather than a right to buy and sell. The deceased's estate has an option to require the surviving partners to buy, and the surviving partners have an option to require the deceased's estate to sell within a specified period from the death. Again, each partner must effect and maintain a life policy to provide the sum required to purchase his share, and will provide for the valuation of that share on death. The policy will be under a special cross option trust, with the other partners also being trustees.
- **The automatic accrual method**
In this method, the partners agree that the partnership will continue on the death of a partner. The deceased partner's share passes automatically to the surviving partners, but only to the extent of the proceeds arising under a life policy effected by the deceased partner. Each partner has an obligation to effect and maintain a policy on his own life for the value of his share. The deceased partner is compensated for the automatic passing of his share to the surviving partners by the sum assured payable to him under his own policy.

The terms of the Partnership Agreement and the wishes of the partners about how this issue should be dealt with will determine which of these options is most suitable.

Partnership Protection Policy

Where one of the partners dies, the surviving partners need to be able to generate a lump sum to purchase the deceased partner's share. They can achieve this through a Partnership Protection Policy. As a result, all the partners can ensure both the financial well being of their beneficiaries, but also protect the surviving partner's interests in maintaining the ongoing of the business.

This can be a particularly complicated matter and therefore it is essential that independent financial advice be sought to establish how to best achieve the partner's wishes.

Limited Liability Partnerships

A Limited Liability Partnership Agreement (a Members' Agreement) is not an obligation under the Limited Liability Partnerships Act 2000. This Act is similar in many respects to the Partnership Act 1890 with a presumption of implied terms in the absence of a written agreement.

What should a Partnership Agreement include?

Some of the key areas you will want to cover in your written Partnership Agreement are:

- **Basics**
 - What is the name of the partnership?
 - What is the purpose of the partnership?
 - What is the duration of the partnership?
- **Running the Business - responsibilities, performance and remuneration**
 - What is each partner's role?
 - What is each partner's responsibility and duty within the firm, and what level of performance is expected?
 - Are partners expected to make a full-time commitment to the venture, or are business activities permitted?
 - What will be the salary of each partner, and how will profits or losses be distributed?
 - What are the working hours and holidays?
 - What are the decision-making procedures?
 - What are the arrangement for choice and funding of partner's cars?
- **Contributions**
 - What will each partner be contributing to the partnership in terms of cash, assets, loans, investments, and/or labour?
 - If a partner lends money to the firm, what will be the terms or repayment?
 - Will the partners be expected to make additional contributions to the partnership, and if so, how will that be handled?
- **Withdrawal of partners and admission of new partners**
 - What guidelines should be followed if one partner wants to leave the partnership?
 - Will partners be allowed to sell their interests in the business to outsiders?
 - On what grounds can a partner be expelled from the partnership (misconduct, non-performance of duties)?
 - How will new partners be admitted to the partnership?
- **Buy-out procedures**
 - What guidelines should be followed if one partner wants to retire or leave the partnership?
 - What happens if a partner is

- incapacitated or dies?
- Will the partnership take out "key man" life insurance to ensure the surviving partner is able to buy the deceased partner's shares from his/her heirs?
- Will partners who leave have to sign a non-competition agreement?
- **Disputes**
 - What methods will be used to settle disputes that can't be otherwise resolved?
 - What procedures should be used in the event of a tie vote between partners on crucial partnership decisions?
 - Will you use mediation or binding arbitration?
 - If disputes can't be resolved, is there a mechanism in place for dissolving the partnership?
- **Financial arrangements**
 - What banking arrangements will be made for the partnership?
 - Which partners will have cheque-signing privileges?
 - Who will be authorised to draw on the partnership's accounts?
 - How will the books be kept?
 - What are the profit-sharing arrangements and drawings on account (see above for partners' salaries)?
 - What are the arrangements for partnership capital (and interest payments)?
 - How will tax payments be made?
- **Retirement**
 - When are partners normally expected to retire?
 - What arrangements apply on retirement or disability as to repayment of capital, partnership annuity etc?
- **Dissolution**
 - When can the partnership be dissolved?
 - What happens to the partnership if the partners decide they can't work together?
 - What arbitration or dispute mediation arrangements exist?
- **Valuation**
 - What methods will be used to determine the value of the business in the event of a sale, dissolution, death, disability or withdrawal of a partner?

Further Information

The information provided in this publication does not, nor is intended to, constitute financial advice or recommendation on action you should take. You should always do your own research and seek advice from an appropriately qualified advisor.

We often provide links to other websites to be helpful to readers but we are not responsible for the content on those websites.

This guide is for general interest - it is always essential to take independent professional advice on specific issues.

We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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