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INCOMING AND OUTGOING PARTNERS: LEGAL CONSEQUENCES ON FIRM'S LIABILITY

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I. INTRODUCTION

One of the rules of central concern in the area of commercial jurisprudence is the law of partnership which is enshrined in the Indian Partnership Act, 1932 (hereinafter "the Act" in India). A partnership firm is not an entity separate of its partners, it is a group of people who conduct business jointly with the intention of making profits. Accordingly, any alteration in the structure of a firm, such as the introduction of a new partner, the retirement or expulsion of an old one, has important legal implications; in particular, regarding the liability of the firm to third parties. The legislation has to cater to two conflicting interests at the same time; the security of the creditors and third parties servicing the firm, and the fair treatment of partners joining or leaving the association.

The issue regarding liability of such growths is controlled mostly by the provisions of the Act, Sections 31 to 38, interpreted in combination with the overall principles of agency, novation and holding out. An incoming partner will be on different terms of law, and the Act is sensitive to draw the line between pre- and post-admission liabilities, as well post-retirement obligations. Interpretation by the courts has also enhanced and enriched the statutory system; the interpretation has clarified uncertainty in the statute and has widened the application of the law to suit the needs of business.

In this assignment, we look into the legal implications that accrue to firms and their partners on the one hand, and the admission of a new partner and the retirement or expulsion of an old partner on the other hand. It explores the developed legal status, the state of which comes out of the Act and traces the role played by the judicial decisions in the development of this area of law.

II. THE INCOMING PARTNER: LIABILITY AND ITS LIMITS

2.1 The Statutory Position

The introduction of a new partner in a firm is covered in Section 31 of the Act¹. The principle is that entry into a firm as a partner can only be effected with the agreement of all the existing partners other than where the partnership agreement stipulates otherwise. After being admitted, the new partner becomes entitled to the rights and is entitled to bear responsibility as a partner since the day of his admission.

The limitation that is critical about the liability under the Act is with reference to time of the incoming partner. Section 31(2) is clear that he who is made a partner into an existing firm does not become liable to the creditors of the firm to anything done before he was made a partner². It is a cardinal safeguard that is accorded to the incoming partner. The firm has debts and obligations which were incurred before his admission; these liabilities are not transferred to the him unless he actually consents to take them on. This reasoning is based on simple rules of contract: an individual cannot be bound by obligations arising prior to his admission to the association, without his consent.

It is at the same time the future liability of the incoming partner. Since his admission date, he jointly and severally shares with those to whom the business was admitted all the liabilities of the firm in the ordinary course of business³. He makes, practically, a principal himself to the actions of his co-partners, and of the agents of the firm, and becomes liable to all contracts of the firm after the date of his admission.

2.2 The Question of Assumption of Past Liabilities

Also, though the incoming partner is indemnified by the Act as of default, it does not forbid him to voluntarily assume existing liabilities. An assumption like this can be accomplished expressly by a particular agreement, or by innuendo in the terms of the partnership deed. And where the novation, or in other words, the three-party agreement between the previous company, the new partner and the creditor actually exists, the creditor may accept the waiving of the past partners and be prepared to hold the new company, including the new partner, accountable. This doctrine of novation therefore allows a contractual redistribution of a liability which would otherwise not exist by operation of law.

It should be remembered that consent of the creditor is an essential aspect of any such novation.

¹ Indian Partnership Act, 1932, s. 31.

² Indian Partnership Act, 1932, s. 31(2).

³ Indian Partnership Act, 1932, s. 31(1).

The acquiescence of the partners in a simple internal arrangement whereby the incoming partner undertook to assume the past debts, is not liable to any party or dissolve the liability of the old partners towards a party. The creditor does not give up his right to pursue action against the original partners until a valid novation is made.

III. THE OUTGOING PARTNER: RETIREMENT, EXPULSION, AND CONTINUING LIABILITY

3.1 Modes of Cessation of Partnership

A partner is no longer considered to be a member of a firm by retirement, expulsion or insolvency. The retirement of a partner is covered by section 32 of the Act under which a partner may retire with the consent of all the other partners⁴, or in an express agreement among the partners, or, where the partnership is at will, by giving written notice to all other partners of his intention to retire⁵. Expulsion which is addressed in Section 33 can only be authorised by the partnership agreement and should be exercised in good faith and in the best interest of the firm.

3.2 Liability of the Retiring Partner for Acts Done Before Retirement

The termination of the partnership of one of them does not, in itself, absolve him of liabilities to debts and obligations incurred by the firm prior to his date of retirement⁶. The section 32(2) of the Act created it clear that a retiring partner would be liable to third parties to all acts of the firm committed prior to his retirement. This is a liability which is joint and several with his previous co-partners. Such liability may, however, be relieved by an agreement between the partners (the retiring partner and the remaining partners), and the creditors whereby the creditor accepts such a firm (the reconstituted firm) as his debtor and free the retiring partner.

This outburst can either be explicit or implicit. An implied discharge has also been found to exist in cases where the creditor, knowing of the retirement, nonetheless proceeds to transact solely with the reorganised firm; and in a way that is not consistent with an intention to hold the retiring partner liable. Courts have been hesitant, however, to imply such implied novation, requiring there to be evidence of the intention on the part of the creditor.

⁴ Indian Partnership Act, 1932, s. 32.

⁵ Indian Partnership Act, 1932, s. 32(1).

⁶ Indian Partnership Act, 1932, s. 32(2).

3.3 Liability of the Retiring Partner for Acts Done After Retirement: The Doctrine of Holding Out

The more complicated and contentious part of the retirement liability would be whether the outgoing partner would be liable to third parties due to actions committed by the firm following his exit. Section 32(3) of the Act stipulates that a retiring partner remains a partner as far as the third-party is concerned until notice is sent to the third-party of his retirement⁷. The given provision is closely related with the general principle of estoppel that the Act reflects in Section 28 under the title of holding out.

The rationale supporting the rule is that of legitimate expectations of the third parties who, without knowing the composition of the firm has been altered nonetheless, keep on extending credit or doing business with the firm on the belief that the retiring partner still remains a member of the firm. This is safeguarded by the law which does not have the retiring partner declining to accept his liability until he or she gives a reasonable notice of intent to retire.

This principle is further enforced by section 45 of the Act which provides that despite dissolution of a firm, partners remain liable to third parties, on acts committed post-dissolution, until the dissolution is publicly notified⁸. The same provision applies similarly to the retirement of a partner, where the firm still exists in a reconstituted form.

3.4 What Constitutes Sufficient Notice

The Act singles out individuals who had transactions with the firm ahead of the retirement and lack thereof. In the case of third parties with whom the firm has previously had dealing, actual notice of the retirement should be given to that or that individual; the fact that it is published in the Official Gazette or in a local newspaper will not suffice to impose such knowledge on them⁹. In case of third parties who had no previous relationship with the firm, all that is needed to shield the retiring partner of liability is the publication in the Official Gazette.

The liability sharing on the part of the retiring partner is the burden of proving that he or she gave notice. In any case where no notice has been given, or where the notice was not proper, the retiring partner will be subject to the principle of holding out, even though he had no intention of retiring. Section 36 of the Act goes on to state that in instances where a partner has died or gone insolvent or retired, the estate or representatives of the partner could be liable in respect of acts of the firm happening since the death or insolvency or retirement of such a

⁷ Indian Partnership Act, 1932, s. 32(3).

⁸ Indian Partnership Act, 1932, s. 45.

⁹ Indian Partnership Act, 1932, s. 34.

partner unless proper notice has been given¹⁰.

3.5 Liability of the Estate of a Deceased Partner

Section 36(1) of the Act is that the estate of a deceased partner is inapplicable to the acts of the firm committed after his death, on condition that facts of his death, themselves will amount to the sufficient notice to persons having any transaction with the firm¹¹. The demise of a partner is taken as a way of giving constructive notice, to the extent that, the death is a fact publicized which cuts down the relationship of the partner with the firm. Based on this the estate is usually bulwarked against post-death liability, with liabilities prior to death remaining under Section 36(2)¹².

IV. JUDICIAL INTERPRETATION

4.1 The Doctrine of Holding Out: Judicial Development

The holding out doctrine, which is embodied in the Act, is largely a product of judicial exposition. The historic *Scarf v. Jardine*¹³ case settled by the House of Lords held that when a creditor knows of a change of firm chooses to deal with the new firm, he is deemed as having accepted the novation and they cannot claim against the retiring partner henceforth.. The election, when once made, cannot be revoked. This principle has been internalized into the Indian law and has always been applied by Indian courts.

By holding out, to a creditor who had acted on the representation, a person when he was not and had never been a partner was liable as such, as was the case as in *Tower Cabinet Co Ltd v. Ingram*¹⁴ where the name of the partner was signed to a notepaper of the firm.. The court pointed out that the representation should have been given to the individual claimant and the claimant should have given credit on that basis. This aspect of direct reliance differentiates liability by holding out held against strict tortious or statutory liability.

4.2 Indian Judicial Interpretation of Incoming Partner's Liability

The statutory insulation of the incoming partner against pre-admission liabilities has always been maintained by Indian courts. As in *Raman Lal Kochar v. Punjab National Bank*¹⁵, the Calcutta High Court inferred that the liability of the debtors the firm had incurred before the

¹⁰ Indian Partnership Act, 1932, s. 36.

¹¹ Indian Partnership Act, 1932, s. 36(1).

¹² Indian Partnership Act, 1932, s. 36(2).

¹³ *Scarf v. Jardine* (1882) 7 App Cas 345 (HL).

¹⁴ *Tower Cabinet Co Ltd v Ingram* [1949] 2 KB 397.

¹⁵ *Raman Lal Kochar v. Punjab National Bank* AIR 1969 Cal 224.

admission of an incoming partner would not be held against him, unless there was an express or an implied promise to take over the liabilities. The court did not find it viable to hold the new partner liable on the mere fact that the former partner had information of the current debts when he was admitted.

In *Gulabchand v. Kudilal*¹⁶, the Madhya Pradesh High Court worked out a question on whether an incoming partner could be liable in case the accounts of the firm remained to be continued and there was no differentiation between overall pre- and post-admission transactions.. The court believed that continuation of accounts was not an assumption of past liabilities and there had to be an express and unequivocal agreement to make the new partner liable.

4.3 Judicial Treatment of Retirement and Continuing Liability

The courts have been very rigid in regard to the need of notice to the retiring partners. According to *Dhanraj Mills Ltd v. Ahmedabad Mfg & Calico Printing Co*¹⁷ the Bombay High Court, a retiring partner remained liable to the current creditors despite his retirement as no single notice had been communicated to them.. The court had pointed out that gazette notification itself was not enough to absolve liability of those who had even dealt with the firm before.

The other principle, as stated in *Rouse v. Bradford Banking Co*¹⁸ by the House of Lords is no less important.. A continuing partner was then said to have been not relieved of liability on a loan which had been borrowed prior to a change in the firm simply because a new partner had become a partner in the firm and the bank had been receiving interest payments by the new firm. The court argued the acceptance of interest was not sufficient to imply an intention to novate the contract or release the old partner.

The liability of an old partner was the case of *Bhagwan Dass v. Punjab National Bank*¹⁹ in which the Punjab high court was dealing with the liability of an old partner that the bank had continued the firm account without specifically disengaging the retiring partner.. It was decided by the court that the fact that the bank was still carrying out business with a new company was not a novation that would act to discharge the retiring partner. There had to be affirmative evidence of the assent of the creditor to discharge him.

4.4 Liability Upon Insolvency and Death

The role concerning insolvent and dead partners is also explained by the courts. In the Madras

¹⁶ Gulabchand v. Kudilal AIR 1966 MP 275.

¹⁷ Dhanraj Mills Ltd v. Ahmedabad Mfg & Calico Printing Co AIR 1946 Bom 37.

¹⁸ Rouse v. Bradford Banking Co [1894] AC 586 (HL).

¹⁹ Bhagwan Dass v. Punjab National Bank AIR 1952 Punj 82.

High Court case of *Venkataswamy v. Rangaswamy*²⁰, it was determined that because the surviving partners contracted debts thereafter, and after the date of death, the estate of a deceased partner could not be liable to such debts since death in itself was sufficient to bring to an end the agency of a partner.. This decision accorded with the principle underlying Section 36(1) of the Act.

Nonetheless, in the case of *Shivabasappa v. Shidlingappa*²¹ the Mysore High Court provided a significant exception, where the profit of the business was still involved in the profits of the firm by an executor or legal representative who was running the business, the estate could be held liable as a quasi-partner under the principle of holding out..

In *Narain Das v. State of UP*²², the Allahabad High Court went on to further hold that liability by holding out could be addressed to the continuing partners where after the retirement of one of the partners an act had been done by the continuing partners to induce the third party to act against him/her, even where the continuing partners had given adequate notice of the retirement..

V. CONCLUSION

The legal provisions on the issue of responsibility by the parties coming into and coming out of the firm demonstrate a delicate compromise by taking into consideration interests of the firm as well as its members, and third parties that engage with it. The settled law, contained in the Indian Partnership Act, 1932, provides the fact that an incoming partner will not face liabilities to pre-admission debts unless express agreement exists, whereas a retiring partner will remain liable as to pre-retirement debts, and post-retirement activities until proper notice is given. The doctrine of holding out, which pervades both the statutory text and the case law, is used to make sure that third parties are not misled by any changes in the composition of the firm, that they have no knowledge of.

This framework has greatly been added on as a result of judicial interpretation. Courts have been steadfast in not wanting to place greater liability than the law considers and require a clear showing of agreement or representation before taking a step out of the default statutory stance. Meanwhile they have insisted on the need to observe the procedural requirements of notice strictly followed, and on the inability of a retiring partner who does not give sufficient notice

²⁰ *Venkataswamy v. Rangaswamy* AIR 1950 Mad 151.

²¹ *Shivabasappa v. Shidlingappa* AIR 1957 Mys 134.

²² *Narain Das v. State of UP* AIR 1962 All 193.

to avoid the consequences of the post-retirement acts of the firm.

Overall, a consistent and principled legal framework as the interaction between the statutory rules and judicial rulings has resulted in an unequivocal and commercially predictable liability of the alteration of the composition of partnerships, as well as in the fair protection of all stakeholders.

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