

Chapter 4 Choosing an Appropriate Business Structure

Adopting a limited liability model

Use of LLPs

4.1 LLP status has a number of advantages over a partnership structure, including the following:

- (a) *Limited liability* – by far the most important benefit is that only the LLP will be responsible for its own contractual obligations and only a member who is personally negligent will be potentially exposed to claims in tort, and even this may perhaps be eliminated or significantly reduced through carefully worded engagement letters. This is of course the key reason for adopting an LLP structure.
- (b) Like a company, an LLP will be able to contract in its own name so that there will be no need to deal with novation of contracts every time partners retire or are appointed. Neither will there be a complex web of indemnities between generations of partners (see **CHAPTER 2**).
- (c) The LLP will have unlimited capacity (see **3.3**), including the ability to grant floating charges.
- (d) The tax position of members of an LLP is very similar to that of the partners in a partnership. In order to benefit from some of the advantages of practising through a body corporate, individuals who are accustomed to practising through a partnership may feel more comfortable transferring the partnership business to an LLP, rather than a company.

However, there may be a number of reasons why a firm will decide not to convert to an LLP (which is the short-hand phrase often used to describe the process whereby the partnership business is transferred to an LLP), and these are discussed in the following section.

What might prevent a partnership converting to an LLP?

4.2 Potential barriers to conversion include the following:

- (a) *Current partners* – most partnership agreements will require a very substantial majority before the partnership can dispose the whole of its business to an LLP (see **4.3** below), as a separate corporate body,

Adopting a limited liability model

and be dissolved. Some even require unanimity, and unanimity will be required if there is no partnership agreement. Is there a danger that a disaffected minority may use the exercise of an effective veto as a weapon in a dispute on something completely unconnected? It is important to think through the decision that will be required and how to achieve it.

- (b) *Retired partners* – in some (increasingly rare) cases, retired partners are entitled to an annuity from the current partners. Sometimes they are even given the right to a lump sum if the firm is ever dissolved or its business transferred, and this may give retired partners an effective veto. In these circumstances their agreement should be obtained, and ideally they should be asked to release the partners from their personal obligations in return for a covenant from the LLP. However, the obligation to pay the annuities will then have to appear on the LLP's balance sheet (see (e) below) and in many cases it may be appropriate for the members to retain the liability to pay the annuities personally out of their profit shares, with the LLP having no liability at all. Arrangements will have to be made to release retiring members and to bind incoming members.
- (c) *Banks* – banks are likely to have two levels of exposure, loans to partners individually to finance their capital contributions and facilities provided to the partnership itself. In an ideal world, from a limited liability standpoint, the bank would be asked to provide facilities to the LLP or company, rather than to each individual member who would then have a personal liability, and to release the partners personally from any continuing liability. However, banks may insist on security and on continuing personal guarantees from the partners. Their attitude will depend very much on their perception of the firm and its management. Many larger and better managed firms are often able to take facilities for the LLP without any requirement for personal guarantees, provided that the balance sheet of the LLP is strong enough.
- (d) *Landlords* – landlords generally have direct personal covenants from at least some of the partners, who, in turn, have rights of contribution from the other partners. In many cases, landlords will be reluctant to give up these rights and may insist on being given equivalent protection in the form of personal guarantees. Some far-sighted firms may have negotiated leases in a form which allows them to substitute an LLP as tenant unilaterally. Either way, the position of landlords needs to be considered.
- (e) *Accounts* – the requirement of filing accounts may be a major issue for many firms. Furthermore, the requirement that the accounts comply with UK generally accepted accounting practice may be a barrier to

Choosing an Appropriate Business Structure

conversion. For example, if provision has to be made on a capitalised basis for retired partners' annuities, or vacant property, will this make the LLP's balance sheet look so bleak as to preclude incorporation at all? Can the offending liabilities be kept off the balance sheet of the partnership and retained by the partners, or will this mean that the LLP does not provide sufficient protection to make conversion worthwhile? Can other steps be taken to address the problem? These issues need to be reviewed with the firm's accountants.

- (f) *Clients* – experience suggests that limited liability in itself is unlikely to lead to the loss of clients, provided that it is handled carefully. Clients tend to choose their professional advisers on the basis of the strength of the relationship and their track record, rather than because each partner will be jointly and severally liable if something goes wrong. But, especially if the firm is heavily dependent on a small number of major clients, it will be as well to sound major clients out before incurring substantial expense. The need to enter into new engagements with all clients post-conversion may be a daunting prospect, but is unlikely to be significant enough to be a barrier to conversion. While the process may be laborious, it can present a business development opportunity as contact is re-established with all clients.
- (g) *Tax and regulations* – more complex overseas structures may be required if LLP or company status is adopted. For example, a firm with overseas offices which incorporates as an LLP may find that it is treated as a company for tax purposes in some countries and the risk is obviously much higher where a partnership incorporates as a company. Companies and LLPs may also be prohibited from practising at all in others by local regulations. This may mean that the business in such jurisdictions will have to continue to be conducted in partnership. Running an LLP and one or more partnerships in parallel gives rise to a number of significant issues. How can it be ensured that clients know when they are being advised by the partnership or by the LLP? How can the 'holding out' risk associated with referring to all 'partners' by that term whether they are partners in the partnership or members of the LLP, or both, be minimised? How can profits generated by the partnership and the LLP be shared on a combined basis without tax and liability issues arising? How can those practising in the partnership be compensated for the loss of a right to a contribution to losses from those who are no longer partners in the partnership? How can the risk of double taxation be minimised? Major international professional practices have had to cope with these and many other issues when they have transferred the bulk of their practices to an LLP. Expert advice should be sought at an early stage.

Adopting a limited liability model

Incorporating an existing partnership business as an LLP

4.3 This will involve four key steps:

- (1) drawing up the members' agreement;
- (2) registration of the LLP;
- (3) transfer of the business of the partnership to the LLP; and
- (4) winding up the old partnership.

The steps to be taken to register the LLP are discussed at 3.5. Issues arising on drawing up a members' agreement are discussed in **CHAPTER 5**, together with a commentary on the model LLP agreement set out in **APPENDIX 5**.

Turning to the business transfer, the process of incorporation as an LLP is very similar to incorporating as a company.

Accordingly, the business of a partnership will actually have to be transferred to the LLP as a separate legal entity. This should make it much less likely that foreign courts will refuse to recognise the limited liability of an LLP, any more than they would in the case of a company, and contrasts with the situation in most states of the USA where application is simply made to register an existing partnership as an LLP.

The following issues arise as a result:

- (a) The assets which are to be transferred to the LLP must be identified and, if third party consents are required, the consents obtained. Plenty of time must be allowed in the conversion timetable to allow the consents to be obtained. Some assets may deliberately be left behind in the partnership – for example, it may be appropriate to leave some debtors in the partnership so that the cash eventually realised could be used to pay creditors (to the extent that the LLP does not undertake to pay creditors pursuant to the transfer agreement).
- (b) It will be necessary to identify liabilities and obligations of the partnership which are to be assumed by the LLP (and therefore reflected in its accounts), and any which are to be retained by the partnership. If a particular liability is to be transferred, in some cases it may be sufficient for the LLP simply to covenant to indemnify the partners in the partnership in respect of those liabilities. In other cases it may be desirable to ask the third party creditors concerned to release the partners in the partnership from liability, in return for a substitute covenant from the LLP. Unless creditors (like banks or landlords) release the partners from the partnership, they will remain at risk from personal claims even after incorporation as an LLP. This

Choosing an Appropriate Business Structure

means that there may have to be detailed negotiations with major creditors who may, in some cases, insist on continuing liability from the partners. Time must be built into the timetable to allow for this.

- (c) Clients will have to authorise the assumption of responsibility for client assignments by the LLP and to release the partnership. This provides an opportunity to regularise all client relationships, and to build in terms and conditions reflecting the fact that the LLP, and not its members and employees, are responsible for advice given to the client. It will be necessary to identify all clients with ongoing engagements or relationships. In order to avoid clients being troubled several times by different contacts, it will also be necessary to identify the relationship partner who will be responsible for managing the relationship with each client. The form and timing of communications with clients will need careful planning, taking into account the fact that the final decision to convert sometimes takes place only a few weeks or even days before actual conversion. In the case of law firms, the Solicitors Regulation Authority will expect former clients for whom documents or client monies are held to be informed of conversion. In the case of audit assignments, shareholder consent will be required. Where no authorisation is forthcoming, the partnership will have to complete that assignment (either directly or through the agency of the LLP). Again, the amount of time and resources required to handle client relationships should not be underestimated.
- (d) Employees of the partnership who are to transfer to the LLP will need to be identified. It is likely that all or most of the business of the partnership will be transferred to the LLP. In this case, it should be expected that all the employees of the business will transfer automatically to the LLP by operation of law pursuant to the *Transfer of Undertakings (Protection of Employment) Regulations 2006*. Under these regulations, the LLP will have responsibility generally for employees from the date of the transfer. It may be appropriate for the LLP to assume in addition all past liabilities of the partnership to employees. Where staff are employed by a service company, title to the shares in the service company will need to be transferred to the LLP and the service agreement with the partnership will need to be novated by the LLP. The details should be set out in the transfer agreement.
- (e) *Other contracts*. Contracts entered into on behalf of the partnership in relation to the operating requirements of the business may or may not require the consent of the third party to the assignment. Each contract will need to be identified and a decision taken about whether the contract is a material contract which should be novated by the LLP. Consideration should be given to the criteria for materiality and,

Adopting a limited liability model

in relation to each material contract, as to whether consent should be sought in advance of assignment to the LLP. For non-material contracts it may be appropriate for the LLP simply to indemnify the partnership in relation to ongoing obligations and (possibly) past obligations (although it should be noted that the former partners will then remain liable under the contracts). The partnership should hold the benefit of the relevant contracts on trust for the LLP. If contracts are still to be performed at the point where the original partnership is to be dissolved, then the assignment may need to be perfected at that time.

- (f) *Consideration.* If all the partners in the partnership become members of the LLP with interests in the same proportions, the ‘consideration’ for the transfer to the partnership will, for each partner, be his membership of the LLP. The transfer agreement will generally provide for each partner’s accounts with the LLP to be credited and debited with the sums previously credited and debited to the partnership. If the proportionate shares are altered at the time of conversion, or some partners are not to go forward as members of the LLP, this will need to be reflected in the transfer agreement.
- (g) *Stamp duty and VAT.* See CHAPTERS 22 and 23.
- (h) Regulatory issues may also be important. For example, if the partnership is a firm of solicitors, the LLP will need to seek recognition as a recognised body (see 3.17) and, if it is authorised under the *Financial Services and Markets Act 2000 (FSMA 2000)*, the *Consumer Credit Act 1974* or similar legislation, the same authorisation will have to be obtained for the LLP before it starts business. If the firm has overseas offices, it will need to think about local professional and tax rules.
- (i) Especially where the firm has overseas branches, taxation will be an important issue. It will be necessary to obtain local advice about whether conversion will involve any taxation on disposal of assets by the partnership or will affect the tax treatment of partners’ shares of profits and losses in the future. Tax clearances may be needed and, in some cases, may take months or even years to obtain.

While none of the above involves anything unduly complex, there will be a lot to do. Some tasks depend on co-operation from other parties (such as novations with landlords and suppliers). Other tasks depend on successful completion of earlier steps. A comprehensive project plan should therefore be prepared so that the critical path to completion can be mapped out and monitored and all deadlines met. Plenty of time needs to be allowed for third party consents, tax clearances and other matters outside the firm’s control, and sufficient flexibility built into the timetable and project plan to allow adjustments as matters progress.

Choosing an Appropriate Business Structure

A team needs to be established with responsibility for driving the project through, and a project leader appointed with overall responsibility for the project and the authority necessary to ensure that all fee earners, support staff and external advisers play their part. If there is no-one suitable within the firm, an external project manager may be desirable, and ideally he should have prior experience of LLP conversion. The team needs to meet regularly throughout the project so that all members understand how their contribution fits in and is affected by what others are doing, and vice versa.

Most firms find that this process has collateral benefits. Once a full list of clients, relationship partners, suppliers and so on has been established, it is relatively easy to keep up to date. Once engagement letters are in place, it is relatively easy to require and police complete coverage by engagement letters. Procedures and practices will need to be established to ensure that the firm's processes are maintained and improved beyond conversion.

The final act is to wind up the old partnership. In some cases, even after the business has been transferred to the LLP, the partnership may be left with assignments to run off, debts to collect, creditors to pay and potential exposure to past claims where the transfer of these assets and liabilities to the LLP is impossible or undesirable. Some issues may take years to work themselves out. Sometimes the old partnership may deliberately be left in place for years, so that it can deal with liabilities which are to be kept off the LLP's balance sheet, such as retired partners' annuities.

It will be important to agree before incorporating an LLP how the business of the partnership is to be wound up, and the insurance arrangements to be put in place to cover any residual liability in respect of professional indemnity claims against the partners. In practice, running off of the old partnership business is likely to be undertaken by the LLP as agent for the partners at the date of incorporation and it is important to ensure that the LLP has the necessary authorisations and access to sufficient finance to enable it to conduct this process efficiently and smoothly.

Use of companies

4.4 The benefit of a company is similar to that of an LLP, because third parties can generally only recover from the assets of the limited company (being a separate legal entity) and not from the personal assets of the non-negligent members of the company.

Even after incorporation, directors of a company whose personal negligence leads to loss may be personally liable jointly with company and negligent directors or employees may be liable either to the company under their employment contracts or to the aggrieved third party in tort. However, at least incorporation protects those other director shareholders who were not themselves involved in giving negligent advice.

Why are limited partnerships not used?

Directors, like members of an LLP, also owe fiduciary and statutory duties to the company and to third parties.

The tax treatment of a company is generally thought to be less favourable than is the case for a partnership or LLP and this is the main reason why companies have not been more widely used. These tax consequences are considered in **CHAPTER 20, TAXATION OF CORPORATE ASPECTS**. However, as noted in **CHAPTER 1**, companies are increasingly used in hybrid structures, and are sometimes incorporated by a partnership or LLP to conduct the part of its business which is most prone to professional indemnity claims (eg the audit practice of an accountancy firm). The shares are generally then held as a partnership or LLP asset. However, partial incorporation needs to be structured very carefully to ensure that a third party cannot argue, for example, that he thought he was dealing with the partnership or that the company itself has a claim against the partnership. Otherwise, the third party may be able to pierce the ring fence provided by the company. The company must ensure that it clearly operates discrete services on its own behalf and that it employs all persons providing advice on that area of the business itself, in order to minimise the risk of claimants piercing the ring fence that protects individual partners from claims after partial incorporation.

As noted in **CHAPTER 1**, typically professional partnerships have remained partnerships or have converted to LLPs, rather than companies. The key steps for conversion set out above are therefore described in the context of an LLP conversion, although many of the same issues would arise upon a transfer to a company.

Why are limited partnerships not used?

4.5 Limited partnerships are an important exception to the rule that all partners of a general partnership are jointly liable for obligations incurred by the firm, as is a limited partner in a limited partnership formed under the *Limited Partnerships Act 1907 (1907 Act)*. However, limited partnerships are very rarely used in a professional partnership context, for reasons that are explained below.

A limited partnership is no more than an ordinary partnership which satisfies certain characteristics required by the *1907 Act*.

A limited partnership must consist of one or more general partners and one or more limited partners. A general partner is liable for the obligations of the firm in the same way as a partner of any other partnership whereas a limited partner is generally only liable for the debts of the firm to the extent that he has agreed to contribute to its capital or has withdrawn capital from it. Under *s 4(2)* of the *1907 Act* a limited partner must contribute at least a nominal amount of capital to the partnership but there is no statutory

Choosing an Appropriate Business Structure

obligation on the general partner to contribute to the partnership capital. A limited partnership must be registered with the Registrar of Companies.

As a result of amendments made by the *Legislative Reform (Limited Partnerships) Order 2009*, from 1 October 2009, the information to be registered consists of:

- (a) the firm's name (which must end with 'limited partnership' or 'LP' or if registered in Wales, 'partneriaeth cyfyngedig' or 'PC' – each in upper or lower case with or without punctuation);
- (b) the general nature of the business;
- (c) the address of the principal place of business;
- (d) the full name of each general partner and each limited partner;
- (e) the term, if any, of the partnership, beginning with its date of registration; and
- (f) details of the sum contributed by each limited partner and whether paid in cash or otherwise.

Until 1 October 2009, it was thought likely that limited liability of limited partners is lost if the information held by the Registrar becomes out of date and/or inaccurate, by virtue of s 5 of the *1907 Act*. However, owing to an amendment made to s 5 under the *Legislative Reform (Limited Partnerships) Order 2009*, this now seems unlikely.

Generally speaking, there is no obligation to file accounts (unless all of the partners are themselves limited companies or unlimited companies whose members are limited companies), in which case the general partner will be (subject to certain exemptions) required by the *Partnerships (Accounts) Regulations 2008, SI 2008/569*, to produce and file a full set of accounts for the partnership. General partners can become limited partners, and vice versa, provided that the required details are registered, although a general partner who becomes a limited partner should take the same precautions as a partner in an ordinary partnership who retires (see 2.6). A company can be a general or a limited partner.

Section 6 of the *1907 Act* provides that a limited partner has no implied power to bind the firm, and cannot take part in the management of the partnership business. The partnership agreement can give express authority to the limited partner to act on behalf of the firm, in which case the firm will be bound by his actions in the same way as it would be bound by the acts of any employee or other agent. The danger from his point of view is that his actions will amount to management of the partnership business, thus forfeiting the benefit of his limited liability status. The *1907 Act* contains no definition of what is meant by taking part in the management of the partnership business, but it is generally thought that being involved in

Why are limited partnerships not used?

anything which amounts to an ordinary matter connected with the partnership business will be likely to amount to taking part in management. The draft legislation issued by the Department for Business, Enterprise and Regulatory Reform (BERR) in August 2008, as part of the consultation on the reforms to limited partnership law, set out a non-exhaustive list of activities which could be undertaken by limited partners without being considered to be involved with management. If this list of 'permitted activities' is introduced as part of the proposed programme of reforms discussed below, this will add clarity on this point.

If it were not for s 6 of the *1907 Act*, limited partnerships might be a very helpful way of limiting partners' liabilities; for example, it might be possible to form a limited partnership with a corporate general partner which also enjoyed limited liability. However, the fact that the limited partners are unable to participate in management has effectively prevented the use of limited partnerships for active professional partnerships and their partners.

A further concern is that a professional practice constituted as a limited partnership would almost certainly be a collective investment scheme for the purposes of s 235 of *FSMA 2000*, and would have to comply with the consequent regulatory requirements. The characteristics of a collective investment scheme are: (i) that the contributions of the participants and the profits or income out of which payments are made to them are pooled; and (ii) that the property in question is to be managed as a whole by or on behalf of the operator of the scheme.

Since limited partners are excluded from participating in the management of the affairs of the partnership, and the general partners are regarded as the operator of the scheme, a limited partnership will be a collective investment scheme unless exempted for constituting a particular type of arrangement. Such arrangements are listed in the *Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001* which rarely apply in the professional context.

If the partnership constitutes a collective investment scheme, the general partner must, unless it already has appropriate authorisation, seek authorisation under *FSMA 2000* to operate collective investment schemes. Alternatively, the practice of many general partners is to delegate the functions which constitute regulated activity to an appropriately authorised firm. Authorisation is generally sought from the Financial Services Authority, and this is a procedure which can take six months or more. Otherwise, the operation of the partnership will be illegal and the partnership agreement may be unenforceable.

In addition, the marketing of unregulated collective investment schemes (which would include limited partnerships) is very difficult within the UK regulatory framework unless marketing is limited to institutional investors only.

Choosing an Appropriate Business Structure

The Law Commissions' joint report on Partnership Law (Law Com No 283) proposed extensive reform of limited partnership law and, although the reforms proposed for general partnerships were not taken forward, the Government decided that the reforms for limited partnerships should be implemented. A BERR consultation document issued in August 2008 contained draft legislation intended to implement all of the proposed reforms, but, since then, BERR and its successor, the Department for Business, Innovation and Skills (BIS), have taken a less ambitious approach. On 1 October 2009, the first instalment of the proposed reforms was brought into effect by the *Legislative Reform (Limited Partnerships) Order 2009*, and it is intended that the other reforms to the limited partnerships regime will be introduced in two or three further instalments, although the precise scope and timing of the proposed reforms is still a subject for consultation.

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