

Practical issues in conducting a joint entrepreneurial activity under special partnership agreement (agreement on joint activity)

Preamble

Special partnership (or agreement on joint activity) (hereinafter from time to time referred to as the “Special partnership”) can serve as an effective form of conducting joint business activity by entrepreneurs in every sector of economic activity. The Kyrgyz laws allow entrepreneurs and business corporations to choose a suitable scheme of relationships to achieve common goals. One of those ways is to enter into a special partnership agreement. As part of this article the advantages and some problems that may be encountered by entrepreneurs in practice when conducting their activities under the Special partnership, shall be considered.

Advantages of the Special Partnership

Special Partnership participants. The special partnership agreement is an agreement of two or more entrepreneurs (commercial organizations) who undertake to pool their contributions and act together for commercial and other lawful purposes. In doing so, the Kyrgyz laws allow establishing a Special partnership without incorporation of a legal entity, i.e. there is no need for the Special partnership to register with the competent state authorities. However, it should be noted that in order to conduct activity on the basis of the Special Partnership, the individuals, participants of the Special partnership have to acquire a status of individual entrepreneur. Commercial organizations can also be participants of the Special Partnership¹.

Common Property of the Special Partnership. The property contributed by the Participants of the Special Partnership, owned by them as per the right of property as well as products produced as a result of joint activity and revenues derived from such activity shall be considered as their common shared property unless otherwise provided by law or a relevant agreement². Consequently, in the absence of a specific legal provision or a relevant agreement between the parties to the Special partnership, the common property of the partnership is managed on the terms of equity ownership. Therefore, the profit received by participants of the partnership as a result of their joint activities, shall be distributed in proportion to the value of the participants’ contributions of participants, unless otherwise provided by relevant agreement of the parties to the partnership³. It follows from this provision that participants of the Special Partnership have the right to independently determine the terms of distributing profits derived from joint business activities.

General Management of Special Partnership. The current legislation of the Kyrgyz Republic permits to establish a certain procedure for general management of Special partnership providing a relevant agreement is reached by the parties to the Special partnership. Thus, under Article 973.1 of the Civil Code of the Kyrgyz Republic it is provided that «*General management of the partnership is performed according to a procedure stipulated by the agreement*». Moreover, the laws of the Kyrgyz Republic provide for three ways to conduct general management of the Special partnership: (i) each party is entitled to act on behalf of all parties unless otherwise is provided by the partnership agreement; (ii) through joint conduct of business, which requires

¹ Article 970 of the Kyrgyz Civil Code

² Article 972.1 of the Kyrgyz Civil Code

³ Article 977 of the Kyrgyz Civil Code

consent of all parties to the partnership to conduct each transaction, which on the one hand, shall reinforce control over the assumption of any liability in respect of the Special partnership but, on the other hand, complicate the partnership's work; (iii) through the appointment of individual members, authorized to administer the partnership, including making transactions on behalf of the partnership. The powers of the participant shall be certified by the appropriate Power of Attorney issued to the participant by the other participants of the partnership or provided by the Special partnership agreement⁴. We believe that in order to more effectively administer the partnership, it is reasonable to assign one of the partnership's members to administer the Special partnership. Thus, for instance, the partnership members are entitled to oblige a specially authorized participant to agree upon the essential terms of material transactions with other participants of the partnership (for example, the amount of compensation for rendered services or the volume of work), and compel such party to ensure a proper execution of transactions by Special partnership, including promptly resolve any issues arising with contracting parties during such execution.

Contributions of the Special Partnership Members. One of the essential conditions for establishing the Special partnership is to pay up contributions by its participants. Under Article 971.1. of the Kyrgyz Civil Code it is provided that "*The partner's contribution is deemed to be everything contributed by him into common cause, in particular, funds, other assets, professional and other knowledge, skills as well as business reputation*". It follows from this provision that members of the Special Partnership may contribute funds, other movable property, land and other immovable property, professional or practical knowledge as well as business reputation and goodwill into common business.

Certain Problem Aspects of the Special Partnership

Transfer of Movable Property as Contribution to the Special Partnership. As the Special partnership operates without state registration as a legal entity, and therefore has no other bodies to administer the partnership as well as a stamp or seal or other means of identification, a question arises how to certify the transfer of contributions to the Special Partnership. The current laws have no provisions with regard to the procedure of registration the contributions transfer of the Special Partnership's participants.

Transfer of Immovable Property as a Contribution to the Special Partnership. If a participant of the Special partnership wishes to transfer his immovable property in order to ensure the activity of the Special partnership, certain difficulties may arise in registration of transfer of rights with respect to the property. Given the particular form of establishing the Special partnership and the fact that the regulatory and legal acts of the Kyrgyz Republic, governing the state registration of transactions with immovable property do not expressly provide for grounds and procedures for registration of immovable property transfer as a contribution to the special Partnership, the authorities of state registration of rights for immovable property when applied by the parties concerned, have the right to refuse to register such a transaction due to the lack of appropriate registration procedures. If such a problem is encountered, the partnership's right to contribute their immovable property for development of their common business is actually limited, and therefore, we believe that in order to establish a uniform procedure for state registration of such transactions, the relevant amendments should be made to the laws on state registration of transactions with immovable property.

Accounting Problems in the Special Partnership.

⁴ Articles 973.1, 973.2 and 973.3 of the Civil Code of the Kyrgyz Republic

- (i) The Kyrgyz laws provide that keeping accounts of the common property of the Special Partnership members can be assigned by them to one of the legal entities⁵, participating in the partnership. Subject to Article 211.1 of the Civil Code of Kyrgyz Republic, the party charged to keep accounting of the Special Partnership under the agreement, shall keep a separate accounting of principal activity of its company and the activity of the Special partnership. However, the tax laws of the Kyrgyz Republic do not stipulate the ways of recording the contributed assets in the accounting documents of the Special Partnership as well as documenting the distribution of the profits gained by the participants. In addition, it is unclear how to certify recording as receipt of funds due for services or work performed by the Special Partnership. As the laws of the Kyrgyz Republic do not provide for specific requirements to document financial transactions of the Special Partnership, we may assume that the accounting documentation is to be drawn by the authorized participant and the receipt and expenditure of such funds shall be certified by the signature of such participant. We believe, that in order to avoid a diverse interpretation of the issues relating to accounting of the Special Partnership it is necessary to work out a regulatory legal act which would provide precise requirements to keep the books of the Special Partnership including requirements to draw the primary accounting documents of the partnership.
- (ii) In addition, the review of the abovementioned legal norm which provides that accounting of common property of the Special Partnership participants can be assigned to *one of the legal entities (highlighted by me)*, participating in the partnership, does not state how to keep accounting of the Special partnership with participation of the individual entrepreneurs. Does this mean that if the parties to Special partnership are individual entrepreneurs, they are not obliged to keep accounting of the partnership activity or is there a specific accounting procedure for such partnership? Article 58.2 of the Civil Code of the Kyrgyz Republic provides the following: *“The rules of this Code which govern the activities of the legal entities that are commercial organizations, are applied to business activity of the citizens performed without registration as a legal entity, unless otherwise provided by the law or legal substance”*. In this connection it can be concluded that accounting of the common property of the parties to the partnership, who are private entrepreneurs, can be assigned to one of the entrepreneurs participating in the partnership.
- (iii) As the Special partnership receives income during joint business activity and therefore certain tax obligations may arise with respect to such partnership as well as an obligation to keep proper accounting of such activity, in case the partnership violates the accounting procedures, it shall be held liable provided for by Kyrgyz laws. Thus, for instance, under Article 346.2 of the Kyrgyz Code on administrative responsibility, the lack or misstatement of accounting, failure to provide accounting reports, balance sheets, calculations and other documents relating to calculation and payment of taxes to state budget shall be punished by an administrative penalty equal to 20 (twenty) calculation indices⁶. In our view, in order to eliminate any misunderstanding with regard to accounting of the Special partnership activity, it is necessary, as it was noted above, to work out a legal standard act, stipulating the regulations of keeping accounting for Special partnership.

⁵ Article 972.2 of the Kyrgyz Civil Code

⁶ As of today the amount of calculation index is 100 soms.

Some Tax Liabilities. If one of the participants contributes into common property a plot of land on which a tenement house is constructed, under Article 334.2 of the Kyrgyz Tax Code with respect to such plot which is in the common ownership of several individual, each of these individual shall be liable to pay land tax as per shares stipulated by the entitling documents for such plot or a relevant agreement of the parties.

Family Rights Protection. In case of purchase of an apartment in the built block of flats by spouses, it should be noted, that in order to conclude a transaction, the consent of both spouses must be obtained. Thus, in order for a spouse to execute the transaction which requires notarization and (or) registration as per procedure established by the law, it is necessary to obtain a notarized consent of other spouse. The spouse, whose notarized consent to such a transaction has not been received, is entitled to demand the invalidity of the transaction by the court within three (3) years from the date when he (she) learned or should have learned about such a deal⁷.

Responsibility of Special Partnership Participants on Common Obligations. The laws of the Kyrgyz Republic provide for two types of liability of the partnership participants on general obligations that arise as a result of joint activities.

- (i) If the Special partnership *is not related to entrepreneurial activity*, each participant of the Special partnership shall be responsible for shared contractual obligations, i.e. responsible for such obligations with all his property in proportion to the value of his contribution into common cause. As to joint obligations which arose not from the agreement, the partnership participants bear joint responsibility⁸. The notion of joint responsibility is set out below.
- (ii) If the Special partnership *activity is entrepreneurial*, its participants shall bear joint responsibility⁹ on joint obligations. That means that a contractor, i.e. a party to a transaction concluded by the Special Partnership shall have the right to demand from any participant of the partnership to perform his obligation either in full or in part of breach of law. The participant of the partnership that fulfilled the demands of the contractor has the right of recourse against other participants in equal shares with deduction of his share¹⁰. Thus, for example, if during construction of the apartment house with participation of two or more legal entities or entrepreneurs, the apartment's buyer was caused damage in the form of a crack on the walls of the apartment or leaky roof, the partnership participants shall bear joint responsibility with regard to such damage. That means that the Special partnership participants involved in the construction of the apartment shall be liable with all their property and must fully indemnify for losses. However, the partnership participants can determine another procedure of mutual settlements with regard to reimbursement of caused damage among themselves by concluding a relevant agreement¹¹.
- (iii) In addition to the issue on the Special partnership liability we should note the following. The entrepreneurs who plan to undertake joint entrepreneurial activity should keep in mind that participants of the Special partnership are responsible for all obligations where the debtor is the Special Partnership. It follows from the aforesaid analysis of the Kyrgyz laws that the Special partnership participants have heightened responsibility. Whereas, for example, in case of conducting

⁷ Article 36.3 of the Family Code of the Kyrgyz Republic

⁸ Article 313.5.5 of the Civil Code of the Kyrgyz Republic

⁹ Article 976.2 of the Civil Code of the Kyrgyz Republic

¹⁰ Article 313.5.5 of the Civil Code of the Kyrgyz Republic

¹¹ Article 313.5.5 of the Civil Code of the Kyrgyz Republic

entrepreneurial activity by participating in the limited liability company (hereinafter “LLC”), the LLC’s participants are not liable for obligations of LLC and bear a risk of losses related to the activities of the LLC limited to the value of their contributions¹², i.e. the liability of the LLC’s participants is limited.

Law proceedings with participation of the Special partnership. If controversies arise between the Special partnership and its contractors, considering conditional establishment of the Special partnership and the established procedure for judicial protection of the contractors’ rights, or any other interested parties, difficulties may arise in filing the statement of claim on the protection of violated rights in the court. The court has the right to refuse acceptance of the statement of claim, for example, for recovery of damages resulting from the construction of the apartment of wrong size or the location of this apartment, for instance, not on the third floor, but on the ninth, because the civil procedural laws of the Kyrgyz Republic do not provide a procedure for acceptance of claims in respect of the Special partnership. I suppose the court will take action against one of the participants of the Special partnership, and he, in turn, will be able to sue the other participant in the partnership as a co-respondent.

Conclusion. The above review of the current laws of the Kyrgyz Republic shows that subject to improvement of the Kyrgyz laws, the Special partnership can serve as an effective tool for regulating legal relations of entrepreneurs in their joint activity. Thus, subject to appropriate additions to the laws on state registration of transactions with immovable property in order to certifying the fact of contributing plots and other immovable property into common property of the Special partnership, its participants shall be able to organize more profitable business. In case of adopting a normative legal act providing the rules of keeping accounting of the Special Partnership activity, the entrepreneurs shall be able to avoid all sorts of claims and misunderstandings from tax authorities.

¹² *Article 127.1 of the Civil Code of the Kyrgyz Republic*