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PARTNERSHIP

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INTRODUCTION

IT would be ungracious not to admit in the first lines of this paper that the idea of writing it was generated by the Presidential Address to the Faculty of Actuaries, delivered by J. L. Anderson on 19th October 1964. That address was largely concerned with the problems of senior (but non-technical) management of a life office, and it was at once apparent that those problems differed substantially from the management problems of a partnership.

The larger partnerships are often of a professional or quasi-professional nature and in many professions a student spends his formative years working for a partnership. However, chartered accountants and solicitors need to study, as part of their training, aspects of the law, finance and operation of limited liability companies so that if, for instance, a chartered accountant enters the service of a limited liability company the new surroundings are at most unfamiliar, they are not unknown. By contrast, most actuarial students spend their formative years in the employ of a limited liability company or a mutual society and, while they study the type of advice a partnership may give, they learn nothing of the law, finance and operation of a partnership. Accordingly, an actuary moving to a partnership may find himself in surroundings which at the least are unfamiliar, more probably they are completely unknown.

This paper sets out to describe those surroundings and the problems which arise in them. It is intended to be general and representative to a large extent of the whole range of partnerships but, as the author has been a partner in a stockbroking firm for a number of years—and has never been associated in any capacity with any other partnership—it is perhaps inevitable that the reader will find that career reflected in the analysis of the various problems.

THE LEGAL BACKGROUND

It would be inappropriate to attempt to give here a comprehensive survey of partnership law, especially as a large part of such a survey would be concerned with problems which are unlikely ever to affect an actuary in any partnership in which he finds himself. A brief outline of the position under English law is, however, essential to the later parts of the paper.

Partnership is defined by the Partnership Act, 1890 as "the relation which subsists between persons carrying on a business in common with a view of profit". A company is also a combination of persons but the two combinations differ fundamentally since a partner cannot, like a shareholder, lose his individuality and escape personal liability for what is done in the name of himself and his co-partners.

The Registration of Business Names Act, 1916 provides that, with one minor exception, the partnership name must be registered and the full names of each of the partners has to be disclosed on every "trade catalogue, trade circular, showcard, or business letter issued by the firm." Partners who are of foreign nationality and partners who have changed their names must, in certain circumstances, disclose the fact. Any changes of partnership and of registered particulars with regard to partners must be filed within 14 days.

No partnership formed with the object of carrying on business for gain can be established if it consists of more than twenty persons, and in banking businesses the limit is ten. These numbers include both general partners (that is, partners who have all the rights and powers of a partner) and also partners who have restricted rights or powers.

The Partnership Act, 1890 also provides "Every one who by words spoken or written or by conduct represents himself, or knowingly suffers himself to be represented, as a partner in a particular firm, is liable as a partner to anyone who has on the faith of any such representation given credit to the firm". This is known as the principle of "holding out" and rules of professional conduct often extend the liability attracted by "holding-out" much beyond financial credit extended to the firm.

A large part of the law of partnerships is concerned with the decision as to who is a partner, especially when there is a debt to be recovered but it will be seen that this problem cannot arise for the type of partnership which issues written matter regularly. It must disclose all partners on its letter headings and any person whose name is included on its list of partners in correspondence, etc., is to be treated as a partner under the principle of "holding-out", regardless of whether he may have restricted standing under the terms of the Deed of Partnership.

Corresponding to the Memorandum and Articles of Association of a limited liability company, a partnership often has a Deed of Partnership. Such a Deed is not essential but it is helpful. In the absence of a Deed, the law makes provision for the regulation of most matters but the partners may wish to handle them differently. A well drawn Deed will meet this wish. In the following two paragraphs, the qualification, "Unless the Deed of Partnership provides to the contrary" must be assumed to apply.

When a partnership has been formed, no new partner can be admitted except with the consent of all the existing ones, since a contract cannot be altered against the wishes of any of the original parties to it. For the same reason no member can be expelled from the partnership by a majority of the partners, save only by Court order in circumstances where conduct highly inimical to the partnership is established.

The law has established a code of conduct between partners, only a few of the usual provisions of which are worthy of note:

(*a*) A partner is not entitled, before the ascertainment of profits, to interest on the capital subscribed by him, nor is a partner entitled to remuneration for acting in the partnership business. Partners may sometimes agree to divide the profits as though they were paying a management salary or interest on capital but, in law, such payments are partners' drawings and not comparable with staff salaries.

(*b*) Every general partner may take part in the management of the partnership business. This is a logical corollary to the liability which every partner bears.

(*c*) Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners, but no change may be made in the nature of the business without the consent of all existing partners.

(*d*) Every partner may, when he thinks fit, have access to and inspect and copy any of the partnership books.

(*e*) If a partner, without the consent of the other partners, carries on any business of the same nature as, and competing with, that of the firm, he must account for and pay over to the firm all profits made by him in that business.

Third parties have no right to inspect the Deed of Partnership, whereas they can and indeed must, at their peril, inspect the Memorandum and Articles of Association of a limited liability company. As a result, any act of a partner, which is done within the ostensible scope of the partnership business, and in the ordinary course of business, is binding upon all the partners, unless the person with whom the partner deals actually knows that the particular act is forbidden. Each partner is also liable for the torts of all partners committed in the course of Partnership business. The extent of a partner's liability in a firm is the whole of the firm's debts; he cannot satisfy creditors by meeting his share of a debt so long as any part of that debt is left unsatisfied, although he has a claim against his partners for the excess over his share.

Goodwill is not a part of partnership law but it is closely connected and a comment is not out of place. It has been described as "nothing more than the probability that the old customers will resort to the old place." (Lord Eldon in Cruttwell v. Lye 1810). It can be almost entirely personal, as in a solicitor's business or almost entirely due to situation, as in the ownership of a railway bookstall. It is often the most jealously guarded asset of a partnership and its disposition on the sale or dissolution of a partnership can raise thorny questions. In a continuing partnership, the financial arrangements must include some suitable procedure whereby the goodwill passes from generation to generation.

LIMITED PARTNERSHIPS

Until recently, Limited Partnerships might have been dismissed in a single line but, now that they have been approved for Stock Exchange firms, a fuller discussion is necessary. I will discuss them first generally, and then from the point of view of a partnership under the rules of The Stock Exchange.

The Principal Act in relation to Limited Partnerships is the Limited Partnership Act 1907. Until quite recently this has been a dead letter in view of the simplicity in registering and the advantages attendant upon the formation of a limited liability company. With the passing of the Finance Act 1965 and the introduction of corporation tax the Limited Partnership Act has taken on a new lease of life and no doubt limited partnerships will now be formed in lieu of limited companies to avoid the payment of corporation tax. Under the Principal Act subject to the completion of certain formalities and filing of certain documents it is possible (providing one of the partners remains a general partner and liable personally for all the debts of the partnership) to create a limited partnership whereby the liability of one or more of the partners is limited to a fixed agreed amount. The limited partnership is not dissolved by the death of a limited partner and whilst the partnership continues there is no right to withdraw capital. However, a limited partner has the right, subject to the consent of the general partners, to assign his interest in the partnership. A limited partner is not entitled to participate in the general management of the firm and his position is something akin to a loan creditor and therefore the limited partnership is not very useful to a professional activity except, perhaps in relation to the retention in the firm of a retiring general partner. A person may cease to be a general partner and become a limited partner providing notice is given in the London Gazette and providing one general partner remains. A limited partner is a "sleeping partner" and as such is not entitled to earned income relief in respect of income arising from the partnership.

STOCK EXCHANGE LIMITED PARTNERSHIPS

The effect of the recent alterations in The Stock Exchange Rules is that it is now possible, subject to limitations, to form a limited partnership within the rules providing at least two of the partners remain general partners liable for all debts and obligations of the partnership. Certain formalities have to be complied with and the registration certificate issued pursuant to the Limited Partnership Act 1907 has to be filed with the Council of The Stock Exchange within seven days. The Stock Exchange goes further than the law in requiring the notepaper heading to distinguish limited partners.

Although a limited partner cannot be declared a defaulter, yet if all the general partners have been declared defaulters there is an obligation upon limited partners, at the request of the person appointed in accordance with the rules of The Stock Exchange as Official Assignee, to execute a Deed of Assignment thereby assigning all rights in the assets of the partnership to the Official Assignee.

Limited partners may usually apply for admission as "External Members". Financial institutions (i.e. banks, trusts and insurance companies) are entitled to invest only in jobbing firms and then only by means of participation in a consortium company formed for the purpose; such consortium companies are entitled to apply for external membership. Even in the case of a consortium company, however, there is a restriction placed upon institutions limiting to 35 per cent the holding by any one institution of the equity capital in such consortium company.

An external member is not eligible to appoint a member of the Council nor is he entitled to act as proposer or seconder for such an appointment. External members may be male or female, must be over the age of 21 and must be British subjects by birth or in the case of corporate bodies be incorporated in the United Kingdom.

An external member must be proposed and seconded by the general partners of the firm in which if elected he will be a limited partner.

There is an absolute restriction placed upon members in employing external members and the rules provide that an external member shall be charged commission on business transacted for his account as if he were in all respects a member of the general public.

Although a limited partner is not entitled generally to receive a share of commission he is so entitled if the firm transacting the business is the firm in which he is a limited partner.

It remains to be seen how far the alterations will affect the life of the stockbroking community and whether anyone outside the Stock Exchange circle will want to invest in stockbroking or jobbing firms. Not without good reason one is left wondering whether capital which is available for such investment will go only to those firms prosperous already, without in any way relieving the plight of the small/medium firms urgently in need of further funds. It may be that the principal benefit will be to permit a wealthy general partner to retire without withdrawing his capital and destroying his firm.

THE FINANCIAL STRUCTURE OF A PARTNERSHIP

In the simplest partnership, a small group of people take an equal stake, they each put up the same amount of capital, they are presumed to share equally in the running of the firm and they share profits and losses equally. The only significant difference between this and the most sophisticated partnerships is that the shares in the latter may not be equal, perhaps reflecting unequal contributions.

There is, however, a major financial difference between a partnership and a limited company. In the latter the dividend distributed to the shareholders is equal to the profits earned in only exceptional cases; in a partnership the two are always equal because there is no legal provision for the retention of undistributed profits. There is nothing to stop any partner leaving some of his earnings upon deposit with the firm and many firms would face a serious liquidity crisis if this practice were not followed. It is inevitable to some extent. Consider a firm having a trading year from 1st July to 30th June. Once it starts trading upon 1st July 1966 profits begin to accrue but no partner may draw those profits out until their extent is properly ascertained. Thus the year will end upon 30th June 1967 and, after an appropriate time for the audit, the extent of the profit to be allocated to each partner will become known, perhaps during December 1967. Thus some profits will lie in the firm's accounts for eighteen months before the partner draws them out.

Such a delay in the distribution of profits would be intolerable of course in the case of small partnerships or in the case of junior partners of more wealthy partnerships. Many partnerships therefore provide that through the year partners may draw out a reasonable amount in anticipation of profits. This reasonable amount is calculated on a relatively conservative basis and allows for the retention by the firm of income tax on the partners' share.

The retention of income tax is essential since the income tax payable on partnership profits is, like any other partnership expense, a joint responsibility of the partnership. One assessment is made upon the partnership as a whole; the individual allowances of all the partners are deducted in arriving at the income tax payable and each partner is charged in the partnership books with his share of the income tax but so far as the Revenue is concerned the total tax remains the responsibility of all the partners.

When the balance of profit available to a partner is ascertained after the end of the accounting year, a junior partner would normally be expected—or obliged—to leave behind some part so as to build up capital in the business.

Since partnerships are normally assessed to income tax for any fiscal year by reference to profits earned in the preceding accounting year, it is common for partners to build up over a period some form of income tax reserve. Wealthy firms also frequently arrange for partners to leave behind surtax reserves although surtax, unlike partnership income tax, is a personal liability.

Thus by the retention of profits until after the year end, by the gradual build up of capital and by the retention of income tax—and possibly surtax—reserves, a considerable liquid capital can be at the disposal of the firm, although its permanent capital may be quite low.

This build up of resources facilitates the admission of the able but impecunious young man, and also gives greater freedom in the day-to-day conduct of the business. Thus a partnership remunerated by fees is spared the need of excessive pressure for interim payments, although this is no excuse for slack billing.

GOODWILL

Clearly a successful professional partnership has a goodwill in its name and reputation and the probability of existing clients continuing to do business with that firm. The financial value of this goodwill is theoretically the difference between the profits made by the firm and the sum of what the partners would earn as employees and the return which they might expect on the capital which they employ in the business of the firm. At one time it was almost a universal practice for an incoming partner to make a goodwill payment fixed by reference to average adjusted profits in the firm, for adjusting payments to be made between partners of the firm as their profit-sharing ratios changed and for a goodwill payment to be made to an out-going partner in respect of the share of profits which then vested in the continuing partners, in each case based on the profits up to the relevant date. If a partnership were regulated solely by the Partnership Act a payment in respect of goodwill would fall to be made to a deceased partner and on any retirement of a partner the partnership would be dissolved and reformed in circumstances where the goodwill would have to be purchased by the new partnership from the old.

In all but a comparatively few cases the modern custom is for the Partnership Deed to provide that the goodwill always passes to the continuing partners without payment otherwise than in circumstances where there is a complete dissolution of the firm and a sale made to outside parties. In other words, each partner as he comes in acquires a "working life interest" in the goodwill. It has long been settled law and practice for estate duty purposes that if goodwill passes to continuing partners on the death of one, duty is charged only on whatever sum, if any, has to be paid to the deceased partner's estate, as the Partnership Deed provisions in relation to goodwill are a contract for full consideration. When the Finance Bill 1965 was published it was disconcerting to find that as partners are, for capital gains tax purposes, "associated persons" all disposals of parnership assets, including goodwill, were deemed to take place at market value and not (as in most partnership arrangements) at book value. The relevant clause in the Bill was amended and the capital gains tax position follows the estate duty position, i.e. tax is levied only on the transfer of assets and goodwill which under the partnership arrangements result in a payment being made to a partner in excess of what he paid for (or the value at 6th April 1965) those assets. In passing, it should be noted where there is a father and son type of partnership the arrangements for passing of goodwill and other assets may be challenged both for estate duty and capital gains tax purposes as taking place between persons who are "associated" for reasons other than the mere fact of being partners and that the partnership provisions are not bona fide commercial arrangements.

Where goodwill payments are made, the Act provides for any profit on disposal to be taxed as a Capital Gain except to the following extent in the case of a disposal at the time of retirement:

(*a*) if the retiring partner has attained the age of 65 years, the first £10,000 of gain is untaxed,

or (*b*) if the retiring partner has not attained the age of 65 years, £2,000 of gain is untaxed for every year by which his age exceeds 60 years, with apportionment for fractional periods.

These concessions are both contingent upon the retiring partner having been a partner for at least ten years.*

There is, however, a penalty to be paid. The general rule provides that, on death, all assets are deemed to be sold and long-term Capital Gains Tax levied on the amount by which the taxable gains exceed £5,000. Now, if the deceased benefited earlier by the foregoing concessions, the excess of that earlier exemption over £5,000 is deducted from the £5,000 exemption at death.

A disposal at death or retirement is clear and complete but every change of partnership shares involves some acquisition or disposal of goodwill. Whether the Revenue will, in fact, seek to raise an assessment on the profit on disposal of goodwill at any reduction in a partner's share and, if so, how the problems will be reduced to manageable proportions are questions to which the answers are still not known.

The considerable change which has taken place with regard to payments for goodwill—which has probably arisen principally because of the impracticability of providing working capital and goodwill payments out of net income after tax—resulted in many partners in professional firms who had in the past paid for goodwill, being unable to sell that goodwill even at the price they had themselves paid, despite increasing business in the firm; in many cases such partners surrendered their right to receive goodwill payments in exchange for annuities. Similarly, even in partnership which had not "traded" in goodwill it was recognised that the necessity of locking up money in providing working capital of the firm had deprived individual partners of investment opportunities which would have made some compensation for continuing inflation and therefore the practice of paying retiring partners or the dependants of deceased partners certain annuities has become widespread. It may be said that these annuities are in some respects akin to payments for goodwill. Until 6th April 1965 there was the greatest possible freedom in making such annuity payments but the Finance Bill 1965, in abolishing the deduction

* Because this is a paper on partnership, all the above is written in terms of "retiring partners". The Act is, however, wider ranging and refers to owners disposing of business assets, an extension which must be considered in the case of a partnership which has developed from a one-man business at a relevant recent date.

of covenanted payments from the payers' surtaxable income, failed to make any exception for partnership annuities. This was rectified in the course of the passage of the Bill, although the wording of the Section was unsatisfactory. This Section has now been considerably improved by the current Finance Act and, broadly speaking, an annuity is deductible from profits if it is to the retiring partner himself (or to his personal representatives for any period from his death to a period of not more than ten years from the date of his retirement) or to his "dependants". An annuity which may be paid to a partner in one firm who has sold or transferred his practice to another firm by way of amalgamation is also deductible. It is, however, now necessary that all such payments be part of the partnership contract and it is no longer possible to deal, after the retirement or death, with the matter ad hoc by Deed of Covenant having regard to all the circumstances.

These annuities must be distinguished from payments which are made to retiring partners as consultants, which are a normal expense of the firm, but difficulties may arise if such consultants' fees are held not to be justified commercially when they may be disallowed as expenses of the firm and not come within the excepted partnership annuities dealt with in Section 12 of the Finance Act 1965 as to be amended by the Finance Act 1966.

TAXATION

The taxation of a partnership is on a conventional Schedule D basis and can best be illustrated by a simple example.

A partnership traded from 6th June 1950 to 5th June 1960 with results as follows:

Year ended 5th June	*Profit Earned*	*Year of Assessment (to 5th April)*	*Basis of Assessment*
	£		£
1951	6,000	1950/51	$\frac{10}{12} \times 6{,}000 = 5{,}000$
1952	8,000	1951/52	6,000
1953	12,000	1952/53	6,000
1954	14,000	1953/54	8,000
1955	17,000	1954/55	12,000
1956	15,000	1955/56	14,000
1957	16,000	1956/57	17,000
1958	18,000	1957/58	15,000
1959	12,000	1958/59	16,000
1960	4,500	1959/60	18,000
		1960/61	$\frac{2}{12} \times 4{,}500 = 750$

The general rule is that the assessment is based upon the profits earned during the accounts year ended during the preceding year of assessment. Thus the basis of assessment for 1955/56 is the profit earned for the accounts year ended during 1954/55, that is the profit of £14,000 earned during the year ended 5th June 1954. Income tax on these profits is payable in two equal instalments due on 1st January and 1st July 1956. Surtax is payable, in a single instalment on 1st January 1957.

If there were a change of partners, or a change in their proportionate shares, between 1954/55, the assessment is shared on the basis of the profit sharing arrangements of 1955/56, notwithstanding the actual profit of £14,000 was differently shared when it was earned.

The "previous year" rule would on its own give a nil assessment for 1950/51 and for 1951/52. Likewise it would give assessments for 1961/62 and for 1962/63. The principle, however, is to have an assessment for every day of trading—and not for other periods—and to regard the previous year rule as a convenient device to avoid unreasonable delays in payment when accounts are slow or the agreement of the assessment protracted.

Therefore assessments are raised for 1950/51 (on a time apportionment basis of the first year's profits) and for 1951/52 on the basis of the first year. It follows that the profits of the first trading period are the basis for taxation for $2\frac{5}{6}$ years. A new business will often start slowly so that this basis will often be welcome to the taxpayers. There are, however, provisions for abatement if the profits decline in the second year.

At cessation, the final two months are similarly assessed on a time apportionment basis of the past period's profits. The Revenue has the option to reassess the two penultimate years on actual profits, as distinct from the previous year basis. Thus, in the example, the Revenue could reassess 1958/59 and 1959/60 on the following principle:

$$1958/59 - \frac{2}{12} \times 18{,}000 + \frac{10}{12} \times 12{,}000 = 13{,}000$$

$$1959/60 - \frac{2}{12} \times 12{,}000 + \frac{10}{12} \times \ 4{,}500 = 5{,}750$$

This would not be to the advantage of the Revenue so the option would not be exercised.

It may be noted that Stock Exchange rules require all member firms to provide in their annual accounts for income tax on the higher of the two bases that would apply if the firm were to cease trading on the accounting date.

This exposition of the early and final years of a partnership is of more than academic interest even to a continuing partnership, since there is an option available to the firm whether the admission of a new general partner or the withdrawal of an existing one may be treated as the cessation of the old partnership and the start of a new one. The decision whether to exercise this option, or to choose to be taxed as a continuing body, is a matter for professional advice. The arithmetic is elementary, the estimates of future profits are important but a thorough knowledge of tax law is vital. But careful attention to this point can, at the very least, substantially ameliorate the hardship of a downturn in profits.

Finally, it is worth noting that there have been considerable benefits in uniting a partnership with a company. Stock Exchange firms have been able to become unlimited liability companies and they have been permitted to have unlimited liability service companies. So long as some saving could be made after company rates of taxation rather than personal rates, there were considerable advantages but, with the change to Corporation Tax and the introduction of Capital Gains Tax, the gilt is now much thinner on that particular gingerbread.

OWNERSHIP, DIRECTION AND MANAGEMENT

Anderson, in his address, analysed carefully the roles of directors and management and the following summary does not differ appreciably from his, except that it brings in the shareholders, to whom Anderson did not refer.

Ownership of a limited company rests in the shareholders and they depute the running of the company to the Board of Directors. Directors can normally be appointed or removed only by shareholders. The nature of this relationship was recently described in the following terms:

"It is clear that in a large majority of cases the degree of interest taken in the detailed policies followed by Boards of Directors is extremely limited. This is evidenced by the spectacularly small proportion of shareholders who attend annual general meetings or extraordinary meetings of a company. What is overlooked, however, is the small but significant number of occasions upon which shareholders do attend meetings, do exercise their prerogatives and on occasions do refuse to re-elect directors or insist on changes of membership of the board or the policies which the board follows. This is a phenomenon which is very much part of the fabric of British society today, wherein large numbers of people elect others to represent them on boards, on trade union committees, or even in Parliament.

The range of policy and decision which these electors are prepared to delegate on behalf of those whom they have elected to look after their interests is very wide indeed, and as long as these limits are observed there is an apparent lack of interest on the part of the elector. But occasionally the bounds of tolerance are exceeded and at once there are vociferous protestations from substantial bodies of those electors."

'Consent or Command in Committee' by Wilfred Brown (now Lord Brown) and Elliott Jaques
The Manager, January 1965.

Thus, the dividing line between shareholders and directors is clear. The Directors are left to get on with a job and, provided that the shareholders are satisfied with the overall result, there is no interference with the activities of the Board.

Anderson (op. cit.) draws the dividing line between the Board and the management very clearly and two quotations bring out the two really significant points.

> "It is sometimes held that the board is concerned with policy and the management with the execution of policy, but that is an over-simplification. I believe that the management should have a considerable say in the determination of policy and that usually, although not always, the initiative on matters of policy should come from the management. But the board has, of course, the ultimate authority and the board must therefore be convinced that the suggested policy is sound. This lays a very heavy responsibility on the management to put their case fairly and without bias, and the first essential is that the board should be supplied with adequate information."
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> "The most important single function of the board is to choose the senior management and, if need be, to change it. It is therefore desirable that the directors should have some contact with those officials who may be candidates for promotion to one of the top posts in the foreseeable future."

Some of the most difficult problems of partnership arise from the fact that these three roles, of ownership, direction and management, are inseparably in the same hands. Why is this so?

As we have seen earlier, anyone who is a partner is personally liable for anything done by the firm. A partner cannot, like a shareholder, depute affairs to a third party and feel content, and in many partnerships of a professional nature this joint responsibility is laid even more definitely by the professional body. To quote from one of the regulators of my own professional conduct, the Council of The Stock Exchange, London, it is a fairly open secret that, on occasion, firms have been disciplined and every partner subjected to penalty when it was quite clear that the degree of offence committed by the various partners was different. But the principle is that all partners stand equally in line and are held equally responsible for the actions of the firm. Ownership and direction cannot, therefore, be divorced.

The same factors limit the scope for separating direction and management especially in partnerships selling advice. The partner who is personally responsible for damages if that advice be the subject of a successful action is reluctant to delegate the responsibility for it. Even more important, the world has got used to the idea that any business of a significant size will come under the scrutiny of a partner. He may use assistants, but it is inconceivable that he would be as far from the day-to-day reports as the directors of a major engineering group will be from a quotation for a contract by a subsidiary company. Direction and management cannot therefore be divorced, partly because of the legal background and partly because the customers would not stand for it. Thus, the three roles of ownership, direction and management are inseparably in the same hands and it is necessary next to consider the implications.

FULFILLING THREE ROLES

The main problem for the directors of a limited liability company when they consider their responsibilities to the owners is concerned with dividend policy and with the level of earnings; if the assets of the company are earning inadequately, then the question arises whether equity to shareholders requires that the activity showing such a poor return should be discontinued and the money returned to shareholders or employed more profitably in a different activity.

In a partnership all the profits are distributed so no question of dividend policy can arise. Similarly, the question of earnings on assets rarely arises in professional partnership since the main resource they use is human ability and assets employed tend to be very low in relation to the return. It therefore follows that the inability to divorce ownership and direction is not usually a cause of difficulty in a partnership.

The real problems arise over the conflict between direction and management. Supposing that out of a partnership of twelve, three partners are together running an activity which appears to give a poor return having regard to the resources devoted to it. Two partners running a different activity suggest that the firm's profits would rise considerably if they could take over all the resources devoted to the less profitable activity, and they seek the agreement of the full partnership.

In a limited company, such a problem would be examined by the General Manager who would put a full report to the Board, together with a recommendation. The Board would ask such questions as it saw fit, it would see separately the various protagonists, it might delay decision for further information, but, in the end, it would vote, the majority view would prevail and all would get to work to operate the system chosen.

In a partnership, one starts with the knowledge that 'no change can be made in the nature of the business without the consent of all existing partners'. Is the proposed change sufficiently great to justify that clause being invoked? Perhaps not, or perhaps the Deed of Partnership varies the Partnership Act provisions so as to delete that provision.

Next, the discussion will turn upon the nature of the estimate that this change will produce certain benefits. This probably means retraining and redeployment. Are the three partners to contract out of any discussion whether their senior assistants will suffer personally in salary or promotion prospects as a result of the change? An impartial director would probably raise the point, yet if the partners directly concerned do so, they may well be accused of confusing their two roles.

At some point in the discussion, it will be apparent to the other partners that the position of the three partners themselves is involved. Can they go to the second activity with dignity? What role can they play there themselves? They cannot be expelled against their will, yet they cannot be left without an activity to control, each drawing a full partner's income and making no contribution. The independent board might well decide upon early retirement for the three, the partnership cannot.

This theoretical problem brings out the point that no-one can divorce his two roles completely. Because a clear line cannot be drawn, it is all the more incumbent upon partners to try to avoid confusion at all times. It can also throw a heavy burden upon the Senior Partner, whose role must now be examined.

THE ROLE OF THE SENIOR PARTNER

By any normal management standards, a large partnership is a certain formula for inefficient management unless the danger is recognised and steps taken to overcome it. We have already seen that the three functions of ownership, direction and management are hopelessly confused, but there is an aspect which has all the seeds of even worse trouble.

If, in any organisation, people whose co-operation is vital to the running of the organisation, find themselves in continuing disagreement then there is urgent need for some way of resolving that position. Obviously, the first approach is an attempt to bring about a reconciliation but, inevitably, the point must be reached from time to time when a reconciliation is impossible. At this point, in a company, a decision must be reached, one party must be removed from the company and the other party must continue. The decision as to when attempts to compromise should be abandoned, the choice and the ruthless enforcement of the decision is a major function of a board; if the dispute is within the board, the burden may well fall heavily upon the chairman, but certainly the board will in most cases settle the difficulty without recourse to their controllers, the shareholders.

In a partnership, the law recognises only partners, the senior partner is a conventional term, not a legal concept. Further the law provides no simple mechanism whereby such a dispute can be settled, except by one party voluntarily resigning. It is self-evident that a man finding himself in a position which cannot be permanently sustained is much more likely to resign, or compromise, if he is aware that there resides somewhere the power to settle the problem by expelling him. Where that power does not exist there is always the danger that, not only in major partnership disputes but also in more routine matters, the partner will tend to be more unbending. This can easily lead to a situation in which all change is eschewed and no attempt is ever made to get out of the familiar rut. Only later, under the pressure of competition does the realisation dawn that the world has passed on. If, by that time, changes in partners have taken place a rapid dash to catch up may be practicable, but it is belated. The result is that partnerships are inherently liable to go through cycles of progressiveness and stagnation. To counteract this the senior partner must be an effective force.

Senior partners are as varied as firms. There are men who, by virtue of age, financial stake or personality, so dominate their partners that, for all practical purposes, the firm becomes indistinguishable from a sole trader with non-partner assistants. No regular partners' meetings are held, few partnership papers are circulated, major decisions are taken without effective discussion and people wait, some with doubt and others with hopeful anticipation, for the day when a new team of partners takes over the management of which they have no experience. Apart from prompt decisions on all matters, the great merit of this system is that, if the dominant partner is progressive, he can force through those changes which are necessary for progress. But, alas, it is an observed fact that too often the dominant partner prefers less, not more, change than the average of his partners' views. And even if he be really first-class, it is by no means certain that an equally satisfactory successor will emerge.

At the other extreme, there is the firm where the senior partner is just the first name on the list of partners; he has no power to speak for the firm or to take any decision which is beyond the compass of any other partner. The great merit of this is that all partners are involved in all decisions. The weakness is the confusion and delay that is inevitable in all government by committee.

The middle road seems to offer the best hope of success. Some decisions can reasonably be left to one man in the interests of greater efficiency. Even more, one man can make it his job to ensure that the firm progresses, he can lobby, persuade and bully to prevent the firm relapsing into a rut. He can hold himself freely available to all partners to discuss ideas, offering advice and guidance in the light of his knowledge and experience of such discussions with and about all aspects of the firm's organisation. If, in such discussions, a proposal develops which he thinks it would be to the firm's advantage to adopt, then he can tackle the problem of how to get it adopted. Often this is easy, no objections are raised in principle and the detailed application is quickly settled.

On the other hand, there may be strong objections in principle. At this point, the problem arises whether he should abandon the whole idea because he accepts the force of the objections, or whether, remembering the logic of an earlier paragraph which pointed out that such abandonment might be the highroad to a period of stagnation, he should continue. In the latter case, he cannot rely on any power or arbitration, his only weapon is his dexterity. The first step is to make quite clear in his own mind what are the points of view of the various parties. Often imprecision of statement leads to quite unnecessary dispute. If that does not suffice, the next step is to re-examine the fundamentals. Is there an acceptable compromise which will attain the desired end in a different way? Again, it may be the type of proposal which lends itself, in some way, to a pilot scheme or other trial run. Finally, there is the question of 'public opinion'. Despite the inherent tendency of partnership to foster intransigence, not all partners are always wholly intransigent, and a partner who finds himself at variance with all his partners will certainly re-examine his view to see whether he can meet them at least half-way. All may fail, and the proposition will then be shelved until circumstances change.

It may be objected that this procedure is little different from that followed in many companies, and that is probably true. But the salient point which remains is that, if a general manager fails to carry colleagues in a view, he can still say, 'Well, this is what will happen' and in most cases, his colleagues will accept that they have now to try loyally to execute his wishes, and to forget the disagreement as soon as possible. A senior partner can never do that. He can only too easily leave an unsolved problem and a smouldering resentment, which emerges in a sensitive reaction to subsequent proposals.

In theory, this danger exists only in regard to major matters of policy since differences arising as to ordinary matters connected with partnership business may be decided by a majority of partners. But how often, in so many spheres, do day-to-day disputes develop into 'matters of principle'! A twilight problem becomes a major policy matter to the objectors and an ordinary routine problem to its supporters.

These problems are fortunately rare but, because they do sometimes arise, it is very common for Partnership Deeds to provide that a partner shall retire if requested by all other partners (or all other but one in large partnerships) so to do. Again, there is a less common provision that, in the event of a dispute, the partnership may be dissolved, with the name of the firm vesting in a top group of partners.

THE USE OF COMMITTEES

Brown and Jaques (*op. cit.*) distinguish between three types of committee:

(*a*) The true committee, where each member has authority to take corporate responsibility for action,

(*b*) The command meeting, where a manager meets his subordinates to take their views on all aspects of a proposed action, but where the manager will himself take the decision and bear the responsibility for it,

(*c*) The collaterate, where a number of people meet to examine a problem which impinges upon their various provinces, but who are subordinates of a manager or other superior whose prescribed policies limit the discretion of the subordinates.

There exists also in public life the committee of enquiry which is set up to ascertain the facts about a problem and to make recommendations. The terms of reference of the committee are specific and it is unusual, but not unknown, for a committee to go beyond its brief.

There is a strong case for a large partnership using sub-committees of the full partnership, operating as 'collaterates' in the classification of Brown and Jaques; the following scheme has been operating in one case for a number of years.

The largest body which can handle executive problems efficiently is no larger than half-a-dozen, and the partnership has at all relevant times been considerably larger than that. Some delegation is therefore essential and matters which are the concern of a section of the business entirely within the province of one partner are delegated to him. Ad hoc reports on specific matters are rendered to the partnership as a whole but generally partners are allowed the maximum freedom within their own province unless and until their actions have repercussions on the provinces of other partners.

This leaves a large range of problems not yet delegated but not suitable for handling by the partnership as a whole. A number of sub-committees, each consisting of about five partners, have been set up, each with its prescribed terms of reference. Even at the cost of straining those terms of reference, any problem is referred to the committee whose terms seem to bring it nearest to the matter. (The only exceptions are matters related to new partners or the financial arrangements between partners). Most of the committees meet at least once a month and their agenda are circulated to all partners, together with all papers. Any partner who, not being a member, feels that he has something pertinent to contribute to a committee's discussion, is encouraged to put his point privately to the chairman in advance or, if it is of sufficient moment, to attend the meeting when the matter is discussed and make his point himself. He may not, unless the committee so desire, stay for its discussion, nor may he vote when the committee reaches its decision.

The committees' minutes are circulated to all partners and, formally, they are recommendations to the partnership meeting which is held monthly. The main item of business at that meeting is the consideration of committee minutes, and an attempt is made to ensure that those partners who were not involved, appreciate the significance of what they are asked to approve. Usually, after a brief discussion each set of minutes is adopted and executive action follows. Sometimes, despite the opportunity for having met the committee earlier, one or more partners dissents strongly. When it is clear that this is the position, the chairman moves that the minutes be referred back to the committee so that the members may meet the dissenting partner and try to reach agreement.

Three other aspects should be mentioned: first, that the chairmanships of the committees are in a relatively few hands and that the chairmen together have a fairly good idea of what will be acceptable to each committee and what will not. With that background knowledge and a certain amount of preliminary discussion of controversial items, the chairmen can ensure reasonably smooth and prompt decisions on most things. Secondly, the senior partner takes no part in any committee and any partner who feels that a particular committee decision is oppressive may appeal to him. Like the Conciliation Officer of the Ministry of Labour in industrial disputes, he has no power to overrule either side but he can, and is expected to, intervene when apparent deadlock arises. Thirdly, the chief executive of the firm is a member of all committees. In this way, all discussions can be tempered by the practical knowledge of what resources are available and the earliest warning is given of decisions likely to need changed resources.

There is no doubt that decision and effective action would be speeded considerably if each of the present chairmen of committees were given the full authority now vested in the committee, and less partners' time would be diverted from the main business. Why, then, have this structure of continual committees? The reasons are twofold, first to ensure that the democratic concept of a partnership is maintained. The partners are recruited largely for their initiative and energy and they are not of the nature to abandon their concern for substantial matters. Secondly, to educate younger partners. Partners are recruited from the staff and usually start with some tendency to imagine that the firm's management is in some ways lacking. One of the main problems which faces the existing partnership is how to assimilate the new men, to teach them the problems of management, to get them to speak up and criticise constructively. If such a new man is put upon one committee and his contribution is thoughtful and progressively more valuable then it is likely that his comments upon the actions of other committees will also be of increasing value. If, too, he can be moved round the committees, he will gradually get a thorough working knowledge of the firm.

It is too soon to say what will be the long-term effects of this system, but the initiators see some hint that, as a history of rational committee discussions builds up, the number of emotional reactions may decline. The committee offers a suitable forum for scientific management, such as the examination of staff selection methods, salary scales and promotion, or the return of income for resources employed in differing activities. Every time that a discussion in such terms takes place, it is just slightly less likely that the next subject will attract emotional response. It is not clear, however, whether the advance in this direction is due to the system or to the type of partners who have been recruited.

SUCCEEDING GENERATIONS

It will be remembered that Anderson said, "The most important single function of the board is to choose the senior management and, if need be, to change it." There is no doubt that the most important single function of a partnership is to choose the new partners.

Let us examine how this function is exercised.

The first step is in the recruiting of staff.* It is highly desirable that, when engaging new staff, one should consider the question "Is it conceivable that this man might one day be a partner in the firm?"

If the answer is 'No' it may well be unwise to put his foot on a ladder, the summit of which is partnership. The well-known principle of Buggins' Turn may one day lead to a feeling that his long and worthy service justify a partnership; by that time one may be arguing, not his positive contribution to one's own firm, but rather the help he could give to a competitor.

The next step is the training of staff and here a real problem arises in the large firm. Suppose that, as is often the case, the firm is divided into a number of groups with differing activities and suppose that, in one of these groups, a young man begins to make his mark. One view will hold that he should then be fostered and encouraged to make his full contribution where he is, to the maximum profit of the partners and the most efficient running of that activity.

The other view, to which I subscribe, would require that the young man be moved to a new activity. He might be even better there so that the firm's overall revenue would show a net increase but, more importantly, it would give another partner a chance to find out just how good the man was. In this way the decision whether to make A, B or C a partner would be based upon more widely held knowledge. Finally, when the young man became a partner he would have a better knowledge of the firm and would be able to contribute the more.

The third step is the selection of the partner. One could set out a host of tests but, in my view, only one test need be applied, "Looking forward over the remaining years during which I shall derive income from the firm, can I reasonably say that my income will be increased as a result of making this man a partner, above what it would be if he is not made a partner"? The factors to take into account in trying to answer that question will vary. A firm remunerated by fees, such as a consulting actuary, a chartered accountant or a solicitor would need to look at different aspects from a firm remunerated according to the amount of money involved in a given contract, such as a stockbroker, an estate agent or an architect. Certainly, in either case, considerable weight will be given to personality, since an ability to get on well with existing or potential clients is invaluable. The fact that for most professional firms, advertising is prohibited, makes it essential that every partner seeks out and takes full advantage of, every

* One takes it as axiomatic that staff will be recruited only in so far as the necessary intellectual and other qualities are present in the recruit. Nepotism can do harm not only by its immediate adverse impact on the morale of the rest of the staff but it can destroy the quality of the management in the long run.

suitable opportunity for the projection of his firm in a favourable light. This does not imply playing ducks and drakes with rules of professional conduct. Nor does it mean hounding every new acquaintance. But only those firms which are unable to take on more work, or which know that they already have a monopoly of their type of work can afford to neglect this aspect of their partnership responsibilities.

Having decided that, so far as can be judged, a man seems likely to make a satisfactory partner, many partnerships then invite him to enter into a period of probation. He becomes a salaried partner, that is to say, his name is added to the list of partners on the notepaper and he is presented to the world as a partner, but though his liability is unlimited, he is limited both in power and participation in profits. This situation may be brought into effect by a suitable deed of partnership if so desired. Alternatively, the deed may concern itself only with general partners and leave the salaried partners as a special type of employee.

Cases have been known where the type of business required substantial capital and where, as a result, it has not been possible for a salaried partner to put up enough capital to become a general partner. In such cases only a small proportion of the names on the notepaper are general partners. But that situation is probably not widespread and more often the salaried partner is aware that he has reasonable hopes of becoming a general partner.

This period of probation permits the general partners to train the new man for the extra responsibilities which are likely to fall upon him. The committee system described earlier is a useful framework for this development. As the man is allowed increasing freedom in his handling of affairs, especially those involving dealings and meetings with clients, it is possible to assess whether he is maturing in the new atmosphere. Similarly, one can look for evidence of an adult attitude in his changed relationship with the firm's staff.

At the conclusion of such a period of apprenticeship, it will normally be the decision that he should now be made a general partner; but one problem may still remain—the limit of twenty partners laid down by law. Partly to meet this problem and partly to ensure the continued progress of the firm, it is desirable to have some arrangements to reproduce the retirement arrangements of a limited company.

A partner cannot be expelled so long as he complies with the provisions of the Deed or Partnership Act (as the case may be) and indulges in no scandalous or financially improper conduct. It can therefore happen that a partner can continue to attend long after the result of his attendance has changed from being a net contribution to the profits into being a net debit. By retaining responsibility for an activity long after clients have started to drift away to competitors who offer a more up-to-date service, by querulously resisting change and in a host of ways trouble can arise. When it does arise it is too late to seek a way out.

The alternatives are to have a partnership deed which provides for retirement at a fixed age, or to have a gentleman's agreement to the same effect. In either case, it is often desirable that the handing over to the next generation should be gradual and it is quite common practice for a retiring partner to remain available to the firm (his name may still appear on the notepaper as a consultant partner, or associated member in the case of The Stock Exchange). I have discussed some aspects of this problem earlier in the section headed 'Goodwill'.

CONCLUSION

As I have written above, "By any normal management standards, a large partnership is a certain formula for inefficient management" but I hope that the subsequent discussion offers a credible formula for mitigating that inefficiency.

It remains only to emphasise that the views here expressed are my own, that my partners would not necessarily agree with all nor with any particular one of them and that the pattern described should not be taken as a true description of the partnership of which I am a member. On the other hand, it would be appropriate to express my indebtedness to my experience in that firm in the development of the views I now hold.

I am also indebted to Mr. E. Belton and Mr. E. E. Ray for considerable help in the earlier sections dealing with the law and taxation of partnership.