

An Update on Limited Liability Partnerships Michael Archer, March 2007

From material originally presented to ACE members at a seminar on 28 June 2000 by Michael Archer, updated for an ACE Seminar 20 June 2001, and last updated March 2007.

Limited Liability Partnerships - To be or not to be?

For a long time this question concerned whether the law would ever come into force. But then the Limited Liability Partnerships Act 2000 came into force on **6th April 2001**. From that date you could start to practice as a limited liability partnership. The Act is supplemented by the Limited Liability Partnership Regulations 2001 (S.I.1090).

Additional regulations apply:

- to prevent use of LLPs for tax avoidance; and
- to define accounting standards for LLPs.

The second element of the question is whether anyone wishing to practice should become an LLP, or convert to an LLP if they are an existing practice. In order to answer that question it is useful to analyse first of all what business structures currently exist. This will put LLPs in their context.

Existing regime

The main possibilities for other structures are:

- limited liability companies
- companies limited by guarantee (rarely found, but the ACE is an example of one)
- sole proprietors (that is individuals who are in business in their own name and in their own right) and
- partnerships (that is two or more persons in business together).

Of these, it is partnerships that are of course relevant to consider in the context of limited liability partnerships and whether LLPs offer an attractive alternative. You need therefore to consider the features, good and bad of partnerships, which provides the background and explains why a new business structure is about to come into being.

Before doing so, I should say at this point that those who practice as sole practitioners may wish to form themselves into an LLP in order to take advantage of limited liability while still being able to practice on a self-employed basis. Another partner will need to be found – but this can be a spouse or simple limited company.

Partnership issues

Features of partnerships can be regarded as unattractive features. Joint liability of the partners for the debts and obligations of the firm; joint and several liability for acts and defaults of the firm, any one partner or its employees (eg. negligence). That means that each partner can be liable for the whole and sued individually rather than together. Continuing liability after retirement. This means

that after retirement, there can still be liability with regard to those liabilities incurred while a partner. These can arise after a person has ceased to be a partner. It means a retired partner has to rely on those continuing the practice to continue professional indemnity insurance at sufficient levels and to be able to provide an indemnity to him.

But it is not all bad. This may explain why partnerships have continued to exist. They can keep their accounts private. There is no requirement for an audit or audit disciplines. They provide a flexible management structure which the partners can define for themselves in their partnership agreement. They enjoy favourable tax treatment, the partners are self employed and changes to profit sharing ratios and transfers between partners are often ignored as taxable transactions because they are subject to Inland Revenue concessions.

Why change?

What are the other reasons for partnerships considering changing from their current structure to something different? Obviously liabilities are a key aspect to that decision. Professional indemnity claims show an increasing trend. This brings a need for partners to safeguard their personal assets and protect themselves from the risks that they personally face in running their businesses. There is also the size of firms to consider in that partners may not know each other. They may be one in a firm with hundreds of partners. Firms are also more diversified, with greater specialisation, so that partners may not know what type of activity is being conducted in other parts of the firm and what risks may be associated with it. Added to this, in the construction industry, construction professionals are faced with an aggressive market place where, before even starting work, often difficult negotiations take place on terms of appointment under which issues of liability, indemnities, and warranties are being dealt with and where thoughts about who might be liable if something goes wrong on a construction project are in the forefront of everyone's mind.

Limited Liability Partnerships

It is these issues that have caused pressure on government (promoted principally by the major accountancy practices) to create a new law proposing a structure where partnerships can continue, but with limited liability protection.

It is achieved by the LLP, just like a company, being incorporated as a separate legal entity. Thus it is the LLP that will continue the business and will trade with its clients/customers. The members, (ie. the former partners), are agents of it and can commit it to its contractual dealings. Limited liability is achieved because, if the business fails, it is the assets of the LLP which are at risk. Creditors cannot get at the personal assets of members. Members risk only what they have invested in or committed to the LLP – eg. capital and undrawn profit.

There is an exception to the above – the clawback. This operates where the LLP has gone bust, and the members of the LLP have been taking out drawings when the LLP was in fact insolvent. This is explained under '*Duty of good faith*' below.

The relationship between members and with their LLP will be governed by the Members Agreement which enables members to make their own terms just as they would with their partnership.

Membership

The Members Agreement would deal with the terms under which someone becomes a member, remains a member and conducts themselves as a member, and cease to be a member. It can also prescribe the authority of a member to commit the LLP to contracts.

Incorporation

The process of creating an LLP is simple. There needs to be a minimum of two participants. Thus, for the sole proprietor engaging in business, if he wishes to take advantage of the limited liability protection afforded to LLPs, what he needs to do is to find a partner (even if this is a limited company as a nominee).

An incorporation document is prepared which essentially is an application to the Registrar of Companies to register the LLP. There is a compliance statement which is signed. The name of the LLP with its registered office, names and addresses of members are given and those members who are designated members will be identified. Designated members are those who have particular filing responsibilities similar to the company secretary, or nominated partner at present who may sign the firm's tax return.

After submitting the application, the Registrar will then issue a registration certificate and from that point the LLP is formed.

There are then ongoing filing requirements with the Registrar of Companies.

Other filing requirements

These include an annual return in which details of members are given and any changes to members will be notified to the Registrar.

Publicity of accounts

The members will have the right to see accounts of the firm. There are particular requirements as to the contents of the accounts. These will show the average number of members, aggregate of members' capital, members contributions to capital and the average amounts of capital they have drawn within the accounting period.

Accounts will need to be audited if the thresholds for a small 'company' are exceeded. Currently these are net assets of £2.8 million and turnover of £5.6 million. For small firms, no audit will be required. Auditing will give rise to additional disciplines and costs which you should discuss with your current accountants.

Publicity of accounts and other financial information

Where profit exceeds £200,000, the firm must disclose in its accounts what profit was taken by the highest existing member. Accounts will need to show a 'true and fair' view of the accounting position of the firm and will need to conform to different accounting standards. Thus, they may show a different picture to that shown by the partnership's accounts. This is particularly the case as regards liabilities – the expected liability to pay annuities to retired partners, the liability that reflects the firm's holding of vacant office space, an anticipated shortfall from a professional indemnity claim, or pension scheme deficits etc. These will need to be provided for in the accounts and could, with some firms, mean that the accounts they publish (and show to their clients) show a less rosy picture.

The Members' Agreement

The preparation of the Members' Agreement will require some careful thought and advice. Given that there is no underlying structure which members of an LLP can rely on to establish the terms of their relationship between each other and the LLP itself, the Members' Agreement is essential.

There are however provisions in the LLP Regulations which provide default terms. Can you rely just on these and avoid the expense of preparing your own Members' Agreement?

Default provisions

Unless you have a contrary provision in your Members' Agreement the default provisions will provide the following:

- Equal sharing of the capital and profit in the LLP.
- An indemnity from the LLP to the member in respect of liabilities incurred by the member as agent in conducting the LLPs business.
- A right to manage the LLP, but no right to be remunerated for management.
- Unanimity in terms of voting between members on certain key issues such as varying shares of members and varying the business, but majority voting is required on ordinary issues.
- A right of members to inspect financial records of the LLP.
- A duty of each member to inform the other members of all matters affecting the LLP.
- A duty of a member to pay over profits derived from a competing business.
- A duty to account for benefits derived from the LLP.

Unsuitable?

These default provisions may not be suitable or sufficient in most cases. The Members' Agreement will need to have details of how meetings and votings are conducted. Remember that the LLP is a separate entity and whether it has or has not agreed to a particular matter may need to be demonstrated. The default provisions do not say how decisions are to be made. You decide your own rules but you will need to record your decision making properly. The assumption of equality is rarely found in firms where partners have different levels and different profit shares and different contributions to capital. In addition, there are no default retirement provisions and most Members' Agreements will need to deal with this so as to provide for payment out of capital, undrawn profit etc.

Members' Agreement continued

There is also the question of whether there should be a limit imposed on the authority of a member. Certain members may have their authority restricted in committing the company to employ new staff, to enter into long term commitments like leases etc. In addition, the management structure of the LLP can be set out and the powers of authority internally established. Restrictive covenants may also need to be imposed on members to prevent them from competing with the LLP after leaving the LLP. The profit shares will also need to be established and sometimes these in partnerships can be quite sophisticated. Treatment of capital becomes an important issue with an LLP and may need to change accepted practice in a partnership. Does capital include undrawn profit from previous years? Can it be reduced? Can it be treated as a loan to the LLP and withdrawn at will?

As far as retiring members are concerned, they will want to ensure that they are provided with an indemnity with regard to any previous liabilities incurred when they were partners. In addition, they will want to be indemnified by the firm for claims made against them in their own capacity and for the firm to continue to maintain professional indemnity insurance to cover that risk. But how far will the

indemnity go? Should continuing members provide personal indemnities? If not, does this mean that the chain of indemnities previously given stops at the door of the last partners?

Minority protection

This is a feature of the legislation which imitates that found in companies legislation. It involves the right of a member who feels that the LLP has been run in a manner unfairly prejudicial to its interests to petition a Court for relief. This can happen where, for example, a member has been excluded from management or decisions are being made contrary to his interests. While it is not possible to exclude the right of a member to petition for unfair prejudice in such circumstances, it does emphasise the importance of the Members' Agreement which should deal with most issues like this which can be anticipated. It would for example, for a locked out member, who has been refused a say in management and effectively dismissed from the firm, provide for the repayment to him of his entitlement, whether this be his undrawn share of the profit and his capital, or the value of his interest in the LLP, by these continuing members.

The default provisions give a member a right to a say in management. This means that excluding a member in this way, or suspending a member, even while their notice runs out, would not be possible unless the default provisions were excluded.

Insurance

Professional indemnity insurance in the same manner as before should be maintained for the LLP because the firm will need to protect itself. Insurance should also extend to the members themselves in case they are sued for their personal negligence. This is still a possibility, although any claimant seeking to establish that a member of an LLP has been personally negligent will have to prove such a claim. They will need to demonstrate that they have relied on that particular member's advice. Such claims obviously are more difficult to make the larger the size of the firm. The converse is true. A member would be in the same position as that which would apply where a claim for negligence was made against a Director of a limited company. The Members' Agreement should therefore provide an obligation to maintain insurance and to provide an indemnity. This obligation may need to extend after the member has left the firm.

In addition members of an LLP ought to take out Directors and Officers Insurance. Although this is something that could be considered as a partner within a firm, it is more relevant for members in an LLP, just as it would be for directors of a limited company, because there are statutory requirements and statutory offences affecting members from which they may need some protection and cover, in terms of legal expenses, for any defence of such proceedings. It may find its way into different hands – different members, also into the hands of receivers or liquidators, if the firm failed, who may review the conduct of the members to see if they have caused it to fail or to see if they should incur some liability. For this reason, care may need to be taken in the drafting of the Members' Agreement so that obligations that are intended to govern the relationship between members are not used by the LLP (in whoever's hands it is) to bring a claim against a member.

Duty of good faith

Members are agents on behalf of the LLP and therefore will owe a fiduciary duty to the LLP. This duty is a strict one and if breached makes the member vulnerable to creditors' or liquidators' claims.

Clawback

There is a clawback provision in the legislation where if members have been taking out drawings from the LLP at a time when the LLP is insolvent they can be asked to repay those drawings. The

clawback claim is made by a liquidator and he can attack any drawings, made in such circumstances, within two years' prior to the liquidation of the LLP. Such clawback has similarities with a claim for wrongful trading made against directors of limited companies. However, it is much more narrowly defined and, following representations made by us to the DTI, is limited only to those drawings which are shown to have been taken out at a time when the member knew the LLP was or would become insolvent. (Previously it had been suggested that the whole of the previous two years' drawings may be subject to attack).

Salaried members who are officially members have a particular interest in knowing the financial status of the LLP at all times since they will be vulnerable to the claw-back even if the LLP had contracted to pay them such drawings.

We will see later that a salaried member may have that title but not in fact be a member officially.

The concept of 'wrongful trading' will apply to members of an LLP too. As with directors of a limited company, members who continue to trade knowing that the LLP was heading for insolvency and this caused creditors to lose their money may be required by the liquidator of the LLP to pay a sum of money to the LLP in liquidation. This will be unconnected to the drawings the member had taken out.

Becoming an LLP

The procedure is very similar to that applying where a partnership incorporates as a limited company because there you have a separate legal entity and you need to transfer the business and all its assets into that new entity. Thus similar issues that arose in relation to companies also arise on the incorporation of an LLP. Those issues include the following:

- **Current engagements/appointments/collateral warranties.** Ideally these need to be novated so that the partners are released from liability. In practice this is often not possible given the number of contractual arrangements that there are. The best that can be done may be simply to assign them. This will not relieve the partners of their liability if there should be a breach of contract claim. In addition, some engagements may not be assignable or the clients may refuse assignment and they may have to be continued in the name of the partnership with the LLP doing the work.
- **The transfer of assets** will be subject to a transfer agreement identifying the assets and providing for an indemnity to the partners in respect of liabilities – both trading liabilities and any other
- **Liabilities** that may have arisen out of the previous operations of the partnership. This indemnity may go further and indemnify the partners as regards their personal liabilities to retired partners, but it is an issue to consider to what extent new members of the LLP will provide counter-indemnities to the previous partners too. If they do, this dents the liability protection afforded by the LLP in the first place. If the chain of indemnities ceases on incorporation however, those who are the last partners would only be able to look to the assets of the LLP.
- **Commercial agreements.** These need to be novated or assigned in the same way.
- **Leases.** Need to be assigned or the premises formally sub-let. This will require the licence of the landlord. Firms are recommended to do this properly so as to preserve their security of tenure and rights to compensation. This is much more important these days. Before when businesses were desperate to get out of their leases in the recession this was less of an issue.
- **Employment issues** also need to be considered because TUPE applies and this requires firms to inform and consult staff and elect on behalf staff representatives prior to transfer. For larger

firms, procedures for this may already be set out in an information and consultation agreement with their staff.

- **Debtors.** These may need to be collected by the LLP on behalf of the partnership or assigned.
- **Bank security.** Obviously new facilities obtained from the bank will need to be repaid and the LLP will then at the same time take out equivalent facilities. This means that the LLP itself must apply to the bank for those facilities. The bank may ask for security to be given by the LLP by way of a fixed and floating charge.

Drawbacks

So what may prevent a partnership now from deciding to incorporate as an LLP given, the flexibility in creating a partnership governed by one's own terms and the additional benefit of limited liability.

These are some suggestions.

Client/supplier reaction – what will your clients, suppliers, bank and landlord say when you tell them about incorporation as an LLP. Isn't the only reason for incorporating as an LLP to limit liability? They will therefore be the ones who are adversely affected. Will they agree to deal with the LLP in the future?

Bank security – the fact that the firm is likely to be asked to give a fixed and floating charge to the bank means that the bank is then in a preferred position as creditor and shifts the balance of negotiating power, should the firm fall on hard times and seek renewal of its facilities or an extension to them. The bank may be more inclined to put in a receiver to safeguard their security rather than having to let the partners trade out of a difficult patch. In addition, the bank may ask for personal guarantees from the members. This also of course dents the limited liability protection.

Leases – the landlords may also require sureties from members to guarantee the lease liabilities. While these are obviously disadvantageous, they should not place members in any worst position than they would be in as partners and may provide an opportunity to negotiate proper terms of release in the event of retirement.

Salaried partners – present a particular problem. Will they be members or not? Initially, when there is a transfer of the practice to the LLP, they should not be a member. This is because the tax exemptions that are allowed on the transfer only apply where the same people are equity partners and members. The salaried partners will have to be appointed as members shortly afterwards. That is, if they are to be 'officially' members of the LLP, i.e. registered as such with Companies House. But they will have to sign an agreement with the LLP covering those terms that apply to them as 'member' if they are to be 'officially' members.

If the salaried member is a member "officially" then the Inland Revenue have indicated that they will be treated as self-employment, as far as their tax status is concerned. However, the Act indicates that, if there has in reality been no change in their status, they will still be treated as employed. This area will need some clarification in the law. Care should be taken to avoid creating a "hybrid" position for a salaried member where their rights and status are confused.

However, as with the title of director in a company, often the person holding that title is not actually a Board director as such because he is not appointed as a director and notified to Companies House. It is only a title. So 'member' can also be a title.

Publicity – obviously the publicity of accounts and financial information concerning the LLP is a disadvantage. However many firms are required by their clients now to send copies of accounts so this may not matter to them.

There is a requirement to disclose personal details of members such as their names and residential addresses. Members may not like the idea that the outside world know where they live.

Financial audit. The LLPs accounts may require an audit if they exceed the audit threshold. This will result in additional cost. It may also mean that the financial standing of the firm may change from that revealed by the partnership's accounts.

There is also the question of status and title. Partners will become known as 'members'. Many LLPs appear to want to continue using the term "partner". This can be confusing.

Obviously LLPs are a lot more regulated than partnerships, with all the filing required of details concerning the LLP, but these are less extensive than with companies.

Does the partnership ethos change? The fact that partners must face their liabilities together can be regarded as a strength. If there is no personal liability outside the LLP, will partners feel less constrained to stay with the firm? If one member is sued personally, and the LLP is no longer there, is that member left on their own to meet such a liability? That is what would happen, unless something was included in the members agreement. Careful advice on this issue will be needed.

To be or not to be?

Thus, compared with companies LLPs present greater flexibility, are more tax advantageous (in that the partners preserve their self-employed status). Like companies the principals enjoy limited liability protection. Balanced against this is increased regulation.

LLPs are likely to prove popular with the professions and will also be a useful vehicle to use for joint ventures and sole practitioners.

Beale and Company LLP guidance

Visit our website for further information on LLPs including a review of the drawbacks with LLPs which will help you decide whether the LLP is a suitable vehicle for you. Also, a questionnaire to help you organise your Members' Agreement resolve the main issues which we believe your Members' Agreement should cover.

Some information about Beale and Company

- We have been advising professional practices in construction industry for over 40 years.
- We are a full service law firm advising business clients and covering corporate/ commercial work, business advice, employment law, property as well as dispute resolution, professional indemnity claims and litigation/arbitration/adjudication.
- We have acted for many firms incorporating as companies – from the largest to the smallest in the industry.
- We have contributed to the Government's consultation process on LLPs.
- Michael Archer is a member of the Association of Partnership Practitioners.
- We are contributors to 'Building' magazine.

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