

Scottish Law Commission
Law Commission for England and Wales

PARTNERSHIP LAW

Summary

of

Joint Consultation Paper

Discussion Paper No 111 / Consultation Paper No 159

September 2000

The Law Commission and the Scottish Law Commission were set up by the Law Commissions Act 1965 for the purpose of promoting the reform of the law.

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This joint consultation paper, completed on 31 July 2000, is circulated for comment and criticism only. It does not represent the final views of the two Law Commissions.

The Law Commissions would be grateful for comments on this consultation paper before 12 January 2001. Comments may be sent either –

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It would be helpful if, where possible, comments sent by post could also be sent on disk, or by e-mail to the above address, in any commonly used format.

It may be helpful for the Law Commissions, either in discussion with others concerned or in any subsequent recommendations, to be able to refer to and attribute comments submitted in response to this consultation paper. The Scottish Law Commission may also make copies of comments received, or summaries of them, available on their website and to any interested party on request. Any request to treat all, or part, of a response in confidence will, of course, be respected, but if no such request is made the Law Commissions will assume that the response is not intended to be confidential.

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PARTNERSHIP LAW

A Joint Consultation Paper

SUMMARY

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**The Law Commission
The Scottish Law Commission**

**THE REFORM OF PARTNERSHIP LAW
A Summary of the Joint Consultation Paper**

1. The Law Commission and the Scottish Law Commission have produced a joint Consultation Paper on partnership law in response to a request from the Department of Trade and Industry. The terms of reference were:

“To carry out a review of partnership law, with particular reference to: independent legal personality; continuity of business irrespective of changes of ownership; simplification of solvent dissolution; a model partnership agreement; and to make recommendations. The review is to be conducted under the present law of partnership, namely the Partnership Act 1890 and the Limited Partnerships Act 1907.”

2. In this short paper we set out the principal issues which we discuss in the Joint Consultation Paper and invite comments from people who use partnerships as the vehicle by which they carry on business as well as from business organisations and professionals who have expertise in the law of partnership.

The importance of partnerships

3. There are many different types of partnership. Many involve an informal association between two persons to carry on a business without any express partnership agreement. Family businesses are often conducted in partnerships. There are also very large professional and business partnerships with many members, which have an elaborate partnership agreement and a management structure as sophisticated as that of most companies.
4. There are almost as many partnerships in the United Kingdom as there are trading companies. The combined turnover of partnerships at the beginning of 1997 was estimated to be £151,523 million (ex VAT). This is more than the turnover of sole traders, who outnumber partnerships by more than three to one. Partnerships are not just micro businesses: 852,000 of the 2.77 million persons employed by partnerships are in firms with at least ten employees.
5. The work carried on by partnerships encompasses the full spectrum of business and industry. As well as providing a vehicle for professional business, partnerships are prominent in the retail trade, and in the construction, manufacturing, agricultural and tourist industries.
6. The main rules of partnership law are set out in the Partnership Act 1890. The Partnership Act 1890 has hardly been amended since its enactment. A review of

partnership law is appropriate to see if the law requires to be changed to meet the needs of modern business. As partnerships have an important role in the United Kingdom economy the reform of partnership law may make a real contribution to both efficiency and competitiveness.

The Nature of Partnership

7. A partnership depends on the existence of a relationship which results from a contract to carry on business. A partnership relationship can arise only by mutual consent. The agreement, which gives rise to the partnership relationship, may be express or inferred from parties' conduct. No new partner can be introduced without the consent of all the partners.
8. The Partnership Act is a default code. Business people may, and often do, contract out of many of its provisions by entering into an express agreement to govern their partnership. But the Act, by setting out a general code, provides a basic framework which can be adapted to suit the differing needs of the wide range of businesses which people conduct in partnership.
9. Within the United Kingdom there are differences between English law and Scots law in relation to partnership. The principal difference relates to separate legal personality. Although the commercial view of partnership is that the firm exists as a business organisation separate from its partners, English law does not recognise the partnership as a separate entity. As a result in England and Wales the firm cannot acquire rights nor can it incur obligations. A firm cannot hold property.
10. It has been suggested on a number of occasions since the mid nineteenth century that it would be appropriate to reform the English law of partnership to reflect more closely the commercial perception by introducing separate legal personality. But Parliament did not take the opportunity to do so when the 1890 Act created the statutory partnership code.
11. In Scotland, by contrast, the common law before the 1890 Act adopted an entity approach to partnership. This was preserved in the 1890 Act in relation to Scottish partnerships. In Scotland "a firm is a legal person distinct from the partners of whom it is composed". A firm is able to own property, hold rights and assume obligations. It can be a partner in another firm and it can enter into contracts with its partners. There are, however, limitations on the Scots doctrine of the separate legal personality of the firm. In particular there is serious doubt as to whether the legal personality of a Scottish partnership can continue on a change in the composition of the partnership. The existing Scots law therefore cannot provide a blueprint for reform.
12. In England and Wales a partner cannot be an agent of the firm as an entity because it lacks legal personality. The critical concept in English law is the concept of mutual agency. Whenever a partner makes a contract, it is on behalf of that partner and the other partners. If the firm breaches the contract, the partners will be liable for any consequential loss. There is no limit to this liability. In Scots law the partners are agents for the firm, which is the principal. The firm has primary liability for all debts and obligations which it incurs through the agency of its partners. The liability of the partners is subsidiary in nature, similar to that of a surety or guarantor but without the

common law privileges of suretyship or (in Scotland) cautionry. In both jurisdictions therefore partners have unlimited liability for partnership debts and obligations.

13. In view of this potential liability, the law requires that a partner must display the utmost good faith towards his fellow partners in all partnership dealings. Partners stand in a fiduciary relationship.
14. Section 24 of the 1890 Act sets out partners' management and financial rights which apply in the absence of contrary agreement. These default rules provide, for example, that partners are entitled to share equally in the capital and profits of the firm, are entitled to take part in the management of the business and can agree ordinary matters connected with the partnership business by a majority.
15. A partner has no right to retire from a partnership otherwise than by agreement. A partnership falls into one of two categories namely a partnership at will or a partnership for a fixed term. A partner in a partnership at will can dissolve the partnership immediately by notice. In a partnership for a fixed term, a partner cannot lawfully retire without the consent of the fellow partners.
16. In English law any change in the membership of a partnership terminates the partnership. In the absence of an agreement to the contrary, the withdrawal of a partner or a partner's death or bankruptcy means that the partnership is dissolved as regards all the partners and that it should be wound up. If a new partner is admitted to a partnership, that partnership ends and a new one is created. Scots law is unclear as to the effect of a change in membership of the firm on the continuance of its legal personality, where partners have agreed that the firm is not to be dissolved by such a change.
17. The dissolution of a partnership and the creation of a new firm where the remaining partners agree to continue the business can give rise to awkward questions of law. In English law a contract with a partnership is a contract with the members of that firm. It is a matter of construction whether a contract can be performed "vicariously" by another set of persons (i.e. a "new" partnership). In Scots law similar issues arise, notwithstanding the separate personality of the firm. It is a matter of construction of the contract with the partnership as to whether the contract is with the firm as it is then constituted, or is with the firm (viewed as a continuing entity) as it might be constituted from time to time. In both jurisdictions partners have to devise means to transfer partnership property from the dissolved firm to the new firm.
18. A partner's liability for new debts incurred on the firm's behalf lasts for as long as other partners (as agents) have authority to bind that partner. Nonetheless, third parties are entitled to assume that other partners remain as agents until they are notified to the contrary. This means that partners withdrawing from a firm should notify clients of their withdrawal.
19. On the other hand it is often difficult for a third party to ascertain who was a partner of a firm at some time in the past when a partnership debt or obligation was incurred. The Business Names Act 1985 does not require a partnership to record when a person became a partner. Nor does it require a firm to keep a record of former partners and the dates when they were assumed as partners and when they withdrew. This can impede a

third party's enforcement of a debt or obligation against the partners of a dissolved firm.

The Main Problems with Existing Partnership Law

20. There appear to be three major problems which we seek to address in the joint Consultation Paper. First, there is the gulf between the commercial perception of the firm as an entity which continues regardless of changes in membership and the legal reality. Secondly, there is the danger of unnecessary discontinuance of business caused by the dissolution of a firm where such dissolution can easily be avoided. Thirdly there is a need to provide a more efficient and cheaper mechanism for the dissolution of a solvent partnership. We consider each in turn.
21. *The firm as an entity:* Many business people dealing with a firm assume that the firm is the entity with whom they are transacting business. The joining of a new partner or the withdrawal of a partner may make no practical difference to the way in which a firm transacts its business. In most circumstances such changes in composition of the firm may be of little relevance to the people who do business with the firm. Yet the law, particularly English law, treats a firm, following any change in membership, as a separate firm from that which existed before the change.
22. *Unnecessary dissolution of the firm:* One of the main objectives of the reform of the law of partnership is to encourage continuity and stability in business relationships. Under the default rules of the existing law it may be necessary to wind up the business of a partnership when one partner ceases to be a partner. Unless the continuing partners can reach agreement with the withdrawing partner or the representatives of a deceased partner a perfectly viable business may have to be discontinued. The winding up of the business may occur against the wishes of a majority of partners who wished and were able to preserve the business.
23. *The mechanisms for dissolving a partnership:* Where a partnership is dissolved and its affairs require to be wound up, the former partners can co-operate to dispose of the business as a going concern or to break up the business and sell off its assets. Although there are technical legal problems, which we seek to address in the Consultation Paper, relating to winding up where the former partners are in agreement, the major problem is the mechanisms for winding up partnership businesses where the former partners are unable to co-operate. The basic problem is the lack of an officer who could take over the property and rights of the dissolved partnership and exercise adequate powers to wind up its affairs in an independent way. When a partnership is dissolved in acrimonious circumstances its affairs are often complicated by a lack of adequate information and by incomplete financial accounts. There is considerable dissatisfaction in both jurisdictions with the arrangements by which an officer of court winds up the partnership business. Expense and delay are common complaints. While the complexity of many dissolutions makes some expense and delay inevitable, there is scope to improve the situation by ensuring that officers responsible for the winding up have adequate powers.
24. There are numerous other problems in partnership law. We suggest possible reforms in paragraphs 49 to 56 below.

The Principal Proposals for Reform

The Partnership Act as a default code

25. Partnership would remain an association based on the contract which the partners enter into. Under the existing law partners can contract out of the provisions of the Partnership Act which govern the relations of partners to one another. Under our proposals it would remain possible for partners to contract out of such provisions of the default code contained in a new Partnership Act.
26. If consultees favour the introduction of separate legal personality for the firm which continues notwithstanding changes in membership, this can be introduced as a default rule. As mentioned in paragraph 30 below parties would be able to contract out of continuity of personality.
27. Numbers in square brackets below refer to part 24 of the Joint Consultation Paper which summarises the consultation questions.
28. *The introduction of separate legal personality:* One method of removing the gulf between the commercial perception of partnership and the legal reality is the introduction of separate legal personality. This would involve the firm being an entity which could enter into contracts, undertake obligations and own property in its own right. Continuing legal personality would involve the firm continuing as an entity notwithstanding changes in its membership through the withdrawal of a partner or the assumption of a new partner. A firm with continuing personality could own property, including contractual rights, in its own name and would not require to transfer or assign such property on a change in the composition of its partners. Persons dealing with the firm could pursue their remedies primarily against the continuing firm. Only if the firm were unable to meet its obligations would the third parties require to claim against the assets of the continuing or former partners. [24.4]
29. In the Consultation Paper we put forward alternative methods by which continuing legal personality may be introduced or (in Scotland) clarified. One option is to introduce continuing legal personality either as a default rule or as an arrangement which partners could agree to adopt. The other option is continuing legal personality dependent on registration in a new register of partnerships.
30. *Legal personality without registration:* Under this option the Act would confer legal personality directly on all partnerships, as is currently done in Scots law. A partnership would be constituted by contract. Once constituted it would be recognised as an association with legal personality separate from the members of whom it is composed. So long as the partnership, as an association, is not dissolved the personality would continue. The legal personality conferred by the Act would not necessarily end on a change in the membership, provided that the number of partners did not fall below two. Continuity of personality would become a default rule but partners could opt out of it by providing in their partnership agreement that certain events would result in dissolution. There would be a transitional period after the enactment of legislation to allow parties to organise their affairs. During that period partnerships could opt out of continuing personality. [24.5, 24.7(6), 24.12, 24.13]

31. This option would have the advantage of legislative and administrative simplicity. There would be one set of default rules for English and Scots law. There would be no need for a new administrative system. It would have the advantage of conferring the benefits of greater legal continuity without requiring the partners to comply with any formalities or incur any costs. It would preserve informality and flexibility, which are two of the greatest advantages of partnership as a business vehicle.
32. The option would have the disadvantage that it would not, by itself, provide a historical record of partnership information. People joining a firm as partners and persons transacting with a firm might be unaware of whether it had continuing legal personality on a change of membership. Continuing personality would provide less practical benefits if both the partners and outside parties were ignorant of its existence. But the informality of existing partnership law can give rise to no less uncertainty as to the identity and characteristics of a partnership in the absence of continuity of personality. If most partnerships continued as legal entities regardless of changes in membership, people dealing with partnerships would become aware of continuity of personality as a norm.
33. *Legal personality dependent on registration:* Under this option only a registered partnership would have legal personality capable of continuing notwithstanding changes in its membership. A registered partnership would exist from the date of registration. In Part 20 of the Consultation Paper we discuss the details of a registered partnership. The name of the partnership, the names and addresses of the partners, and the address of the partnership's registered office would be stated on the register. There would also be a retention period for filings to allow the identification of relevant partners in future legal proceedings. Under this option, non-registered partnerships would have no legal personality.
34. The option of the registered partnership would give partners a choice of having a partnership with or without separate personality. The choice, manifested by registration or non-registration, would be clear cut. The registered partnership would have the advantage of providing more information to third parties, such as creditors of the partnership. If the register were kept up to date it would provide a historical record of partnership changes which would enable creditors to identify the partners who would have subsidiary liability for the firm's obligations. It would be easier to provide for transfers of land by and creation of floating charges by partnerships. Outgoing partners would have a clear way of publicising the fact that they had left the partnership. A registered partnership might find that its legal personality was more easily recognised abroad.
35. If the registered partnership were to be the only means by which a partnership could have separate legal personality, the option has a number of disadvantages. It would involve a complex reform and would entail extra costs. As the main advantage of registration would be for third parties, there may be insufficient incentive to register. The option would deprive partnerships, particularly smaller firms, of the benefits of legal personality as it is likely that many would not register. In particular, those who did not know that they were partners would not register. It would make the legislation more complex by creating a new set of rules on registered partnerships which would be in addition to the rules on non-registered partnerships.

36. On balance our provisional view is that the first option – of continuity of personality without registration – is preferable. We invite views on this issue.
37. If consultees favour the first option they may nonetheless wish to see the introduction of the registered partnership as an additional option to obtain the additional benefits which registration may offer. The creation of a registered partnership would bring partnership law in the UK closer to those legal systems in Europe in which legal personality is conferred by registration. We present in Part 20 of the Discussion Paper an outline of a possible scheme for registered partnerships. We welcome views on this scheme as an additional option in partnership law.
38. *The duration of a partnership:* A partnership should not necessarily be dissolved when a partner joins or leaves. We suggest that there should be a distinction between the dissolution of the partnership as regards the partner who leaves and the other partners, and dissolution as regards all the partners. We have been influenced by the Revised Uniform Partnership Act (“RUPA”) adopted in the United States by the National Conference of Commissioners on Uniform State Laws in 1994. RUPA moves away from a system based on the general dissolution of partnerships on, for example, the death or retirement of a partner towards a system whereby a partner can be “dissociated” and bought out while the partnership continues.
39. Adopting the same approach we provisionally propose that the right of a partner to end the partnership by giving notice in a partnership at will should be replaced by a right to withdraw from the partnership. We provisionally propose that the default rules should be altered so that certain situations, such as the death or bankruptcy of a partner, which would currently terminate the partnership, would only dissolve it as regards one partner, leaving the other partners to continue the partnership. We ask whether the court should be able to dissolve the partnership as regards one partner on the application of the other partners in certain circumstances, such as the partner becoming incapacitated or being in persistent breach of the partnership agreement. The court could be given this power in addition to its existing power to dissolve the partnership as a whole in such circumstances. Again this would preserve the partnership relationship between the remaining partners and assist continuity of business activity.[24.14, 24.15, 24.19]
40. We provisionally propose that there should be a general provision that the whole partnership comes to an end at any time, or on the occurrence of any act or event, provided for, expressly or impliedly, in the partnership agreement as having this effect.[24.22]
41. *The effect on the outgoing partner:* Such a regime would alter significantly the position of the outgoing partner who has retired or been expelled from the firm or who has died. The outgoing partner would lose the right to require the winding up of the business of a continuing partnership, unless that right had been conferred by the partnership agreement. In place of that right we provisionally propose that the outgoing partner should become entitled to receive the value of his share in the continuing partnership. The share would be transferred to the remaining partners by operation of law. The value of that share would be a debt which was due to the outgoing partner from the date of the partner’s departure and would bear interest at a commercial rate. This would replace the existing provision which entitles the outgoing partner either to a low rate of interest or to a share of the profits attributable to the outgoing partner’s share in

the partnership assets. The entitlement to such a share in the profits is difficult to calculate and has given rise to unnecessary disputes.[24.24(1), 24.25, 24.26]

42. We recognise that in certain circumstances the right to payment of a debt will not give sufficient protection to the outgoing partner. The remaining partners may not be able to pay out the value of the outgoing partner's share or to indemnify the outgoing partner against the liabilities of the firm. In such circumstances it would be unfair to deprive outgoing partners of the right to protect themselves by applying to the Court to dissolve the partnership as a whole. We therefore provisionally propose that the outgoing partner should have the right to apply to the court to have the business wound up on the ground that there was a substantial likelihood either that the remaining partners would not be able to pay out the share of the outgoing partner or that the outgoing partner would not be indemnified against the liabilities of the firm.[24.24 (2)]
43. In Part 7 of the Consultation Paper we discuss issues relating to the valuation of an outgoing partner's share. In Appendix C of the Consultation Paper we publish a discussion of methods of valuation produced for the Law Commissions by Peter Holgate and Emile Woolf of Kingston Smith, Chartered Accountants.
44. *The mechanism for solvent dissolution:* In order to clarify the law where a partnership has separate legal personality, we ask whether a dissolved partnership should be deemed to continue for the purposes of winding up its affairs and completing unfinished transactions. This will deal with a problem which arises in relation to a winding up carried out by the former partners. More significantly, we propose that there should be a new system for winding up dissolved partnerships under court supervision.[24.35]
45. We propose that the new system should provide for the appointment of an officer with powers and duties modelled on those of a liquidator in a members' voluntary winding up of a company. The officer (whom we describe in this summary as the "partnership liquidator") should have full powers to deal with the assets of the partnership. The rights of the partners to deal with the partnership property would cease on the partnership liquidator's appointment. The partnership liquidator would be regarded as the statutory agent of the former partners for the purposes of the winding up but would be given certain express powers to act, without the sanction of the court or the approval of the former partners. Those powers would include power to bring and defend legal proceedings, to sell or transfer any of the dissolved partnership's property, to borrow against the security of the dissolved partnership's assets and to do all other things necessary for winding up the partnership's affairs and distributing its assets.[24.35(1)-(7)]
46. We recognise that there are circumstances where the interests of the former partners require special protection. We propose that the partnership liquidator would require to obtain the unanimous approval of the former partners before making any compromise or arrangements with creditors, compromising any liability of a former partner to contribute to the partnership to make up losses or deficiencies of capital, and carrying on the business for its beneficial winding up. As partners have unlimited liability for partnership debts and obligations we consider that it would not be appropriate to allow the partnership liquidator to carry on the partnership business without such unanimous consent.[24.35(8)]

47. We also ask whether a partnership liquidator should be able to disclaim onerous property. We see that there may be benefit in allowing a disclaimer of contracts such as long leases, leaving the party whose contract is terminated to claim damages in the winding up. But because there may be complications in relation to other forms of property, we have formed no provisional view on disclaimer.[24.35(9)]
48. We recognise that a partnership, which on dissolution appeared to be solvent, may turn out to be insolvent. We therefore propose that the liquidator should be obliged to report to the court with a view to a change in the procedure, if of the opinion that the partnership will be unable to pay its debts within 12 months of appointment.[24.35(5)]

Other Reform Proposals

49. In our review of partnership law we have taken the opportunity to examine other, less significant, issues where we consider that there is scope for worthwhile reform. The 1890 Act, while attractively drafted, contains many uncertainties when examined in detail. We seek to clarify some of the uncertainties, to update provisions which are outdated or spent and to propose adaptations of the existing provisions in the event that consultees support continuing legal personality.
50. *Partnership and agency*: As a result of the introduction of separate legal personality, partners would be the agents of the firm rather than of each other. But this would not alter the way in which partners conduct business. Nor would it alter the substance of the duties which partners owe to each other. See paragraph 53 below.
51. *Ownership of property*: Another consequence of the introduction of separate personality in English law is that the firm would be able to hold property in its own name. While there may continue to be circumstances in which partners would choose that trustees should hold partnership property for the firm, the treatment of the firm as an entity is likely to mean that the firm and not the partners has an insurable interest in partnership property.
52. *Partners' liability for the obligations of the firm*: As a result of separate personality the firm would have primary liability for its obligations. The liability of a partner for the obligations of the firm would be subsidiary but unlimited. Creditors of the firm will normally require to obtain a judgment against the firm before enforcing their claim against the assets of the firm or of the partners. We propose that the liability of a partner for debts and obligations of the firm should be joint and several.[24.41]
53. *Partners' duties*: We discuss whether a new Partnership Act should contain a statutory duty to act in good faith in partnership relations. There is no doubt that, under the existing law, partners owe each other a duty of good faith in their business dealings. We propose that such a duty should be contained in the Act. But we recognise that when a firm breaks up circumstances can arise where partners find themselves competing for the client base of the former firm. This may result in breach of fiduciary duty, exposing the partners to significant liabilities. We ask whether the court should be empowered to relieve partners from such liability where they have acted honestly and reasonably. We also ask whether a new Partnership Act should contain a statutory statement of the duty of skill and care owed by a partner to the firm. We also ask whether a partner should

owe certain duties to the firm and other duties – such as the duty of good faith and the duty to provide information – to the other partners.[24.54, 24.55, 24.58]

54. *Litigation*: We propose that a partnership with separate legal personality should be able to sue and be sued in its own name and that partners can be sued in the same proceedings as the partnership. In order to make available to third parties necessary information about the partners who are liable for the particular debts of a firm, we propose that a partner or former partner who is sued should have an obligation, if called upon, to furnish the names and addresses of other partners or former partners who may be liable. This information is available under the English Civil Procedure Rules [24.60]
55. *Partnership information*: If the registered partnership were introduced, that would result in the publication of information about former partners who have a subsidiary liability for the firm's debts at any time. But it would be difficult for third parties to obtain such information about those partnerships which were not registered partnerships. We therefore discuss the possibility of extending the categories of information which are required to be disclosed under the Business Names Act 1985 to include such historical information. As this would place a burden on partnerships to maintain records of admissions to the partnership, retirements and deaths and could expose firms to troublesome inquiries, we do not express any provisional view but invite the views of consultees.[24.83]
56. *Floating charges*: At present partnerships cannot grant floating charges. Discussions with interested parties in our pre-consultation exercise revealed a division of views on whether it would be appropriate for partnerships to grant floating charges. We do not propose any change to the law but ask for views on whether registered partnerships, if they were introduced, should be allowed to grant floating charges.[24.84]

The importance of consultation

57. We are very keen to obtain the views of people who carry on business in partnerships as well as from business organisations, lawyers, accountants and other professionals who may have expertise in partnership law. It is very important to our exercise that we obtain responses on the practical consequences of our proposals as well as views on the legal technicalities. We welcome your comments on all or any of the matters mentioned in this paper.

September 2000