



Limited Liability Partnerships

ABOUT ACCA

The Association of Chartered Certified Accountants (ACCA) is the largest global professional accountancy body, with over 250,000 members and students in 160 countries.

ACCA's mission is to provide quality professional opportunities to people of ability and application, to be a leader in the development of the global accountancy profession, to promote the highest ethical and governance standards and to work in the public interest.

This booklet is published in good faith for the benefit of ACCA members and their clients. Its contents are intended for general guidance only and should not be used as a substitute for undertaking further research or seeking professional advice in respect of each individual case.

Neither the Publisher nor the ACCA, including any of its employees, shall be held liable to any reader of this booklet (including any member or client of a member) for any losses of any kind, however they are caused, including, without prejudice to the generality herein, losses which are incurred by any reader (including any member or client of a member) in acting or failing to act, or advising or failing to advise a third party to act or refrain from acting, upon any guidance given or views expressed in the booklet.

No part of this publication may be reproduced, in any format, without the prior written permission of ACCA.

© The Certified Accountants Educational Trust (CAET 2001)

March 2001

ISBN 1 85908 343 9

Contents

PAGE 2	1 Introduction
PAGE 3	2 Background
PAGE 5	3 The Legislation
PAGE 6	4 Basic Features of an LLP
PAGE 7	5 Setting up an LLP
PAGE 11	6 Administration of LLPs
PAGE 14	7 Members of the LLP
PAGE 26	8 Accounting by LLPs
PAGE 31	9 Audit of LLPs
PAGE 33	10 Taxation of LLPs
PAGE 37	11 Insolvency
PAGE 39	Annex A, B & C

1

Introduction

PAGE 2

The Limited Liability Partnership (LLP) Act received the Royal Assent on 20 July 2000. The LLP format is available for adoption by businesses as from 6 April 2001.

The intention of this booklet is to introduce the main features of the LLP and to explain how it will differ in practice from existing business formats. It has been prepared for the benefit of existing firms which might be interested in converting to LLP status as well as those individuals and firms that are likely to be involved in providing professional services to LLPs. The booklet is written on the assumption that readers will be broadly familiar with the operational and disclosure rules

which apply currently to partnerships and companies.

Out of necessity, the references to the specific provisions of the LLP legislation have had to be summarised in the booklet. References are given to enable readers to access relevant documents for themselves.

For information, the abbreviation 'CA 85' when used in this booklet refers to the Companies Act 1985.

Background

PAGE 3

2

The LLP is a type of business vehicle which is new to the UK, although it is well established in the USA and has been available under legislation in Jersey since 1996.

The genesis of the LLP Act lies in the 1990s. During that decade, the increasing incidence and scale of actions against professional advisers for liability in respect of financial loss to stakeholders became a matter of acute concern. Audit firms in particular came to feel highly exposed, for two reasons.

First, since aggrieved creditors or investors of a failed company may seek redress against the company's

directors or its auditors, it was felt by many in the audit profession that they, who are likely to carry substantial professional indemnity insurance, were being specifically targeted by litigants regardless of the level of their fault for the loss claimed. The cost to firms of defending actions rose sharply in the decade – as did the cost of insurance.

Second, under English and Scottish partnership law, each partner is jointly and severally responsible for the liabilities of the firm. In the light of the increasing level of risk, it became harder for many in the larger firms to reconcile their firms' increasing size and specialisation with the traditional partnership

structure, in which all partners are agents of each other. Many felt that to require each partner in a large, highly specialised firm to accept unlimited financial responsibility for the actions of his or her partners had become an unrealistic proposition.

It was speculated that, given the huge sums which were increasingly involved in negligence claims, the continuing exposure of partners to joint and several liability could deter the most talented young accountants from entering the audit profession. Were this fear to be realised, it could, in the long term, damage the quality of UK auditing and, in turn, the whole of the financial services sector.

Background (continued)

PAGE 4

Towards the end of 1996, the then President of the Board of Trade, following concerted lobbying by large audit firms, committed the government to bringing in a law to establish the LLP as a means of addressing these concerns. On the change of government in May 1997, the incoming Labour administration adopted this plan and the work on drafting LLP legislation continued without interruption.

There has been extensive consultation with interested parties during the drafting process. The most important change which resulted from the consultation was to abandon the government's original plan to restrict access to

the LLP structure to large, regulated, professional firms. The presumption behind this proposed restriction was that, since it was the large, professional firms that had lobbied hard for the creation of the LLP, only firms in that sector needed to be considered as possible adopters of the new vehicle. It soon became apparent, however, that it would be unfair and restrictive to limit access to the new legal entity to firms with more than twenty partners and firms that conducted a particular line of business. It was, accordingly, agreed that the right to set up an LLP should be extended to firms of all sizes and which carried on business of any lawful type.

The Legislation

PAGE 5

3

The primary statute creating the LLP is the Limited Liability Partnership Act 2000 (the Act). The Act is supplemented by the Limited Liability Partnership Regulations 2001. Copies of both documents can be accessed via the HMSO website at www.hmso.gov.uk.

The Act and the Regulations do not create an entirely new body of free-standing LLP legislation. Much of the text of the Regulations in particular is taken up by specifying, in many cases with modifications, which provisions of other statutes, notably the Companies Act 1985, the Insolvency Act 1986 and the Company Directors Disqualification

Act 1986, are to apply to LLPs. For the benefit of those who need access to the full body of LLP legislation in user-friendly form, it was anticipated that legal publishers would make available, during 2001, consolidated versions of all statutory provisions relating to LLPs. Alternatively, readers can read the Act and Regulations in cross-reference to the other, existing statutes to which the Act and Regulations refer.

Given that the intention behind the development of the LLP was always that its external character should mirror that of the limited company, it is not surprising that existing companies legislation

should play a major part in shaping the LLP's legal status and responsibilities. The statutory rules applying to LLPs will, accordingly, present few difficulties to those who are already familiar with the provisions of companies legislation.

It should be noted that existing partnership law, especially the Partnership Act 1890, does not as a rule apply to LLPs and it should not be looked upon as applying on any form of default basis.

4

Basic Features of an LLP

PAGE 6

The LLP resembles the limited company in two key respects, as follows:

- it is a corporate body with separate legal personality
- the liability of its 'members' is limited.

Because the LLP is a corporate body with separate legal personality, it can take and be the subject of legal action in its own name; it can own property in its own name; and it continues to exist irrespective of changes in its membership. Whereas Scottish partnerships have long enjoyed separate personality, their counterparts in England and Wales remain an aggregate of relationships between the individual partners.

In so far as its status and external responsibilities are concerned, then, the LLP is very similar to the limited company. In terms of its internal affairs, however, the approximation is closer to the traditional partnership. The intention is that each LLP will be free to decide for itself exactly how it wishes to organise its own internal affairs. For example, there will be no overriding rules requiring the holding of General Meetings or approval for profit distribution.

An LLP may be formed by at least two natural or legal persons. So, unlike the position with limited companies (but like partnerships), the LLP has a minimum

membership, of two, who may be individuals, companies, or a mixture of both. It should be noted that, under s24 CA 85, which is applied to LLPs, where an LLP conducts business with fewer than two members for at least six months, its sole acting member is liable, with the company, for the debts contracted by the LLP during that period.

The LLP has 'unlimited capacity', which means that it may carry out whatever activities it wishes. There is thus no need for the LLP Agreement (the equivalent of the partnership agreement) to set out the firm's 'objects'.

Setting up an LLP

PAGE 7

5

To set up an LLP, its founders must go through a formal procedure to register the LLP at Companies House, in much the same way as is done to incorporate a limited company at the moment. Two documents are required to be filed: first, an 'incorporation document', and second, a statement in a form approved by the Registrar of Companies (the Registrar), made by either a solicitor engaged in the formation of the LLP or a subscriber to the incorporation document, to the effect that the basic registration formalities in s2(a) of the LLP Act have been complied with. It is a criminal offence for a person making the latter statement to include in it anything which they know to be false or do not believe to be true.

On full compliance with these formalities (and payment of the appropriate fee – yet to be determined), the Registrar will issue a certificate of incorporation. This certificate will be conclusive evidence that the formalities have been complied with and that the LLP is incorporated in its given name.

It should be noted that, as is the case with companies, the LLP does not have capacity to act until it is formally incorporated. Any person purporting to contract on behalf of the LLP before it technically exists will be liable on that contract.

THE INCORPORATION DOCUMENT

The document will need to be either in the exact form approved by the Registrar or closely modelled on it. It will need to state the following:

- the name of the LLP
- whether the location of its registered office is to be in England and Wales, Wales or Scotland,
- the address of the registered office
- the name and address of each of the persons who are members of the LLP on incorporation.

Setting up an LLP (continued)

PAGE 8

It must also specify which of the members are to be **designated members** of the LLP (or, alternatively, it must state that every member of the LLP is to be a designated member).

NAME

An application to register an LLP must state its proposed name, which must be followed by the expression 'limited liability partnership' or the abbreviations 'LLP' or 'llp'. Accordingly, a firm may be known as, e.g., Smith & Jones limited liability partnership, Smith & Jones LLP or Smith & Jones llp. An LLP whose registered office is to be situated in Wales may opt to append to its proposed name the Welsh equivalents of

these terms: if it does so, its name will end with one of 'partneriaeth atebolrwydd cyfyngedig', 'PAC' or 'pac'. It is a criminal offence for any person to carry on business under a name which includes any of these terms unless that person actually is an LLP and thereby entitled to use the term concerned.

The LLP Act applies to LLPs similar rules to those which currently apply to the approval of names of limited companies. An LLP may not be registered with a name which is the same as a name which is held by a registered limited company. Likewise a name may not be registered if, in the opinion of the Secretary of State on the advice of the Registrar, its

use would constitute a criminal offence or would be offensive. As with limited company names, special approval is required for names which include any term or expression set out in the Company and Business Names Regulations (SI 181/1685) and any name which, in the opinion of the Secretary of State, would be likely to give the impression that the applicant firm is connected with the government or any local authority.

Where an LLP has been registered with a name which the Registrar and the Secretary of State, on reflection, feel is the same as or 'too like' the name of a limited company, a direction may be

issued, within twelve months of the firm's registration by that name, for it to change its name. Where it comes to light that misleading information has been given for the purpose of incorporating the LLP with a particular name, or that certain undertakings or assurances with regard to the name have not been fulfilled, then, again, a direction may be given for the LLP to change its name. In this latter case, the direction may be given within five years of the registration by that name. Finally, where, in the opinion of the Secretary of State, an LLP's name gives so misleading an indication of the nature of its activities as to be likely to cause harm to the public,

he may in writing direct the firm to change its name. If any such direction is made and the LLP fails to comply with it, then the LLP and any designated member who is in default commit an offence.

An LLP, once registered, can change its name at any time. Where it does so, it must formally notify the Registrar, on a form approved for the purpose and signed by a designated member or authenticated in a manner approved by the Registrar. Unless the proposed new name is unacceptable on one of the grounds discussed above, the Registrar will insert the new name in the Register and issue a certificate of change of name.

REGISTERED OFFICE

An LLP must at all times have a registered office, which must be situated in England and Wales, Wales or Scotland (NB the Welsh equivalents of 'limited liability partnership', etc. may, technically, only be adopted if the incorporation document specifies that the registered office is to be situated in Wales). Any change of location of the registered office must be notified to the Registrar on the appropriate form.

LLP AGREEMENT

Note that there is no requirement for an LLP to have an Agreement (the equivalent of the partnership agreement). It follows that there is no requirement to file any such

Setting up an LLP (continued)

PAGE 10

Agreement in the process of incorporation or otherwise to place it on the public record.

Administration of LLPs

PAGE 11

6

The administration of the LLP is not intended to be regulated to the extent that is required in the case of limited companies. What administrative rules are applied to LLPs are more to do with ensuring third parties are made aware of the firm's status and membership than with considerations of governance. These rules are summarised below.

IDENTIFICATION

The LLP is required to comply with the various Companies Act rules regarding the identification of itself and its officers. As will be seen, these provisions, although very straightforward, carry potentially serious penalties for non-compliance. Partnerships which

are not familiar with them should, therefore, pay special attention to them.

The firm's name must be painted or affixed outside every office or place from which it carries on business (s348 CA 85). This notice must be legible and in a conspicuous position. In the case of non-compliance the LLP and its members are liable to a fine.

The firm's name must appear in legible characters on all business letters, notices and other official publications, all cheques and orders and all invoices, receipts and letters of credit (s349 CA 85). If an LLP issues any business letter, notice, publication, invoice,

receipt, etc. which does not comply with s349, it commits an offence, as does any member who issues it or authorises its issue. Also, if any member signs or authorises the signature of any cheque or order on which the LLP's name is incorrectly presented, he is personally liable to the holder of the cheque (in the case of default by the LLP).

If the LLP has a seal, it must have the name of the LLP engraved on it in legible characters (s350 CA 85).

The following information must appear in legible characters on all the LLP's business letters and order forms (s351 CA 85):

Administration of LLPs (continued)

PAGE 12

- the firm's place of registration (i.e. England and Wales, Wales, or Scotland)
- the firm's registered number
- the address of its registered office.

Where the firm's name ends with any of the permitted abbreviations of limited liability partnership, there must be a statement to the effect that the firm is a limited liability partnership.

The Business Names Act 1985 has also been amended to add the LLP to the list of entities that come within its supervision. That Act places additional obligations on an LLP which conducts business under a name which does not

consist of its full corporate name, including the permitted abbreviation: for example, where Smith & Jones LLP actually trades as 'S&J'. Where an LLP is subject to the Business Names Act, its business letters, orders, invoices, etc. must state its full corporate name and the names of each of its members. (This requirement does not apply to an LLP with more than 20 members provided that it indicates on its various items of stationery the address of the place of business of the LLP where a list of members is open to public inspection.) It must also display in a prominent position, in any premises where the firm carries on business and to which customers or clients have access, a notice

indicating the firm's corporate name and address and the names of its members.

A specimen mock up of LLP-compliant stationery is shown in **Annex A**.

If the LLP has a seal, it must have the name of the LLP engraved on it in legible characters (s350 CA 85).

ANNUAL RETURN

The LLP is required to file an annual return. Companies House will adopt the same practice as it uses with respect to companies, i.e. it will send out to each LLP, in advance of its 'return date', a 'shuttle' form on which is pre-

printed relevant information which is already held on file on that company. The LLP return will be brief: it will simply set out the registered address of the LLP, the names and usual residential addresses of the members, an indication of which members are designated members, and the address where any register of debenture holders is kept.

LLPs have 28 days from the return date to complete and return the form together with the filing fee (which at the time of writing had yet to be determined). Non-compliance is an offence for which the firm and its designated members are liable.

DEBENTURES AND CHARGES

Where an LLP keeps a register of debentures, s190 CA 85 applies. The Register must be open to inspection by registered debenture holders and members of the LLP free of charge.

The LLP is also subject to the rules on the registration of charges set out in Part X CA 85. In addition to maintaining its own register of charges granted by it over its assets, an LLP is bound to notify the Registrar whenever it grants any of the charges, including floating charges, notifiable under (the modified) s396 CA 85.

STATUTORY FORMS

The various statutory forms applicable to LLPs will be available for downloading from the Companies House website (www.companies-house.gov.uk).

7

Members of the LLP

PAGE 14

The 'members' of the LLP are the individual persons through whom the LLP operates. The term as it is used in the context of LLPs should not be confused with its meaning in the context of limited companies, since the member of an LLP will invariably have management as well as ownership rights.

The legislation does not give a great deal of guidance as to the overall legal responsibilities and duties of members, other than to imply, by virtue of their status as agents of the LLP, that they owe fiduciary duties to it. The full extent of members' duties will, inevitably, fall to be clarified by the courts. In relation to the specific

areas of wrongful trading and clawback of withdrawals, referred to below, it is provided that the courts are required to assess a member's conduct in the light of the knowledge, skill and experience that may reasonably be expected of a person occupying that role. In the circumstances of these provisions at least, members will be expected to act in accordance with a legal benchmark of skill and care.

The main issues associated with membership are as follows.

APPOINTMENT OF MEMBERS

The first members of the LLP (as already stated there must be at least two of them and they may be

individuals or corporate bodies) are those who are listed in the incorporation document as being its first members. Thereafter, the circumstances in which persons may become (and cease to be) members are left to be decided by the internal rules of the firm.

A member may cease to be a member in accordance with an agreement made with the other members or, in the absence of any agreement on the procedure to follow in this regard, by giving reasonable notice to the other members.

Where persons either become or cease to be members, notification must be made to the Registrar

within 14 days. Details of changes in the name or address of a member will need to be filed within 28 days.

STATUS OF MEMBERS

The members of the LLP are, broadly, the equivalent of the partners in a partnership and the owner/managers of a limited company. Whereas partners in a partnership are (under English law) the agents of each other, members of an LLP are, expressly, agents of the LLP (s6 LLP Act). The members have a financial stake in the firm and, in the absence of contrary agreement, a right to participate in its management. Since the LLP, unlike the English partnership, has legal

personality, it can and does act as a principal in agency terms.

Each member of the LLP can, therefore, bind the firm. Under s6(2) of the LLP Act, however, the LLP will not be bound by the actions of a member if that member has no authority to act for the LLP in the respect concerned and the person they deal with either knows that they lack such authority or does not know or believe them to be a member of the LLP.

As far as third parties dealing with an LLP are concerned, a person who has ceased to be a member is regarded as still being a member unless the third party has had

notice of such cessation or due notice of the member's cessation has been delivered to the Registrar as required. Thus, departing members should, in their own interests, make sure that proper notice is given.

s4(4) of the LLP Act provides that a member shall not be regarded as being an 'employee' of the LLP unless, in the case of a converting partnership, he or she was regarded as being an employee of that partnership. The intention of this appears to be to ensure that a salaried partner of a partnership which converts to LLP status may continue to be deemed to be an employee.

Members of the LLP (continued)

PAGE 16

DUTIES OF MEMBERS

As the Companies Act does with respect to company directors, the LLP Act imposes a range of specific statutory responsibilities on members and, separately, designated members. In general terms, members are responsible for ensuring that the LLP complies with governance requirements, e.g. to appoint auditors and to approve annual accounts, while designated members are responsible for preparing and submitting statutory information to nominated parties, in particular the Registrar.

Over and above these individual duties, it is implied that all members, by virtue of their being agents of the LLP, owe fiduciary

responsibilities to it. There is no specific statutory duty of good faith in members' dealings with each other, but their fiduciary responsibilities mean that they must act in good faith in the best interests of the firm and exercise due skill and care in the performance of their functions.

THE LLP AGREEMENT

The LLP Act and Regulations do not, for the most part, intrude upon the relations between members. This is in keeping with the intention to allow the internal arrangements of an LLP to be as flexible and autonomous as they are in traditional partnerships. There is no requirement, for instance, for LLPs to hold Annual

General Meetings. s5 of the Act states that the mutual rights and duties of members, as between themselves and the LLP itself, are to be governed by agreement between the members or between the members and the LLP. As is the case currently with partnership agreements, there is a (limited) range of 'default' provisions in the LLP Regulations which will apply to members and the firm in the absence of specific agreement on a particular matter. These default provisions are reproduced in **Annex B**.

As previously stated, the principles and provisions of partnership law are not to be applied to LLPs in the event of any failure to make

specific provision for a particular matter: the LLP is a wholly separate type of entity and uncertainty and disputes may well arise where any matter is not covered by express application by the LLP Act and Regulations or by a separate agreement. For this reason, although there is no legal obligation for any LLP to enter into a separate agreement, it will be highly desirable for them to do this and to take legal advice as to its contents.

Examples of issues which will, invariably, need to be covered in an LLP Agreement, and which are not covered by the statutory default provisions, are the manner by which the Agreement may be

revised, the appointment and removal of designated members, the admission of new members, and internal governance arrangements. Where a partnership converts to an LLP, it may decide simply to adopt the substance of its old 'partnership agreement'. If it chooses to do so, it should be careful to ensure that the terminology is adapted, to ensure, for example, that references to 'partners' are changed to 'members'.

In certain circumstances, the LLP Act overrides any provision in the LLP Agreement as to the rights of members. Under s7 of the Act, where a member has died, or has become subject to the law on

bankruptcy, sequestration or liquidation, has granted a trust deed for the benefit of their creditors or assigned the whole of any part of their share in the LLP, neither they nor their personal representative, trustee, liquidator or assignee may take any part in the management or administration of the LLP.

DESIGNATED MEMBERS

The term 'designated member' is introduced by the Act to indicate the persons within the LLP who are to assume responsibility for certain statutory compliance functions on behalf of the firm. Designated members are responsible under the Act for putting their names to and/or filing

Members of the LLP (continued)

PAGE 18

a range of statutory documents, such as the annual accounts, the annual return and details of changes in membership. (A list of the major statutory obligations is set out in **Annex C**). In this, their role will be comparable to functions carried out by the directors and secretary of a limited company. There must be at least two designated members in each firm: if the number falls below two, every member is deemed to be a designated member. Where an LLP fails to comply with a specific obligation, in most cases both the LLP and its designated members will have committed an offence.

Each LLP must, on incorporation, indicate which of its members is to hold the post of 'designated member' (or state that every member is to be a 'designated member'). Where individual members are specified at the outset, others may become designated members at any time by agreement with the other members. Details of resignations and appointments of designated members are required to be notified to the Registrar in an approved format within 14 days. (This does not apply where the LLP has declared to the Registrar that all of its members are to be 'designated members').

SHADOW MEMBERS

The company law concept of 'shadow director' is extended to LLPs. Thus, in the (perhaps unlikely) event that the members of an individual LLP are collectively accustomed to acting in accordance with the instructions of a particular person, that person will be deemed to be a 'shadow member' of the LLP and will be subject to the same liabilities as members proper. A person who issues instructions purely in a professional advisory capacity will not be deemed to be a shadow member.

DISPUTES BETWEEN MEMBERS

While the expectation is that LLPs will make their own arrangements

to provide for dispute resolution, there are three residual statutory provisions in this regard. First, the regulations apply to LLPs sections 459–461 CA 85. These sections, as they apply currently to companies, entitle a member or members with a minority interest to petition the court on the ground that the affairs of their company are being run in a way which is unfairly prejudicial to their interests. If, on an application by a member or members of an LLP, the court finds in favour of the applicants, it may order, *inter alia*, the petitioning members' interests to be bought out or that a change be made in the LLP Agreement. Note, however, that members of an LLP can, by unanimous written

agreement, determine to exclude the application of the sections concerned for whatever period they determine. Conceivably, the exclusion could be of indefinite duration.

Second, under a modified version of s431 CA 85, the Secretary of State may initiate a formal statutory investigation into the LLP's affairs on the application of 20% of the current membership of the LLP.

Third, paragraph 8 of the LLP Regulations states that no majority of members of an LLP may expel any member unless a power to do so has been conferred by express agreement between the members.

LIABILITY OF MEMBERS AND DESIGNATED MEMBERS

This issue can be looked at under three main headings:

- 1) Financial liability.
- 2) Criminal and civil liability under the LLP Act and Regulations.
- 3) Disqualification.

Financial Liability

Members' guarantees

s1(4) of the LLP Act states that the members of an LLP have such liability to contribute to the firm's assets in the event of its winding up as is provided for in the Act. The LLP Regulations expand on this by modifying, in its application to LLPs, s74 of the Insolvency Act

Members of the LLP (continued)

PAGE 20

1986. This modified section provides that, in a winding up, any present or past member is liable to contribute financially to the extent that they have agreed with the LLP or with other members. However, a person who has ceased to be a member will not be liable if the agreement between them and the firm exempts them from continuing liability.

Therefore, if the Agreement between the members requires each to pay £100 on the winding up, this is the amount which the law requires them to pay to the liquidator. To this extent, the position of the member as regards personal liability is comparable to that of the member of a company

limited by guarantee. It will be up to each LLP, when drafting its own Agreement, to decide how it wishes to deal with this aspect.

Membership falling below two
By application of s24 CA 85, where an LLP continues for more than six months with a single member, that member becomes liable jointly and severally with the LLP for the debts of the firms contracted for during that period.

Liability for cheques, etc.
By application of s349 CA 85, any member who signs or authorises the signature of a cheque, order, etc. on which the LLP's name is incorrectly presented is liable to the holder of the instrument

(unless the amount is paid by the LLP).

Insolvency: Wrongful Trading (s214 Insolvency Act)

Where an LLP goes into creditors' (i.e. insolvent) voluntary liquidation, the liquidator will be able to investigate the circumstances prior to the firm's winding up in order to assess whether any of the firm's members should be ordered personally to pay some contribution (to be decided by the courts in light of the circumstances of the case) towards paying off the company's debts to its creditors.

If the liquidator can identify a point at which, in his or her

Members of the LLP (continued)

PAGE 21

opinion, a member knew or ought to have known that the LLP would not be able to avoid insolvent liquidation, he or she may apply to the court for a s214 order to be made against the member concerned. It will be a defence for any members, in court, to be able to demonstrate that they took 'every step' to minimise potential losses to creditors. In other words, in a situation where the members of an LLP conclude (or, in retrospect should, in the circumstances, have concluded) that their firm cannot avoid insolvent liquidation, they should take some form of remedial action forthwith.

As is the case with respect to the application of s214 to companies, the courts, when assessing whether an individual member knew or ought to have known the likely fate of the firm, will be able to apply both a subjective test and an objective test. In the former case, the courts will consider whether the member concerned, given their particular expertise and experience, could have been expected to understand the firm's situation and take appropriate action on the strength of it. In the latter case, the member's conduct will be assessed against an objective test of what a reasonable person could have been expected to know and do as a member of an LLP.

Insolvency: Adjustment of Withdrawals (s214A Insolvency Act)

Popularly referred to as the 'clawback' rule, this new provision, which is inserted into the Insolvency Act 1986, has been drafted exclusively for application to the special position of LLPs. Under s214A, the liquidator of an LLP may investigate all withdrawals of property made from the firm by any member in the two-year period leading up to the commencement of the LLP's winding up. Withdrawals for this purpose include profit share, salary, repayment or payment of interest on a loan to the firm.

Members of the LLP (continued)

PAGE 22

The liquidator may make an application to the court where he or she considers that at the time of making any withdrawal, the member concerned knew or had reasonable grounds for believing that the LLP was unable to pay its debts (as defined by s123 of the Insolvency Act) or would become unable to pay its debts following the withdrawal (either on its own or in conjunction with other withdrawals being made by other members at the same time).

The court, if it upholds the application, may order a member to make a financial contribution to the liquidator of up to the value of all the property withdrawn by him or her during the two-year period.

In considering an application, the court will assess whether each member referred to knew or ought to have concluded that, after each withdrawal, there was no reasonable prospect of the LLP avoiding insolvent liquidation. In making its assessment of the facts that a member should know and the conclusions that they ought to have reached, the court will make reference to a benchmark of a reasonably diligent person, having (i) the general knowledge, skill and experience that may reasonably be expected of a member of an LLP; and (ii) the knowledge, skill and experience that the member in question actually has.

How the courts deal with cases under s214 and s214A will to a great extent define the level of skill and care that the law will expect of members. The introduction of the 'objective' test in connection with liability for wrongful trading has had a significant impact on the level of skill and care which the law expects of company directors. If, as many believe, the LLP structure is adopted overwhelmingly by professional firms, the courts might well take the view that the standard of conduct to be expected from LLP members should be higher than that which is expected of company directors.

Liability in tort or contract

As discussed in the Introduction, the LLP legislation was developed largely in response to concerns expressed by professional firms about the exposure of themselves and their partners to liability. The protection which the corporate structure of the LLP offers to individual members should not, however, be taken entirely for granted.

In a House of Lords debate, during the course of the progression of the LLP Bill, Lord Goldsmith, a former chairman of the Bar Council, suggested that, where members of an LLP acted in a substantive way as if they were (still) partners in a partnership, the

courts might decide to 'pierce the veil' and treat the LLP's members as if they were in fact partners and outside the protection of the LLP structure. It will be noted that whereas an LLP or a company must be incorporated by a formal procedure, a partnership can be created informally.

The courts have also considered whether, in certain circumstances, a director of a limited company may assume a personal duty of care and therefore personal liability. Ordinarily, of course, a director acts on behalf of their company but the distinction between a company and its directors may become blurred, especially since limited companies

have been able to function with just one director/member. In the case of *Williams v Natural Life Health Foods Ltd (1998 BCC 428)*, the House of Lords considered an appeal against a ruling that a company director owed a personal duty of care to a customer of his company. The Lords overturned the earlier ruling but gave guidance on the circumstances in which a personal duty might arise. In order to establish a personal duty of care, there must be not only a special relationship between a director and a client or customer, but a clear assumption of responsibility. Further, for the courts to impute a personal duty of care to a director, it is necessary for there to be

Members of the LLP (continued)

PAGE 24

objective evidence that, in the circumstances, it is reasonable for a customer to rely on the director's assumption of personal responsibility. Such evidence would include oral or written statements and the actual conduct of the director.

In light of the above, members of LLPs should ensure that, in all their dealings with clients or customers and the public, they do not give cause to believe that the activity being undertaken is undertaken other than by its agents on behalf of the LLP. In the case of a professional firm, the engagement letter should be precise as to the contracting parties.

Criminal and civil liability under the LLP Act and Regulations

The LLP Act and Regulations set out a large number of offences for failure to comply with the statutory responsibilities placed on them by or under the Act. In the case of members generally, their responsibilities are invariably collective. For example, they are collectively responsible for appointing auditors and preparing accounts. Designated members are additionally responsible for filing information and providing information to third parties. For example, they are required by law to file the LLP's annual accounts and to make a statutory declaration in the case of the LLP's members voluntary winding up.

Financial penalties are provided for any breach of any of these requirements.

Disqualification

The Company Directors Disqualification Act 1986 (CDDA) is applied to members of LLPs. Accordingly, the courts can make a disqualification order against any member (or shadow member) of an LLP if it feels that their conduct in that capacity warrants such action. A disqualification order made against a member of an LLP will preclude the person concerned from acting as a director of a company as well as a member of another LLP (and vice versa). Disqualification orders can be made under the CDDA in respect

Members of the LLP (continued)

PAGE 25

of breaches of on-going obligations, for example, following prosecutions for failing to deliver statutory documents to the Registrar, and also on the specific ground of 'unfitness', as initiated by the liquidator following the winding up of the LLP.

One additional paragraph is added to the list in Schedule 1 of the CDDA of matters which the court is required to take into account when considering whether any individual member of an LLP is 'unfit'. This new provision requires the court to consider the extent to which the member has been responsible for the finding by a court that any member of the LLP concerned is required to make a

contribution under s214A of the Insolvency Act (this is the '*Clawback*' rule referred to previously).

8

Accounting by LLPs

PAGE 26

Some supporters of the LLP concept had hoped that the UK government would follow the lead of some foreign jurisdictions and free the LLP here from any serious disclosure responsibilities. This is not the case. For most external purposes, an LLP is intended to approximate to a limited company. It is therefore required to comply with virtually the same accounting and disclosure rules which would have applied to it were it in fact a limited company. This means that, with certain amendments and modifications, the LLP Regulations apply the accounts and audit provisions of Part VII of the Companies Act 1985 to LLPs.

In summary, this means that the LLP is required to keep accounting records, to prepare annual accounts which comply with Companies Act formats and disclosure rules and which give a true and fair view, and to file them with the Registrar within ten months of the year end. All relevant accounting standards and SORPs will need to be observed in the preparation of the LLP's accounts. Unless exempt under s249A–E CA 85, the LLP's accounts will also need to be audited.

The major statutory requirements and modifications are as set out below.

ACCOUNTING RECORDS (s221–222 CA 85)

The LLP must keep at its registered office records of all its accounting transactions. They must be retained for three years from the date on which they are made. In the case of non-compliance, the LLP and every member who is in default commits an offence.

ACCOUNTING REFERENCE PERIOD (s224 CA 85)

The accounting reference date of an LLP is the end of the month in which the first anniversary of its incorporation occurs. An LLP may change its reference date in accordance with s225 CA 85. The first accounting reference period

may be anything between six and eighteen months.

RESPONSIBILITY TO PREPARE ACCOUNTS (ss226 & 227 CA 85)

The members of the LLP are responsible for preparing the firm's annual accounts and, if applicable, consolidated accounts for it and its subsidiaries. The accounts must be approved by the members and signed by a designated member. The accounts, together with the auditor's report where appropriate, must be sent to every member of the LLP and to all the firm's debenture holders (if any) within one month of their being signed, and in any event no later than ten months of the end of the relevant reference period.

The accounts, which must be properly prepared and give a true and fair view, comprise the balance sheet, profit and loss account and notes to the accounts. There is no requirement to prepare a directors' report. Schedule 6 (particulars of directors' emoluments) does not apply to LLPs.

DELIVERY OF THE ACCOUNTS (ss242 & 242A CA 85)

The designated members must file the LLP's accounts with the Registrar within ten months of the end of the reference period. Non-compliance is an offence. In addition, those late filing penalties which are imposed on private companies are applied to LLPs (in

January 2001 these ranged from £100 for a delay of up to three months to £1,000 to a delay of over a year).

'MODIFIED' ACCOUNTS FOR SMALL LLPs (s246 CA 85)

Small LLPs (as defined by reference to the accounting thresholds in s247 CA 85) may prepare their accounts in accordance with the format and disclosure rules in Schedule 8 CA 85 rather than Schedule 4. Should they do this, they are required to carry the standard statement in the balance sheet to indicate that this is what they have done. Small and medium-sized LLPs may also file abbreviated accounts in accordance with Schedule 8.

Accounting by LLPs (continued)

PAGE 28

AUDIT EXEMPTION (s249A–E CA 85)

LLPs which are 'small' and whose turnover is below £1 million are exempt from external audit on the same basis as companies.

CONTENT AND FORMAT OF THE ACCOUNTS (SCHEDULE 4, 4A, 5 & 8 CA 85)

Specific references to share capital are, for obvious reasons, deleted from the standard Schedules in their application to LLPs. The other main divergences from the Schedules are as follows.

Formats

Balance Sheet formats 1 and 2 in Schedule 4 are both available to LLPs. However, in respect of each,

the specific headings dealing with share capital (namely, 'called up share capital not paid' and 'own shares') and the notes which support those items are deleted with respect to LLP accounts. In their place are two new 'Arabic' headings: 'Loans and other debts due to members' and 'Members' other interests'. Under the latter, there are three new 'Roman' sub-headings: 'Members' capital', 'Revaluation reserve' and 'Other reserves'. A new note 12, supplementing 'Loans and other debts due to members' provides that the following amounts must be shown separately under that heading:

- the aggregate amount of money advanced to the LLP by way of loan
- the aggregate amount of money owed to members by the LLP in respect of profits
- any other amounts.

In the profit and loss account, the item 'profit or loss for the financial year' is replaced by 'profit or loss for the financial year before members' remuneration and profit share'.

Notes to the accounts

Revaluation reserve

The revaluation reserve of an LLP may not be under reduced under s31(3), (3A) & (3B) Schedule 4 CA 85.

Loans, etc.

New disclosures, to reflect the special character of the LLP, are introduced. There is a new paragraph 37A inserted in Schedule 4 for LLP purposes, headed 'Loans and other debts due to members'. This requires disclosure of the following:

- the aggregate amounts of loans and other debts due to members as at the start of the financial year
- the aggregate amounts contributed by members during the financial year
- the aggregate amounts transferred to or from the profit and loss account during the year

- the aggregate amounts withdrawn by members or applied on behalf of members during the year
- the aggregate amount of loans and other debts due to members as at the balance sheet date
- the aggregate amount of loans and other debts due to members that fall due after one year.

NB. the substance of this paragraph is also applied to group accounts and to 'modified' accounts prepared by small LLPs.

Remuneration of members

A new paragraph 56A is applied to LLPs. This requires LLPs to give two

items of information. First, a figure for the average number of members in the firm during the year must be given. Second, if the amount of the LLP's profit before members' remuneration and profit share exceeds £200,000, the amount of profit (including remuneration) which is attributable to the member with the largest entitlement to profit (including remuneration) must be disclosed. For the purposes of deciding the amount to be disclosed in relation to the highest earning member, remuneration is to include emoluments specified in paragraph 1(1)(a),(c) and (d) of Schedule 6 CA 85 and which are paid by or receivable from the LLP, its subsidiary undertakings and any other person.

Accounting by LLPs (continued)

PAGE 30

Merger accounting

It is specifically provided that where a 'parent' LLP adopts the merger method of accounting in preparing its group accounts, it must comply not only with the remainder of the revised paragraph 11 of Schedule 4A but with generally accepted accounting principles or practice. This latter requirement effectively requires LLPs to comply with the guidance contained in the Statement of Recommended Practice (SORP) on LLPs, expected to be issued towards the end of 2001.

THE SORP

The SORP (Statement of Recommended Practice), which is being prepared by a working party

appointed by CCAB (Consultative Committee of Accountancy Bodies), is to set out guidance on the particular accounting issues created by circumstances which are unique to the LLP. Apart from the implications of merger accounting, referred to above, the key issue to be addressed by the SORP was expected to be the treatment of profit-based annuities.

Audit of LLPs

PAGE 31

9

All LLPs, save for those which qualify for exemption under s29A–E CA 85, are required to have their annual accounts audited. A summary of the main provisions relating to audit, including the specific modifications, is set out below.

APPOINTMENT OF AUDITORS

The LLP's first auditor is appointed by the designated members before the end of the firm's first financial year. In subsequent years, the appointment is made, again by the designated members, within two months following the approval of the accounts for the preceding financial year. The designated members also have power to fill any casual vacancy. If designated

members fail to fulfil their obligation to appoint auditors, the members generally may convene a meeting to make an appointment. Separately, the Secretary of State may step in to fill any vacancy.

The auditor, once appointed, holds office from the date of their appointment until not later than the expiration of two months from the date of approval of the accounts for the financial year covered by the appointment.

ELIGIBILITY OF AUDITORS

Part II of the Companies Act 1989 is applied to govern the eligibility of persons to audit the accounts of an LLP. An individual or firm which is authorised to audit companies

under the Companies Act is, therefore, eligible to audit LLPs.

REMUNERATION OF AUDITORS

The auditor's remuneration is fixed either by the designated members or in such other manner as the members may determine.

REMOVAL

The designated members of an LLP may at any time determine to remove the firm's auditor. They must, however, give the sitting auditor seven days written notice of their intentions. Similar notice must be given to a sitting auditor where the designated members propose to replace him or her at the termination of their period of office.

Audit of LLPs (continued)

PAGE 32

AUDIT REPORT

The auditor is required to report to the members of the LLP on whether, in the auditor's opinion, the accounts have been properly prepared and whether the balance sheet gives a true and fair view of the state of affairs of the LLP at the end of the financial year and whether the profit and loss account gives a true fair view of the LLP for the financial year.

RIGHTS OF AUDITORS

The auditor has a right of access at all times to the books, accounts and vouchers of the LLP and is entitled to call for such information and explanations as they think necessary from any member of the LLP. Auditors are entitled to receive

notices for, and to attend and speak at, any meeting of members of the LLP where any part of the business concerns them as auditors.

When auditors resign, they are required to submit to the LLP a statement of whether there are any circumstances which they believe should be brought to the attention of members or creditors. They may also require the designated members to convene a formal meeting of the LLP members to discuss whatever concerns they have.

Taxation of LLPs

PAGE 33

10

While the LLP is a corporate body with separate legal personality, for tax purposes the LLP is to be treated essentially as a traditional partnership. The key features of the statutory provisions on tax are as follows.

INCOME TAX

Thus, s10 of the LLP Act adds a new section 118Z to the Income and Corporation Taxes Act 1988, providing that a trade, profession or business carried on by an LLP with a view to profit is to be treated for tax purposes as being carried on in partnership by its members and not by the LLP as such. The property of the LLP is to be treated for tax purposes as partnership property. An LLP

which meets the test of operating as a trade, profession or business with a view to profit will, therefore, be transparent for tax purposes: like partners, the members of an LLP will be individually liable to tax on their shares of the profits earned by the LLP.

CAPITAL GAINS

A new clause (s59A) is added to s59 of the Taxation of Chargeable Gains Act 1992. This provides that, where an LLP carries on a trade or business with a view to profit, assets held by the LLP are to be treated for the purposes of chargeable gains tax as being held by its members as partners, and any dealings by the LLP are to be treated likewise as dealings by the

members in practice. Tax in respect of chargeable gains accruing to the members of the LLP on the disposal of any of its assets is to be assessed and charged on each of them separately. Any acquisition or disposal of assets will not be treated as being made by the LLP itself.

INHERITANCE TAX

A new s267A is inserted into the Inheritance Tax Act 1984. This makes clear that, for inheritance tax purposes, the property of the LLP is to be treated as the property of the partners and that the formation, change in membership and dissolution of an LLP are to be treated as the

Taxation of LLPs (continued)

PAGE 34

formation, change in membership or dissolution of a partnership. Business relief will be available on that basis. Any transfer of value made by or to an LLP is to be treated as made by or to its members in partnership.

STAMP DUTY

Stamp duty is not chargeable on a transfer of property by a person to an LLP within one year of its incorporation provided that, immediately before incorporation, two conditions are satisfied.

The first condition is that the person making the transfer is either

- a partner in a partnership which comprises all the persons who are to become members of the LLP (and no one else); or
- a person who holds the property transferred as nominee or bare trustee for one or more of the partners in that partnership.

The second condition is that:

- the members' entitlements to the property is to be the same as their entitlements to it in the partnership; or
- no difference in the entitlements arises as part of a scheme of which the main or one of the main purposes is to avoid tax.

NATIONAL INSURANCE

Where income tax is chargeable on a member of an LLP in respect of profits or gains arising from the carrying on of a trade or profession by the LLP, Class 4 contributions are payable by that member.

SUMMARY

The above paragraphs outline the main statutory provisions on tax in the LLP Act. Further legislation was planned in the Finance Bill 2001 to address the approach to be taken with respect to the taxation of types of businesses, including investment businesses, which might be motivated to adopt the LLP structure for purely tax reasons rather than to obtain limited liability. In respect of the

taxation of trades and professions, however, the Inland Revenue published, in the December 2000 issue of *Tax Bulletin*, its detailed plans for the taxation of LLPs. These plans, which are accessible via the Inland Revenue's website www.inlandrevenue.gov.uk, include the following important points:

- **Computation of taxable profits of professional businesses** – the approach which is taken to the determination of 'true and fair view' for the purposes of calculating the taxable profits of a professional business (set out in Issue 38 of *Tax Bulletin*, which is also available via the Inland Revenue's website), will

apply equally to the computation of Schedule D Case II profits of an LLP which carries on a professional business.

- **Capital allowances** – where an LLP succeeds to a business previously carried on by a partnership, this will not in itself give rise to a balancing event for the purposes of the Capital Allowance rules.
- **Cessation** – where an LLP succeeds to a business previously carried on by an old partnership, this will not in itself involve the cessation of the old partnership's trade or profession.

- **Partnership annuities** – where an obligation to pay an annuity is transferred from a partnership to an LLP, the members of the LLP will be entitled to higher rate income tax relief for their share of ongoing payments. Incoming members who assume part of this obligation will also be entitled to such relief.
- **Capital Gains: partners' interests** – so long as the LLP carries on a trade or profession with a view to profit, a partner's capital interest as a member of the LLP will not be regarded as a chargeable asset in its own right. Members of the LLP will be directly taxable

Taxation of LLPs (continued)

PAGE 36

on their share of the LLP's assets.

- **Ceasing to trade** – where an LLP ceases to carry on a trade or profession it will no longer be regarded as a 'partnership' for tax purposes and will instead be regarded as a 'body corporate'. The LLP will then cease to be 'transparent'. Where an LLP goes into liquidation, chargeable gains on the disposal of the LLP's assets by the liquidator will be computed by reference to the date on which they were first acquired by the LLP and their cost at that date. During the winding up itself, the LLP's capital gains will be treated in

the same way as any other body corporate.

Insolvency

PAGE 37

11

The LLP Regulations apply to the LLP, with appropriate modifications, all those provisions of the Insolvency Act 1986 (and supporting regulations) which deal with corporate insolvency and rescue procedures. Thus, an LLP may enter into a Company Voluntary Arrangement, Administration, Receivership (including Administrative Receivership), or voluntary or compulsory liquidation. The Insolvency Act's rules regarding eligibility to act as insolvency practitioner are also extended to procedures involving LLPs.

Accordingly, the insolvency of an LLP will be dealt with in much the same way as the insolvency of a

company. The more significant of the modifications for LLPs are as follows.

COMMENCEMENT OF WINDING UP

The commencement of a voluntary winding up is the date on which the LLP 'determines' that it is to be wound up voluntarily. While there is no statutory rule to say that the determination must take place at a general meeting of members, it is likely that LLP Agreements will provide that any determination to wind up should be made at such a meeting.

Following a determination to wind up, the designated members are required to notify the Registrar

within 15 days and advertise the decision in the *Gazette* within 15 days.

In the case of a compulsory winding up where the LLP has not already been put into voluntary winding up, the procedure is deemed to commence at the time of the presentation to wind up.

STATUTORY DECLARATION

The statutory declaration of solvency to be made before entry into members voluntary winding up is to be made by the designated members. It has to be made within the five-week period before the determination by the members that the LLP should be wound up.

Insolvency (continued)

PAGE 38

GROUND S FOR WINDING UP BY THE COURT

An LLP may be wound up by the court if any of the following apply:

- it has determined that it be wound up by the court, or
- it has not commenced business within a year from its incorporation or suspends its business for a whole year, or
- the number of members falls below two, or
- it is unable to pay its debts, or
- the court is of the opinion that it is just and equitable that the LLP be wound up.

With respect to the second ground referred to above, note that there is no requirement for an LLP to

obtain any separate certificate of trading or comply with any other formality before it starts trading: as soon as an LLP is incorporated it may start to carry on business. It remains to be seen how this ground for winding up will be enforced in practice. It serves to illustrate, however, that LLPs are not intended to be used, as many private companies, as 'shell' bodies which may be activated at some future stage when their founders feel they have some substantial role to perform. An LLP is meant to operate as a working partnership. This is reinforced in practical terms by the anticipated taxation rules for the LLP: the Inland Revenue has announced that where an LLP ceases to carry

on a trade or profession it will no longer be taxed as a partnership but as a corporate body.

CLAWBACK RULES

The new rules on recovery of withdrawals made by members prior to insolvent liquidation are discussed earlier in this booklet (section 7, Members of the LLP).

Annex A, B & C

PAGE 39

ANNEX A:

Mock-up of LLP-compliant
business stationery

(example used is an LLP trading
under a business name)

S & J

1 High Street, Wolchester
Tel No xxx xxxx

Members

Andrew Smith
Thomas Jones

Registered Office: 1 High Street, Wolchester
Smith & Jones LLP is a limited liability partnership registered in England & Wales
Reg No xxxxxxxx

Annex A, B & C (continued)

PAGE 40

ANNEX B:

Default provisions which will apply to an LLP in the absence of any contrary provision in a separate agreement between members (extract from paragraph 7, LLP Regulations 2001)

All the members of the LLP are entitled to share equally in the capital and profits of the LLP.

The LLP must indemnify each member in respect of payments made and personal liabilities incurred by him:

a) in the ordinary and proper conduct of the business of the LLP or

b) in or about anything necessarily done for the preservation of the business or property of the LLP.

Every member may take part in the management of the LLP.

No member shall be entitled to remuneration for acting in the business or management of the LLP.

No person may be introduced as a member or voluntarily assign an interest in an LLP without the consent of all existing members.

Any difference arising as to ordinary matters connected with the business of the LLP may be

decided by a majority of the members, but no change may be made in the nature of the business of the LLP without the consent of all the members.

The books and records of the LLP are to be made available for inspection at the LLP's registered office or at such other place as the members think fit and every member of the LLP may when they think fit have access to and inspect and copy any of them.

Each member shall render true accounts and full information of all things affecting the LLP to any member or their legal representatives.

If a member, without the consent of the LLP, carries on any business of the same nature as and competing with the LLP, they must account for and pay over to the LLP all profits made by them in that business.

Every member must account to the LLP for any benefit derived by them without the consent of the LLP from any transaction concerning the LLP, or from any use by him of the property of the LLP, name or business connections.

**ANNEX C:
Principal Companies Act-derived
duties of designated members**

s233 Duty to sign the annual accounts

s242/244 Duty to deliver annual accounts and audit report to the Registrar within stated deadline

s363 Duty to deliver the annual return

s385 Duty to appoint auditors

s388 Power to fill a casual auditor vacancy

s390A Power to fix auditor's remuneration

s391A Duty to send notice regarding the removal or replacement of an auditor and circulation of auditor's representations

s392A Duty to convene general meeting at requisition of auditors

s652A Power to make application to the Registrar for strike-off

s652C Duties following strike-off

s713 Enforcement of duties to make returns

s725 Service of documents.

The Association of Chartered Certified Accountants

29 Lincoln's Inn Fields London WC2A 3EE United Kingdom

tel: +44 (0)20 7396 5900 fax: +44 (0)20 7396 5959 www.accaglobal.com