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Contractual Aspects of Formation and Composition of Commercial Partnerships

1. Introduction

According to the principle of freedom of contract, the participants in a joint business undertaking are free to agree on the legal form of company that best suits their needs. One of the possibilities is setting up a commercial partnership. A partnership is a form of business entity known worldwide that enables two or more persons to engage in commercial activity without creating a company that is a legal person. The main feature of a partnership is that the partners are personally liable to the creditors of the partnership. Although nuances of the organisation of commercial partnerships may vary from one European country to another, the two main legal forms are the general partnership and the limited partnership. The main feature of a general partnership is that the liability of the partners to the creditors is not limited. In a limited partnership, there are general partners, who are personally liable without limit, and limited partners, whose liability is limited by the amount of their contribution to the capital of the partnership. In commercial partnerships, as contrasted against capital companies (private limited companies and public limited companies), there are more possibilities to fix the rights and obligations of the partners by contractual means. In private limited and public limited companies, the mutual relations of company members, composition, the powers and the duties of the management, and supervisory institutions are quite strictly regulated by law. The partnership agreement is the main legal tool shaping the structure and composition of a partnership. In a number of European countries — for example, Germany, Latvia, and Estonia — the regulation of commercial partnerships is closely connected with the rules governing civil law partnerships. Whereas commercial partnerships are founded for commercial purposes, civil law partnerships can be created for the attainment of any common goal through united efforts of the partners. Usually, the rules governing civil law partnerships can be found in the civil codes, whereas commercial partnerships are regulated in the commercial codes or other special laws. Unlike commercial partnerships, civil law partnerships cannot be registered in the commercial register. The civil code provisions governing partnership contracts apply also to commercial partnerships, to the extent that the special rules concerning commercial partnerships do not provide otherwise. Partnership agreements establishing commercial partnerships are contracts with features of both contract law and company law. They not only regulate the relationship of the partners but also create legal implications in relation to third parties.

2. Conclusion of a partnership agreement

A partnership agreement establishing a general or limited partnership can be concluded either by a natural person or by an entity possessing legal capacity. That means that not only legal persons but also other commercial partnerships can form a commercial partnership. Civil law partnerships and other entities that do not have legal capacity cannot be parties to a contract creating a commercial partnership. As a general principle, the partnership agreement is form-free and can be concluded even by implied conduct.^{*1} For example, an actual joint commercial activity undertaken by partners can qualify as conduct establishing a partnership agreement.^{*2} The general civil law rules on forms of legal transactions apply. Special form has to be observed only if the law provides formal requirements for specific obligations — e.g., if immovable property is contributed to the property of the partnership.^{*3} In any case, written form is advisable as a tool for evidence. As soon as the agreement is concluded, the partnership comes into existence. These principles regarding the form of a partnership agreement apply also to any subsequent changes in the agreement.^{*4} In relation to third parties, however, a partnership exists only from the time it is recorded in the commercial register or, alternatively, from the first entry into commercial transactions before registration.^{*5} The partners have broad discretion to choose the contents of the partnership agreement, in particular as regards issues such as decision-making, profit-sharing, and representation.^{*6} As far as the mutual relations of the partners are concerned, the principle of freedom of contract applies to the greatest possible extent. With regard to relations to third parties, the contractual freedom of the partners is restricted by law.^{*7}

3. The legal nature of a partnership agreement

The basic features of an agreement creating a commercial partnership are identical to those of civil law partnership agreements. Compared with other private law contracts, the partnership agreement is a specific one. On the one hand, a partnership agreement establishes performance duties — for example, an obligation to contribute to the property of the partnership. Thus, a partnership agreement has features of a contract establishing obligations. On the other hand, the agreement is an organisational contract aimed at the formation of an association of persons.^{*8} The partnership agreement is a reciprocal contract, though it is not aimed at exchange of performances.^{*9} The typical forms of reciprocal contract, such as sales contracts, leases, or employment contracts, entail an exchange of performances to fulfil contractual obligations. The aim of a partnership agreement is a consolidation of performances.^{*10} The reciprocity of contractual obligations in a partnership agreement means that any partner can request the other partners to perform in keeping with the agreement — in particular, to contribute to the property of the partnership.

Since there is no mutual exchange of performances under a partnership agreement, no partner, as a general principle, can deny performance on grounds that other partners fail to perform their duties.^{*11} According to the predominant view in German legal doctrine, a partner can withhold his performance only if 1) the partnership consists only of two members and the other member does not perform and 2) all other members of the partnership fail to perform.^{*12} Wider application of the right to withhold performance would lead to a

¹ T. Klauberg. *Gesellschaftsrecht in Estland, Lettland und Litauen*. Heidelberg, Munich, Berlin: Verlagsgruppe Hüthig Jehle Rehm 2004, p. 30; A. Baumbach, K.J. Hopt. *Handelsgesetzbuch*, 30. Aufl. Munich: Verlag C. H. Beck 2000, § 105 HGB para. 54; A. Loebers. *Tirdzniecības tiesību pārskats*. Rīga: Valters un Rapa 1926.

² E.R. Führich. *Wirtschaftsprivatrecht*, 6. Aufl. Munich: Verlag Franz Vahlen 2002, p. 366.

³ J. Ensthaler. – J. Ensthaler (Hrsg.). *Gemeinschaftskommentar zum HGB*, 6. Aufl. Neuwied, Kriftel, Berlin: Luchterhand 1999, § 105 HGB para. 16; E. Klunzinger. *Grundzüge des Gesellschaftsrechts*, 12. Aufl. Munich: Verlag Franz Vahlen, 2002, p. 60; U. Eisenhardt. *Gesellschaftsrecht*, 10. Aufl. Munich: Verlag C.H. Beck 2002, para. 214; A. Meyer-Hayoz, P. Forstmoser. *Schweizerisches Gesellschaftsrecht*, 8. Aufl. Bern: Stämpfli Verlag 1998, § 12 N 75.

⁴ A. Baumbach, K.J. Hopt (Note 1), § 105 HGB Rn. 62.

⁵ The Commercial Law of Latvia (*Komerclikums*), section 89, para. 1. Available at: <http://www.ttc.lv/New/lv/tulkojumi/E0040.doc>; the German Commercial Code (*Handelsgesetzbuch*), section 123, para. 2.

⁶ Legal Framework for Doing Business in Latvia. Published by law firm Lejiņš, Torgāns, Vonsovičs. Riga 2005, p. 41.

⁷ See the Commercial Law of Latvia, sections 89-96 and the German Commercial Code, sections 123-130b.

⁸ U. Eisenhardt (Note 3), para. 46.

⁹ H. Sprau. – Palandt. *Bürgerliches Gesetzbuch*, 62. Aufl. Munich: Verlag C.H. Beck 2003, § 705 BGB para. 13.

¹⁰ I. Saenger. – *Bürgerliches Gesetzbuch. Handkommentar*, 3. Aufl. Baden-Baden: Nomos Verlagsgesellschaft 2003, § 705 BGB para. 10.

¹¹ See A. Baumbach, K.J. Hopt (Note 1), § 105 HGB para. 48.

¹² I. Saenger (Note 10), § 705 BGB para. 10.

paralysis of the partnership.^{*13} In addition, from the time the partnership comes into existence in relation to third parties, no partner can withdraw from the agreement on grounds that another partner has failed to perform.^{*14} In such cases, according to German and Latvian partnership law, only notice of termination or, if good cause exists, a claim for termination of the partnership is possible as regards withdrawal.^{*15} Whereas the general rules governing withdrawal from a contract are contained in the law of obligations, the notice of termination and the termination claim are regulated by partnership law. According to section 99 of the Commercial Law of Latvia, notice of termination may be issued by a partner if the partnership was established to act for an indefinite time and the notice is issued not later than six months prior to the end of the accounting year. Any commercial partnership can be dissolved under section 98 of the Commercial Law of Latvia if a member, for good cause, submits a termination claim to a court. 'Good cause' is a general clause whose meaning has to be fleshed out in practice with a certain content by courts and legal doctrine. Section 98, para. 2 of the Commercial Law of Latvia provides a general characterisation for a 'good cause', declaring that good cause shall exist especially when another member of the partnership in bad faith or by allowing gross negligence does not perform significant duties imposed upon him by the partnership agreement or such duties have become impossible to fulfil. A German commercial law commentary lists libel, physical assault, denunciation, criminal charges against one partner by another, fierce enmity, conviction of a partner, lasting illness of a partner, and incompetence of the management as examples of a good cause.^{*16}

In some European countries, such as Germany, distinct rules on commercial transactions exist in addition to general contract law. In Latvia, a doctrine of commercial transactions has existed since the 1920s, although specific laws on commercial transactions have not been enacted so far. Currently, the Latvian Ministry of Justice is planning a draft of a commercial transactions part for the Commercial Law. The concept of a commercial transaction in Latvia is similar to the same notion in German commercial law. A transaction concluded in the course of commercial activities is considered a commercial transaction if at least one of the participants is a merchant.^{*17} The question is whether a partnership agreement can be considered a commercial transaction. This is an issue for those countries where commercial transactions are distinguished from other legal transactions and where the concept of a commercial transaction is inseparably bound to the legal status of a merchant. As a general principle, the conclusion of an agreement establishing a general or limited partnership is not a commercial transaction.^{*18} Such an agreement is a commercial transaction only if at least one of the partners is a merchant and the conclusion of this kind of agreement falls within his usual area of commercial activity.^{*19} According to the German doctrine, even in the rare situation where a partnership agreement is a commercial transaction, the commercial transaction rules of the Commercial Code do not apply to the mutual relations among the partners.^{*20}

4. Important issues of mutual relations of the partners

Significant issues of the mutual relations among the partners are the duties of contribution, the rights and duties of managing the partnership, the prohibition of competition, and loyalty duties. Mutual relations among the partners are primarily governed by the partnership agreement. In Latvia, section 79 of the Commercial Law declares that the mutual relations among the members of a general partnership shall be considered in accordance with the provisions of the partnership agreement and only in the absence of such provisions shall those of the Commercial Law that govern partners' mutual relations be applicable. The same applies to limited partnerships. Only a partner's rights to control the activities of the commercial partnership are not at the disposal of the parties. According to section 86 of the Commercial Law of Latvia, all members of a partnership at any time may ascertain the course of partnership-related matters; become acquainted with the accounting and other documents of the partnership; and prepare for themselves a report regarding the state of partnership property, balance sheets, and annual accounts, whereas agreements to the contrary shall

¹³ H. Sprau (Note 9), § 705 BGB para. 13.

¹⁴ U. Eisenhardt (Note 3), para. 49.

¹⁵ For German law, see I. Saenger (Note 10), § 705 BGB para. 10; A. Baumbach, K.J. Hopt (Note 1), § 105 HGB para. 48.

¹⁶ J. Ensthaler (Note 3), § 133 HGB para. 8.

¹⁷ K. Balodis. Recommended Regulation of Commercial Transactions in the Commercial Law of Latvia. – *Humanities and Social Sciences Latvia* 2003 (40) 3, pp. 116, 117.

¹⁸ A. Baumbach, K.J. Hopt (Note 1), § 105 HGB para. 49.

¹⁹ J. Ensthaler (Note 3), § 105 HGB para. 14.

²⁰ A. Baumbach, K.J. Hopt (Note 1), § 105 HGB para. 49.

be considered void. If not provided otherwise in the partnership agreement, the principle of equality of partners in all their rights and duties applies, including the duty of contribution.^{*21}

The mandatory duty of contribution is one of the most important obligations in the mutual relations of partners. In the absence of a specific agreement, the partners have to contribute equal shares to each other.^{*22} Everything that is appropriate for achieving the goals of the partnership can be contributed.^{*23} An appropriate form for a contribution is monetary payment, input of rights or corporal things, or provision of services.^{*24} In Latvia, the forms of contribution are stated in the Civil Law's section 2243, para. 1, which is part of the material containing provisions governing the civil law partnership. According to this provision, money, property, claims, or work may be contributed. A person who, pursuant to an agreement, may share in the profit without any contribution on his part shall not be considered a partnership member (Civil Law of Latvia, section 2243, para. 2). The contribution issue is important also in connection with the participation of the partners in the profits and losses of the partnership. As a general principle, the profits and losses of a partnership are divided among members in proportion to their contribution to the partnership.^{*25}

Another important contractual obligation is participation in the management of the partnership. The management of the partnership as an issue of mutual relations among the partners has to be distinguished from the representation of the partnership in relation to third parties. Unless otherwise agreed, all partners have a right and a duty of participating in the running of a general partnership. In a limited partnership, the limited partners are excluded from the management but the partnership agreement can provide otherwise. However, contrary to the joint management principle applying to civil law partnerships, a commercial partnership is governed by the principle of individual management.^{*26} This is because commercial activities require swift decisions and speedy action. Whereas in a civil law partnership the general principle is that each decision on management issues is made jointly, in a commercial partnership each member has a right and duty to make his own management decisions. Nonetheless, participation of all partners in the management of the partnership might be cumbersome. Therefore, there is a possibility of entrusting one or several partners with the management or spelling out in the agreement which decisions may be made by an individual partner.

The rules on prohibition of competition are, to some extent, different for a general and a limited partnership. According to section 82, para. 1 of the Commercial Law of Latvia, a member of a general partnership may not, without the consent of the rest of the members, conclude transactions in the sector of commercial activities of the partnership or be a member with full liability in another partnership that performs the same commercial activities. This rule does not apply to limited partners in a limited partnership, except in cases where pursuant to the partnership agreement they are granted rights to manage the partnership or also they have some other significant influence on the management of the partnership (Commercial Law of Latvia, section 122). In Germany, the competition prohibition rules are similar to those in Latvia, although the restrictions concerning limited partners are not explicitly mentioned in law (see sections 112 and 165 of the German Commercial Code). Under German law, the loyalty duties of partners imply that the prohibition of competition applies to a limited partner who manages the partnership or has some other significant influence on the management of the partnership.^{*27} The prohibition of competition is viewed as an expression of loyalty duties also in Swiss and Latvian law.^{*28} Competition prohibition rules are known in Estonian commercial law, too. The Estonian ones are only slightly different from those of Latvian and German law. According to section 95, para. 1 of the Commercial Code of Estonia, a partner shall not compete with the general partnership in the same area of activity or participate in a company that competes with the general partnership in the same area of activity, in a capacity affecting the commercial activities of said company. With regard to a limited partner, the competition prohibition rules for general partnerships apply only if the limited partner is granted the right to manage the limited partnership by the partnership agreement (Commercial Code of Estonia, section 129).

The prohibition of competition is an important expression of partners' loyalty duties, although not the only one. The main reason for loyalty duties is the close mutual relationship of the members of a partnership. The joint personal relationship among the partners is governed by the mutual consideration under the applica-

²¹ E.R. Führich. *Wirtschaftsprivatrecht*, 6. Aufl. Munich: Verlag Franz Vahlen, 2002, pp. 366, 367; U. Eisenhardt (Note 3), para. 231.

²² J. Nørgaard, M. Wegener. – Iversen, Nørgaard, Lindencrone Petersen, Wegener. *Danish Business Law*. Copenhagen: DJØF Publishing 2000, p. 466; see also § 86 (2) of the Commercial Code of Estonia.

²³ A. Meyer-Hayoz, P. Forstmoser (Note 3), § 12 N 37.

²⁴ E. Klunzinger (Note 3), p. 63; O. Zwingmann. *Lehrbuch des Handelsrechts*. Riga: Verlag Ernst Plates 1939, p. 143.

²⁵ See J. Nørgaard, M. Wegener. – Iversen, Nørgaard, Lindencrone Petersen, Wegener. *Danish Business Law*. Copenhagen: DJØF Publishing 2000, p. 467.

²⁶ E. Klunzinger (Note 3), p. 68; O. Zwingmann (Note 24), p. 138.

²⁷ A. Baumbach, K.J. Hopt (Note 1), para. 3; J. Ensthaler (Note 3), § 165 HGB para. 1a.

²⁸ A. Meyer-Hayoz, P. Forstmoser (Note 3), § 13 N 56; A. Loeber. *Die Gesellschaft nach dem lettländischen Zivilgesetzbuch vom Jahre 1937*. *Rigasche Zeitschrift für Rechtswissenschaft*. Faximilausgabe. Bd. 10. 1937/1939. Riga 2003, p. 2796; O. Zwingmann (Note 24), p. 143.

tion of the principle of good faith.^{*29} Since the principle of good faith governs private law as a whole^{*30}, partnership agreements are one of the fields of its application. The loyalty duties' meaning is, in essence, that the interests of the partnership must be observed, whereas the personal interests of other partners shall be pursued as far as is necessary for the success of the co-operation among the partners.^{*31} On the other hand, a partner has to omit everything damaging to the interests of the partnership.^{*32} The loyalty duties govern the contractual relationship among the partners, notwithstanding any provisions to the contrary in the partnership agreement.^{*33} The loyalty duties include, for instance, a duty to inform other partners about any dangers that threaten the partnership, certain duties of confidentiality, and a prohibition to disclose commercial secrets.^{*34} A partner who violates a loyalty duty can be sued by other partners for damages or cessation of the violation.^{*35}

5. Implications of a partnership agreement for relations with third parties

The main implications of a partnership agreement for third parties are connected with legal capacity and representation of the partnership. Conclusion of a partnership agreement does not influence third parties automatically but, rather, creates preconditions for doing so. As a general principle, a commercial partnership possesses legal capacity from the time of its registration in the commercial register. Under its business name a commercial partnership may acquire rights and assume obligations, acquire property and other rights related to property, and be a plaintiff or defendant in a court.^{*36} This means that a commercial partnership acts as an independent entity in relations with third parties. In European countries, the question of whether a commercial partnership is a legal person is answered in different ways.^{*37} With regard to the only European supranational form of partnership, Council Regulation (EEC) No. 2137/85^{*38} of 25 July 1985, in Article 1, para. 3, provides that the member states shall determine whether or not the European Economic Interest Groupings registered in their registries have legal personality. Although a European Economic Interest Grouping does not have a purpose of gaining a profit, this form of partnership is treated as a general partnership by national laws^{*39}. Article 1, para. 2 of Council Regulation No. 2137/85 says that an EEIG shall, from the date of its registration, have the capacity, in its own name, to have rights and obligations of all kinds, to make contracts or accomplish other legal acts, and to sue and be sued. This set of rights and duties of a commercial partnership is common to all member states. The predominant view, at least in countries influenced by German partnership law, is that neither a general nor a limited partnership is a legal person. In Latvia, commercial partnerships do not have legal personality. No entities whose members are personally liable for the debts of the entity are considered legal persons in Latvia. However, a discussion about the personality of a commercial partnership is rather theoretical and has little practical importance.^{*40}

One of the most significant issues in relation to third parties is the representation of a partnership. As a general rule, each partner is entitled to represent the partnership if not excluded from representation by the partnership agreement. A partnership agreement may specify that all or several members of the partnership are entitled to represent the partnership only jointly (joint representation). These members may authorise one member or several members from among their number to conclude specific transactions or specific types of transactions. Restrictions on the scope of representation are not binding on third parties (Commer-

²⁹ E. Klunzinger (Note 3), p. 64; A. Baumbach, K.J. Hopt (Note 1), § 109 HGB para. 23.

³⁰ See I. Kull. Principle of Good Faith and Constitutional Values in Contract Law. – *Juridica International* 2002 (7), pp. 142, 143; K. Balodis. The Role of the Good Faith Principle in the Contemporary Civil Law of Latvia. – *Law and Justice* 2003. Selected articles of 2002, p. 2.

³¹ A. Baumbach, K.J. Hopt (Note 1), § 109 HGB para. 23.

³² J. Ensthaler (Note 3), § 109 HGB para. 14; E. Klunzinger (Note 3), p. 64.

³³ T. Klauberger. *Gesellschaftsrecht in Estland, Lettland und Litauen*. Heidelberg, Munich, Berlin: Verlagsgruppe Hüthig Jehle Rehm 2004, p. 32.

³⁴ E. Klunzinger (Note 3), p. 64.

³⁵ J. Ensthaler (Note 3), § 109 HGB para. 15; A. Baumbach, K.J. Hopt (Note 1), § 109 HGB para. 28.

³⁶ See section 90, para. 1 of the Commercial Law of Latvia.

³⁷ See A. Meyer-Hayoz, P. Forstmoser (Note 3), § 13 N 16.

³⁸ Council Regulation (EEC) No. 2137/85 of 25 July 1985 on the European Economic Interest Grouping (EEIG). – *Official Journal L* 199, 31.07.1985, pp. 0001–0009.

³⁹ See section 2, para. 1 of the Latvian Law on European Economic Interest Grouping of 17 June 2004, published in the official gazette 'Latvijas Vēstnesis', No. 106, 07.07.2004.

⁴⁰ See E. Klunzinger (Note 3), p. 54; O. Zwingmann (Note 24), p. 1383.

cial Law of Latvia, section 92, para. 2). A limited partner is excluded from representation of the partnership. Exclusion of a limited partner from representation is in compliance with a mandatory rule that protects third parties.^{*41} A provision in a partnership agreement enabling a limited partner to represent the partnership would be void. Nonetheless, a limited partner can acquire representation powers if he is issued a procuration.^{*42} Under the Commercial Law of Latvia, section 34, para. 1, a procuration is a commercial power of attorney that grants to the proctor the right to conclude transactions and to perform other legal activities associated with commercial activities on behalf of a merchant, including all procedural activities to be carried out in the course of legal proceedings (bringing of an action, settlement, appeal of a court adjudication, and the like). However, a proctor may alienate immovable property, pledge it, or encumber it with rights pertaining to property only if such rights have been specially granted to him (Commercial Law of Latvia, section 34, para. 2). The representation rights of a partner apply to all transactions and legal actions, including any dealings with immovable property and issuing of procuration. Thus, the scope of the representation rights of a partner in a general partnership is significantly broader than the rights of a proctor.

6. Conclusion

The principle of freedom of contract applies to a much greater extent to general and limited partnerships than to private limited or public limited companies. Many issues, especially those concerning the mutual relations of the partners, can be freely addressed in the agreement that establishes the respective commercial partnership. The law provides only the necessary minimum framework for regulation of commercial partnerships, whereby most of the requirements apply to the relations of the partners with third parties. The rules and principles governing general and limited partnerships are to a large extent similar across Europe, although certain features may differ. Commercial partnerships are governed not only by the special rules of commercial law but also by law of obligations provisions concerning partnership contracts. The general rules included in law of obligations legislation apply as far as the special provisions on commercial partnerships do not provide otherwise. In Latvia, as in a number of other European countries, partnership contracts are primarily governed by civil law, whereas the Commercial Law includes special rules pertaining to both types of commercial partnership. A partnership contract has a dual nature, as a contract establishing obligations and as a so-called organising contract. On the one hand, a partnership contract creates a number of obligations the partners have to fulfil — for instance, a duty of contribution. On the other hand, a partnership contract establishes an entity that can independently perform commercial activity under a joint business name. The predominant view is that general and limited partnerships are not legal persons, although they possess legal capacity. The different views as to the legal personality of partnerships in European countries are reflected in Council Regulation (EEC) No. 2137/85 of 25 July 1985, which provides that the member states themselves shall determine whether or not the European Economic Interest Groupings registered in their registries have legal personality.

⁴¹ U. Eisenhardt (Note 3), para. 392.

⁴² O. Zwingmann (Note 24), p. 174.