CURRENT LEGAL ISSUES RELATING TO LENDING TO TRUSTS AND PARTNERSHIPS

Commentary

BILL NAPIER

Partner
Freehill Hollingdale & Page, Solicitors, Sydney

I have been asked to comment on the partnership aspects of the paper. As Justice Lehane points out, a great deal has been written on partnerships and joint ventures. As he also comments in his written paper, lenders may not see a great deal of practical relevance in the academic argument about the distinctions between partnerships and unincorporated joint ventures. So, taking up the invitation implicit in those comments, I thought I would ***not*** talk about whether those distinctions exist. Instead, I thought I would review briefly the way the principles the paper describes appear to be worked out in true partnership finance transactions, and I assume for the purposes of this discussion companies as the partners.

CHOICE OF STRUCTURE

The first and obvious point is that there are various practical reasons for using a partnership rather than a joint venture, or vice versa:[1]

1. an unincorporated joint venture or association may be undertaken to ensure that joint and several liability is not accorded to the venturers. The joint venturers would usually indicate that they are only severally liable for their respective interests in the joint venture. It is obviously appropriate where each joint venturer intends to obtain its own financing;

2. an incorporated joint venture may be utilised, the major advantage of which has usually been seen to be the limited liability attaching to the shareholders in the joint venture company. The principal disadvantage of an incorporated joint venture is that tax gains and losses are quarantined at a joint venture vehicle level; and

---

1 An unincorporated joint venture at law may nevertheless – and the venturers may of course wish it to – be a partnership for ***tax*** purposes. Alternatively, each joint venturer may wish to calculate its own income, utilise it within its own group and make various term elections separately, and may therefore not wish partnership tax treatment to apply.

3. a general partnership[2] which allows individual partners to stream through to their parents the benefit of tax losses incurred, say, during the construction phase of a major project. A partnership-structured project is usually entered through special purpose subsidiaries of sponsors, so that the benefits of limited liability can then attach.[3] It may be that joint financing and liability is intended, and a partnership is a useful vehicle in this context.

The reasons for choosing a corporate partnership structure are therefore very practical – tax or liability-related – and are certainly not intended to impact adversely on the efficacy of the lending and security arrangements.

TAKING SECURITY

As the paper indicates, the basic proposition is that a partner has no title to specific partnership assets. Each partner has a non-severable beneficial interest in all partnership property, essentially a right to its proportion of the surplus after the realisation of assets and the payment of debts and liabilities. In contrast, a joint venturer has a proprietary interest in each of the joint venture assets as a tenant in common. One of the important points Mr Justice Lehane's paper makes is that a joint venturer can agree, in accordance with the joint venture agreement, to give a first ranking security over its interest in the property to a lender, and that the same result should be able to be achieved in a partnership situation. Leaving aside cross-charges in joint ventures, that is what happens in joint ventures.

In joint ventures, it is clear enough that a security granted can attach to a severable interest. However, in a situation where security is to be given by a corporate partnership, the security-giving is a little more complex because of that absence of title to specific, severable property. As the partnership is not a separate entity capable of holding property, if a lender wishes to take a charge over all the partnership property, it should obviously take security from each and every corporate partner.

There are a small number of important practical points for practitioners acting for lenders. These points have arisen in some recent infrastructure financing transactions which use partnership structures:

1. Lenders need to be careful to distinguish between what is partnership property and what is not partnership property, and to design their securities accordingly. It is possible, to take a simple example, that one partner may bring to the partnership business land for use in the partnership business, but retain separate title to it. Any security arrangement taken by a lender over assets needs to be careful to take security over ***all*** required assets, both assets of the partnership and, if necessary, separate assets of partners.

2. There are important drafting consequences of the non-severability and limited nature of a partner's interest. One case is directly on point. In *Bailey v Manos Breeder Farms Pty Limited*,[4] the State Bank of South Australia had taken securities over the assets of individuals and companies carrying on business as chicken growers in partnership. Receivers were appointed to the assets of the companies who had given the securities, and in due course a liquidator was appointed. One issue in the case was as to the coverage of the debenture charges, and in particular whether the relevant clause of the charges which referred to charging the property, business and assets of "the company" was sufficient to

---

2 I omit from discussion limited partnerships, which are treated for taxation purposes in Australia as companies. This structure has been used in some recent projects, particularly when the treatment of foreign resident partners may be different from Australian tax treatment of the limited partnership.

3 By way of digression, there are increasing numbers of ways provided for under the Corporations Law of "breaching the corporate veil": see section 588G (director's liability for insolvent trading), section 588V (holding company liability for insolvent trading).

4 1990 ACLC 1119.

cover the business and assets of the partnership. It was not. The charges in aggregate only secured the ***personal*** assets of the charging partner. The securities should have in this case been expressed to charge ***both*** the separate assets of the companies and the "partnership property"[5] as a whole.

3. To the extent a distinction can be drawn between:

   (a) a charge taken by a lender over an individual interest held by a company in a partnership – essentially security over a right on termination of the partnership to receive a proportion of the surplus of the assets after liabilities of the partnership are satisfied; and

   (b) charges in favour of a lender intended by all partners to cover the full gross stock of "partnership assets" (without deduction of the claims of general partnership creditors),

   fixed and floating charges from ***all*** partners can, if agreed by all partners with each other, constitute a charge over all partnership assets, rather than simply over a collection of these limited individual interests. It is probably useful, and easiest, to constitute the charge from all partners in a single document. The lender/chargee then has vested in it rights in respect of all assets of the partnership by virtue of its agreement with each partner,[6] and within that document all partners can then agree with the lender that, as a group, they ***collectively*** charge all partnership property – the gross stock of partnership assets – as security.

PRIORITY OF SECURITY OVER OTHER PARTNERSHIP CREDITORS

Priority aspects are obviously also critical.

In a winding up of a partnership of individuals, the Bankruptcy Act requires that creditors of a partnership rank ahead of a separate creditor of a partner who has given a mortgage or charge over its partnership interest.[7] In corporate financing transactions, there is a clear need, however, to ensure that the first-ranking security to a lender is just that: first-ranking. It can be attempted in two ways:

(a) to exclude from the partnership property by agreement among all partners, certain assets, and to agree for one partner to make those assets available to a secured lender by a partner. The use of land in the partnership business, as I mentioned earlier, is an example of such a possibility; or

(b) as Mr Justice Lehane's paper indicates, by ensuring that the agreements reflect the intended priority. It seems possible and desirable in the charge given by the corporate partners for each and every partner to agree with each other and with the lender that its individual interest in the partnership ranks behind the rights of the chargee. Each partner can then be seen to have agreed with the lender as to the ranking of that charge as it affects its own claim against the partnership interests of each other partner. (In addition, by utilising companies as partners, the section 110 Bankruptcy Act principle, as Mr Justice Lehane's paper points out, seems no longer to apply. I know of no case on the point yet, but since section 553 of the Corporations Law replaced section 438 of the Companies Code, the general company law requirements as to proof of debt in a winding-up by each creditor should apply.)

---

5 If only because the term "partnership property" is used in the Partnership Act to describe the assets of a partnership: section 20, Partnership Act, 1892 (NSW). See also *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Limited* (1974) 131 CLR 321 (McTiernan, Menzies and Mason JJ at 327) as to characterisation of the partner's interest as "beneficial".

6 Cf *United Builders Pty Ltd v Mutual Acceptance Limited* (1979-80) 144 CLR 673.

7 Bankruptcy Act 1966 (Cth), section 110.

The charges, as floating charges, are registrable under the Corporations Law.[8]

Accordingly, a partnership charge given by all partners should constitute effective security over partnership assets in priority to the claims of unsecured partnership creditors.

ENFORCEMENT OF SECURITY

Finally, and briefly, enforcement mechanisms available to lenders to partnerships are also important.

While a charge will entitle a lender to appoint a receiver, sell assets and otherwise step into the chargor's shoes in the usual way, Partnership Act and partnership agreement restrictions on assignees and on other matters will apply. In an unincorporated joint venture, lenders will always review joint venture arrangements carefully to ensure that they can exercise a power of sale without, or at least by adequately dealing with, the common restrictions – such as rights of pre-emption in favour of non-defaulting joint venturers, or the dilution or forfeiture of the defaulting joint venturer's interest.[9] In a partnership situation the lender should do the same with the partnership arrangements and should also focus on dealing with the statutory restrictions. In particular, the Partnership Act makes clear:

- that an assignee of a partner cannot become a partner without the consent of all existing partners;[10]
- that an assignee has no voice in the management or administration of the partnership business, nor is it entitled to require an account of partnership transactions or to inspect the books;[11] and
- that an assignee is restricted to a passive receipt of the partner's share of profits agreed to by the partners.[12]

All of these matters will need to be negotiated adequately by financiers and amended by agreement with the partners.

So, a back-to-basics conclusion: the efficacy of lending and security arrangements, as applied in usual corporate situations, should not be impacted adversely by the choice of a partnership as a financing vehicle, but some care in drafting, and attention to the terms of the partnership arrangements, is essential.

---

8 See *Bailey*, supra n 4. Cf a charge over an individual partner's interest which will be fixed and not registrable.

9 See generally "Financing Joint Ventures", A Millhouse, in *Joint Venture Laws in Australia*, W D Duncan (ed) (1994) 125.

10 Partnership Act 1892 (NSW), section 24(7).

11 Ibid, section 31(1).

12 Ibid.