

Quazi-Juristic Personality of Sole Proprietorships and Partnerships in Sri Lanka and Its Causes and Consequences

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Abstract -For healthy, sustainable and developed national market economy in any given country it is vital to have a strong small and medium scale businesses at the bottom tier in the country's commercial pyramid and a balance array of legally different business structures; companies, partnerships and sole proprietorships. Even though both domestically and internationally high attention and extensive debates were constantly placed on company law, the focus and the importance assigned to sole proprietorship and partnership laws in local and international legal spheres are questionable? This paper examined the efficacy of the legal principles emerged and exists pertains to sole proprietorship and partnership under commercial law long ago in modern business context. Study addresses the characteristics and inherent limitations of the sole proprietorship and partnership laws due to their quazi- legal personality. Study further explored the tension between the present Sri Lankan legal framework of sole proprietorships and partnerships against the practical issues encountered by such entities. The paper originated in the principle dilemma between the significant contributions made by the sole proprietorships and partnership businesses to the national economy against the poor legal attention and priority placed for sole proprietorships and partnership laws in the commercial law domain with special reference to Sri Lanka. Study carried out by way of legal analysis of blackletter law buttressed with primary data gathered through interviews with domestic sole proprietors and owners of partnerships to exemplify the domestic legal pitfalls and lacunas pertains to the sole proprietorship and partnership laws comparative to other jurisdictions namely United States, UK, Germany and France.

Keywords-sole-proprietorships, partnerships, companies, quazi-juristic-personality, personal-liability

I. INTRODUCTION

Sole proprietorships and partnerships play a critical and vital role in domestic and international market economies. At the same time, these entities become the bedrock and live wire of internal trade and commerce which links entire country's commercial network by way of connecting inner and outer cities as well as rural commercial sectors via

functioning as the bottom tier of the national commercial pyramid. Therefore, sole proprietorships and partnerships' sustainability, survival and effectiveness become a crucial element for smooth national economic functionality. Despite the above, while extensively high intellectual capital was vested in the corporate law and it can be well observed that there is an inadvertent ignorance on the sole proprietorship and partnership laws world over and significantly with reference to domestic legal framework.

According to World Bank Report 2011, 65.7% of the Sri Lankan business entities were categorized under the legal status of sole proprietorship. As per the first Economic Census in 2013/14 on the Industry, Trade and Services sectors carried out by the Census and Statistics Department of Sri Lanka revealed that 90% of the economic activities fall within in the sole proprietorship segment. (Chandrasekara,2015).

Notwithstanding above, comparative to the shareholders of companies', participants in sole proprietorships and partnerships undertakes an unlimited risk not only for their investment but also for the unforeseen losses and liabilities that may encounter for a given business which can extended to endanger their entire personal assets. But the legislator's lethargy and sloppiness raise the suspicion that the reason for their ignorant behaviour towards these entities may be due to the simple notion that sole proprietors and members of partnerships invest their own money instead of public money and their personnel investment is their personal business. Accordingly, legislators have overlooked the legal facilitation and protection which are due for sole proprietors and partnership business over many decades. Another reasonable argument that can be put forward for such ignorance is that it can be the believe that the participants of the sole proprietorships and partnerships will be vigilant to adopt their own precautionary methods to prevent or mitigate any loss or damages to their investment since they will not jeopardize their own money and personal reputation under any cost. Hence, there is much less stringent laws, regulations, measures and mechanism pertains to the sole proprietorships and partnerships in Sri Lanka.

On contrary to the said thoughts and practices the absolute aim of commercial law is to protect and uphold the investment made by any party irrespective of the type of business and whether money invested by a private party or it is a pooling of public money. Hence, law has a social obligation to provide security for any investment despite the form and nature of the investor and to formulate necessary safeguard mechanisms to protect any form of legitimate business investment regardless of the sources of funds and irrespective of the nature of business structure whether it is a sole proprietorship, partnership or a company. Therefore, law required to provide an equal treatment for all forms of legitimate investments and all types of business structures.

In reality, sole proprietorships and partnerships undertakes and exposed to much higher risks and threats from the market for their investment comparative to well-formed and structured companies. Further, as the most prevalent form of business in Sri Lanka sole proprietorship and partnerships deserve much scrutiny and regulation. Correspondingly, in the collective form, small business is a big business. Over and above in the contemporary business sphere there are high scale partnerships as well. Therefore, the contribution made by these sole proprietorships and partnerships to the national economy cannot be underestimate and demand more attention from legislators and regulators than ever before. Hence, legal support to facilitate and mitigate threats attached to sole proprietorships and partnerships and legal capability to deal the complex and dynamic issues, causes and effect pertains to sole proprietorships and partnerships becomes equally important as much as for companies.

Despite the past and present legal ill-treatment for the sole proprietorships and partnerships from all corners, this paper attempted to explore the actual legal nature of the sole proprietorships and partnerships, application of personal liability theory on these entities and the pitfalls and lacunas of the present principles relevant to the given entities in order to understand and formulate better reforms for the prevailing sole proprietorship and partnership laws.

With the given backdrop under mentioned three research problems were focused in this study;

1. What is the real legal nature of sole proprietorships and partnership entities in Sri Lanka?
2. What is the level of application of personal liability theory for sole proprietorships and partnerships in practise?

3. Are present laws adequate and effective to protect sole proprietors and participants in partnerships in Sri Lanka?

II. METHODOLOGY

This study adopted a qualitative research approach through the re-examination of legal fundamentals attached to the sole proprietorships and partnerships by way of analysing black letter laws and legal practices adopted in domestic and comparative jurisdictions of United States, UK, Germany and France. Comparative jurisdictions were selected based on the simplicity and effective way of forming the said two business structures on the given jurisdictions. Further, sole proprietorships and partnerships on the given jurisdiction plays a prominence role in their respective domestic economies. e.g. Comparative to approximately 2 million private limited companies there are 3.4 million sole proprietorships (over 60% out of total businesses) and another 414,000 of partnership businesses (7% out of total businesses) in U.K. (Company Bug, 2019). Similarly, in U.S. out of all businesses, sole proprietorships accounts for about 72% and another 10% of the business falls in the category of partnerships (Lumen,2019). Moreover, on those selected comparative jurisdictions, legislature provide approximately equal treatment and importance to those two business structures similar to private and public companies.

Aforementioned conceptual and comparative analysis was further supported with the direct interviews with approximately around 50 domestic sole proprietors and 75 partnership business owners.

This was a legal reform-oriented study based on both primarily on relevant legal principles, statutes and case laws which was supplemented with secondary sources of data gathered from interviews, leading peer reviewed researched journals and scholarly writings.

III. QUAZI JURISTIC PERSONALITY OF SOLE PROPRIETORSHIPS AND PARTNERSHIPS

The main purpose of this paper is to explore, compare and contrast the characteristics, causes and consequences of the sole proprietorships and partnerships' personalities over the corporate legal personality of companies in terms of legally and practically. Further, to examine the application of personal liability concept for sole proprietorship/partnership verses companies and to investigate for any difference among those.

A. Sole Proprietorships

As the simplest form of business type, most of the newcomers to the business prefer to register and operate

their businesses under sole proprietorship due to many reasons such as flexibility in operation, freedom of decision making, ease of the required procedural compliance and less stringent regulations pertains to such entities etc. Sole proprietorship can be defined as a business operate by an individual for the sole purpose of the earning profit pursuant to the statutory terms.

As far as legally concerns, there is no legal entity under sole proprietorship other than the proprietor. Hence, there is no perpetuity for sole proprietorships and it expects to literally terminate or dissolve the business with the death of the proprietor. Consequently, it does not legally confer any inherent authority for representative to continue the proprietorship and the business going concern and that will be mainly dictates upon the proprietor's will or intestacy statutes. Consequently, sole proprietorship assets and liabilities are commingled and inseparable from his personal assets and liabilities. Furthermore, sole proprietor becomes labile under direct, vicarious and fiduciary duties. (Crustor,2001)

In *Holberg & Co. v. Citizens Nat'l Assurance Co.*¹ showed the conflict between alter ego notion and corporate legal personality attached to the sole proprietorship and partnerships further how courts grapple this issue when it comes to functioning of these entities in reality. Similarly, criminal law considers sole proprietorship business and proprietor as one and the same. But in the *McKinley v. State*² and *Pagan v. State*³ cases court yet again treated sole proprietorship and proprietor as separate elements before the law. Therefore, due to the present instable legal nature of the sole proprietorships legal issues were encountered and created further complexity, confusion and difficulty to segregate them from the features relates to companies. This raises the first hesitation to believe that sole proprietorships do not acquire any legal personality or rather they actually hold a hybrid characteristic belongs to natural persons as well as companies and forms a quazi juristic personality over the present legal notion of proprietor's personality.

Further, in order to overcome the present limitations links to sole proprietorship such as conveyancing the sole proprietorship property and business ownership under the business name, perpetuity of sole proprietorship beyond the proprietor's demise, obtaining credit under business name, to sue and be sued under business name etc. quazi juristic personality provides better ground before the law over the present proprietor's personality principle.

B. Partnerships

In common law, partnership treated as the collection of the individual partners. S. 1 (1) of the Partnership Act of 1890 of Sri Lanka defines the partnership as a relation which subsists between persons carrying on a business in common with a view of profit. The partnership law mainly governs through the Partnership Deed or Articles of Partnership in the form of an agreement. In absence of those through the course of dealing among the partners and whereas the statutory law has a residual role to supplement the defaulting rules for such agreement. The partnerships functions on the norm of *delectus personae* which means the choice of the person where consents of all partners are required for new membership. Court upheld the same in the case of *Byrne v. Reid*⁴.

There are two main views for partnerships namely aggregate approach and entity approach. The aggregate partnership approach hold that every partner owned a direct stake in the assets and liabilities of the partnership based on the pro-rata share of the partnership while the entity approach consider partnership and partners are distinct from each other and confer separate bundle of rights and liabilities to the partners based on the level of engagement with the partnership business.

Comparative to the sole proprietorships' in other jurisdictions partnerships holds more privileges such as ability to acquire, hold and transfer the property and ownership of the business under the business name, continuation of partnership despite the death or change of the partners through contract without dissolving the business etc. But still in Sri Lanka the law pertains to the partnerships are very much similar to the law of sole proprietorship. Nonetheless, participants of the partnership bound with the unlimited personal liability for partnership's debts and obligations in their personal capacities.

Partnership law in Sri Lanka is governed by the English Law and subject to the Partnership Ordinance No.21 of 1866. (Chapter 179 of the Legislative Enactments of Sri Lanka revised in 1980). While the initiation of partnership law was made with S.3 of Introduction to the Civil Law Ordinance No.05 of 1852, the first ever domestic legislation enacted behalf of partnerships under the Partnership Ordinance No.21 of 1866 as a simple statute with seven provisions. Sri Lankan partnership law was further shaped with the UK Partnership Act 1890. As per the S.18 of Prevention Fraud Ordinance No.7 of 1840(Chapter 84 of the Legislative Enactments which was later revised in 1980) mandate to establish the partnership in writing when its capital exceeds 1000 rupees. S.519(1) of Sri Lankan Companies Act No.07 of 2007 stipulates the maximum number of

¹856 S.W.2d 515 (Tex Ct. App. 1933)

²400 N.E.2d1378(Ind.1980)

³809 N.E.2nd 915(Ind Ct. App. 2004)

⁴(1902) 2 Ch. 735

members to twenty for a partnership. Procedural aspect pertains to the establishment through registration of partnerships are govern by the Registration of Business Names Act No.07 of 1987 and S.64,202, 249 and 252 of the Civil Procedure Code. In *Mahakanda Housing Construction Co. Ltd v. Duhilamomal and others*⁵ domestic courts held that the general law connotes that on the death of one of several partners, the partnership stands dissolved subject to any exceptions stipulated in the partnership agreement. As per the domestic law to institute legal action against a partnership or on behalf of the partnership, it should be filed under the personal names of each and every partner of the partnership. During the period of year 1975 to 1978 under Administration of Justice Law permitted to institute action in the name of the partnership, but it was repealed under present Civil Procedure Code. Consequently, all partners become joint and severally liable under tort whereas the liability for contracts will be enforced based on the agreeability of the partner for the given contract. Partners can be either ostensible/active partners or dormant/sleeping partners.

With the 13th Amendment to the present 1978 Constitution, the powers to enact own statutes reference to registration of business names were vested with the respected Provincial Councils. As per the S.2(1)(b) of the Companies (Special Provision) Law No.19 of 1974 restrict the registration of sole proprietorships and partnerships only to Sri Lankan citizens subject to the exception of S.3(1) of the Gazette extra- Ordinary No.142/9 of 18.09.1974.

IV. ANALYSIS OF DOMESTIC PROCEDURAL LEGAL FRAMEWORK

The extremely vexatious issue faced by both sole proprietors and partnerships when obtaining Business Registration Certificate (BRC) from the respective authorities due to the fact that relevant authorities demand to provide documentary evidence of business registered address in the form of either title deed or as a lease agreement under the name of sole proprietor or partners. On the other hand, if sole proprietor or partnership expects to lease a premise, lessor will demand the BRC in order to execute a lease agreement before letting the premises. Even though statutory or procedurally nowhere mandate to provide such documentary evidence, when it comes to real practice potential participants endure such procedural difficulties.

Similarly, most of the virtual businesses are formed as either sole proprietorship or partnerships and does not require any physical business premises to carry their

operations. Hence in future the requirement of having a physical business address instead of P.O. Box address for such businesses can form limitation in practice as well reference to prevailing laws.

Nevertheless, the legislators are preaching on creation of entrepreneurs and providing facilitation with necessary infrastructure to nurture such entrepreneurial culture, procedural hassles and practical deficiencies as aforementioned will discourage the potential newcomers to commence and operate their businesses as sole proprietorships or as a partnerships in the present domestic commercial law domain.

V. DISCUSSION

The contemporarily law on one hand conferred the characteristics of companies to these sole proprietors and partnerships and on the other hand both sole proprietorships and partnerships are treated as non-legal entities despite the formal legal registration process being adhered by those entities. Thus, there is legally differential treatment and discrepancy for sole proprietorships and partnerships over the companies in the modern commercial law. Further, these sole proprietorships and partnerships considered as they do not owe any legal personality and they are legally treated as solitary alter ego of the proprietor or partners than a separate entity. Solitary alter ego theory warrants proprietor or partners to enjoy the full benefit of profit subject to the personal liability of all entity's debts and obligations inclusive of contractual, tort, agency liabilities ensued from the employees, entity, other agents as well as for own errors, faults and wrongs made during the course of business.

Absence of legal identity for these sole proprietorships and partnerships apart from its owners natural legal personality can either credit or discredit the personal names of the given owners based on the entity's performance even in circumstances where business incur loss or damage due to the employees or agents of the entity by diminishing the entity's creditworthiness and goodwill.

One anti-argument for conferring fully fledged separate legal personality for sole proprietorship and partnerships is that entity is owned either by a solo or several individuals and whether the money vested for the given business is personal, not public money. But the counterargument which can refute the given claim with the provision provided in the statutory law under the Companies Act No.07 of 2007 of Sri Lanka where it permits sole or several shareholders to incorporate a business with corporate

⁵(1981) 2 S.L.R.

legal personality which provides personal shielding for corporate liability beyond the given shareholding.

Further, piercing of the veil concept vice versa reverts to the assigned corporate legal personality to the owners of companies leads to the contention that both corporate legal personality and owners of the business as the same. Thus, the corporate legal personality norm will revert to the business owner's natural legal personality.

Notwithstanding the overt risk borne by the sole proprietors and partners of a partnership and contrary to the equality for all entities and investments notion, law had shown much apathy to place them in equal footing of shareholders of a company in terms of the personal liability shielding.

Geoffrey Morse says that even though partnership and company law are siblings they look like ape and man, while partnership law was stagnated for so long where company law had dramatically evolved and developed to cater modern business needs.

Despite the fact that domestic laws lagged behind, certain countries such as United States back in 1822 onwards attempted to formulate new reforms to the partnership laws and enacted Uniform Limited Partnership Act (ULPA) in 1916 and later in 1976 it was amended as Revised Uniform Limited Partnership Act (RULPA) to suit the present commercial dynamics. These new changes to the partnership law segregated common partnership into general partnerships, limited partnerships and limited liability partnerships based on the level of liability borne by the partners. General Partnership inherits the attractions and distractions of orthodox partnership business, while Limited Partnership mandate to have minimum of one general partner whom liable for all obligations arise from the partnership while limited partner is shield beyond the investment in the partnership and legally permitted to stay as a passive investor. The Limited Liability Partnership is a statutory registered entity which has own separate legal personality distinct from its partners and does not ensue personal liability for partnership debts and obligations. Moreover, it has infinite life span. At present this statutory partnership law reform has developed to an extent that not only a natural person even a corporation permitted to become a partner in modern partnership businesses in certain jurisdictions. Similar trend is notable in United Kingdom. The given approach is more liberally adopted in Germany and France. In France limited partnership admits as a legal person.

VI. RECOMMENDATION

Setting up sole proprietorship business is comparatively quickly and easy in U.K., where business owner only required to register the business name after a self-

assessment at minimal cost comparative to other business structures to secure a local business licence. Further, sole proprietorships are encouraged by the legislature as business nature highly depend on the business growth in due course. Partnerships in U.K. are mostly formed based on the proper reasoning of pooling and striking of diverse business requirements in terms of business expertise, resources, sharing of responsibilities and liabilities among the partners more rationally rather than forming a partnership by ad-hoc agreements over known persons as partners like in the local context. U.S. also follows similar formation process for sole proprietorship and partnership businesses. Thus, domestic sole proprietorship and partnerships formation can be further simplified and should be formed more logically with proper business orientation. French legislature initiated new form of business structure to cater the modern business demands and changing legal requirements under sole trader concept over orthodox sole proprietorship principle to limit the liabilities of sole investor without creating a separate legal personality. Where adoption such mechanism to local context, can motivate domestic risk averse potential sole proprietors whom reluctant to undertake unlimited business liability to form business under sole proprietorship. In Germany there are multiple forms of partnership models as traditional ordinary partnership where there are general partners who become jointly and severally liable for all the debts and liabilities and whereas in Limited Private Partnership model permits for one general partner who become personally liable unlimitedly and the other partner to become limited liability partner. Introduction of this kind of partnership model will enable to raise funds and attract investment for domestic partnership business by limiting investor liabilities. As the third type, Corporate Partnerships can be formed with one individual partner and a corporate as the other partner. This form of partnership model required to have one general partner and other as the limited partner and this model can be utilized to shield all partners with limited liability by making the corporate as the general partner. Under Partnership Company form corporates are excluded and only freelance professionals from same or different disciplines are permitted to become partners by appointing one general partner whom become unlimitedly liable for any professional error made by the partners. On above all, Germany has strong intellectual property safeguarding culture which facilitates protection for new business ideas and innovations which has a direct impact on initiation of businesses sole proprietorships and partnership businesses with minimum risk and fear. These new legal partnership models in comparative jurisdictions call serious attention for archaic domestic partnership law.

Further domestically there is no direct authority or source to obtain accurate number or details relevant to sole

proprietorships and partnership businesses registered in Sri Lanka due to the absence of central body to regulate sole proprietorships and partnerships established in all provinces in Sri Lanka. Thus, various substantive and procedural laws become applicable to the sole proprietorship and partnership business in Sri Lanka based upon the province sole proprietorship or partnership business get registered. Hence, it is mandatory to establish a national central governing body to manage all sole proprietorship and partnership businesses within the country and to vest the said power to respective provincial councils with equally applicable law and common procedure despite their geographical dispersion.

Therefore, it is a high time to reform the domestic substantive and procedural laws pertains to sole proprietorship and partnerships in order to remedy existing loopholes and to upgrade the respective domestic sole proprietorships and partnership laws to cater the modern changing business and social needs.

VII. CONCLUSION

In modern legal context even though sole proprietorships and partnerships does not acquire any juristic personality nor treated as legal entities but in certain circumstances they feature hybrid characteristics of both natural persons personality as well as corporate legal personality. Notwithstanding above in other jurisdictions these entities were permitted to acquire, hold, dispose properties and to sue and be sued under the entity's name. Therefore, modern domestic law had failed to clearly identify and differentiate the sole-proprietorship and partnerships characteristics which differ from company law principles or any unique features only exist with sole proprietor and partnerships. Consequently, sole proprietorships and partnerships acquire quazi juristic personality. Further with the above analysis it can be observed that sole factor of differentiating sole proprietorship, partnership against companies are not purely the concept of personal liability but the level of application of personal liability either it ends at the entity's boundary by limiting personal liabilities of shareholders to their share investment or whether entity liability goes beyond the entity's boarder and makes the sole proprietor or partners becomes vicariously liable for all forms of obligations of the entity. Therefore, level of application of personal liability and the scope of personal liability shielding acquired by the investor becomes the detrimental conceptual element to differentiate these two categories of entities. The current substantive and procedural laws pertain to the sole proprietorship and partnerships were curiously absent from the statutory development purviews and such reforms are long overdue. Hence, prevailing laws not adequate to cater the present and future sole proprietor and partnership complexities and dynamics and ripe for reforms.

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