

# **LIMITED LIABILITY PARTNERSHIPS (LLPs) IN INDIA**

## **A concept whose time has come**

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- “18.1 *In view of the potential for growth of the service sector, requirement of providing flexibility to small enterprises to participate in joint ventures and agreements that enable them to access technology and bring together business synergies and to face the increasing global competition enabled through WTO, etc., the formation of Limited Liability Partnerships (LLPs) should be encouraged.*
- 18.2 *It would be a suitable vehicle for partnership among professionals who are already regulated such as Company Secretaries, Chartered Accountants, Cost Accountants, Lawyers, Architects, Engineers, Doctors etc. However, it may also be considered for small enterprises not seeking access to capital markets through listing on the stock exchange.*
- 18.3 *We recommend that a separate Act be brought about to facilitate limited liability partnerships...*”

— Dr J.J. Irani Expert Committee on Company Law, May 2005 (Excerpt).

### **INTRODUCTION**

In May 2005, the Expert Committee on Company Law headed by Dr J.J.Irani (“Irani Committee”) recommended the introduction of Limited Liability Partnerships (“LLPs”) as a new form of business entity in India. This recommendation followed close on the heels of a similar recommendation made in 2003 by the Naresh Chandra Committee (II), set up to look into reform of the Companies Act and Partnership Act, that the time was ripe for introduction of LLPs in India. Both the Committees were of the view that introducing LLPs as a new business structure would fill the gap between business firms such as sole proprietorship and partnership which are generally unregulated and Limited Liability Companies (LLCs) which are governed by the Companies Act. In addition to an alternative business structure, LLPs would foster the growth of the services sector, in particular the growth of professional firms, which would in turn increase their global competitiveness.

In light of the recommendations made by these committees, this article attempts to provide a brief overview of the LLP concept. It examines the policy

rationale underlying the implementation of LLPs in India and provides some suggestions that policy makers may wish to consider while drafting a proposed LLP legislation.

### **NATURE OF A LIMITED LIABILITY PARTNERSHIP (LLP)**

The LLP as its name implies is essentially a partnership with limited liability. It is a business entity akin to a body corporate having a legal personality separate from that of its partners and combines features of both companies and partnerships. The entity provides the internal flexibility of a partnership i.e. by allowing the partners to adopt whatever form of internal organization they prefer while at the same time limiting their liability with respect to the LLP to their individual contributions. While the LLP gives the benefit of limited liability to its partners, it does not shield them from legal liability arising from their own personal acts, which are not done for and on behalf of the LLP. In other words, such partners continue to be personally liable for their own negligence and for other wrongful acts committed in their personal capacity.

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The LLP is formed by way of incorporation or registration under the governing law. The LLP being a creature of statute (similar to a body corporate) is upon incorporation, an entity that can potentially last indefinitely and can survive changes to its partners. Similar to a body corporate, all property and assets acquired by the LLP belongs to the LLP and not to its individual partners. Similarly all debts and obligations of the partnership arising due to contract, tort or otherwise are assumed by the LLP. In the event of winding up of the LLP, the assets of the LLP are available for distribution to its creditors. The partners are then liable to contribute to the assets of the LLP to the extent they have agreed to do so in the partnership agreement. Any surplus assets are distributed among the partners.

### DEVELOPMENTS IN OTHER COUNTRIES

The LLP is a rather recent legal institution. The concept of LLP was invented in the US State of Texas in 1991 as an alternative to an ordinary partnership, in which innocent partners were guarded from the vicarious personal liability for malpractice liabilities of the firm. The concept was introduced in a country at a time when litigation and damages awarded by the courts and jury was increasing at an alarming rate. The concept, not surprisingly, was extremely popular. In Texas, during the first year after the enactment of the LLP statute, more than 1200 professional firms adopted LLP status. The New York statute adopted in 1994 too showed similar levels of popularity. By the end of the decade, nearly all states in the USA had adopted some form of LLP legislation.

The LLP concept has proven to be popular even beyond American Shores. In 2001, the UK Limited Liability Partnership Act ("UK Act") became part of English Law. The Act offered businesses the option of electing a partnership structure for their operations while controlling the partners personal risk exposure by way of limited liability. Closer to home, Singapore has recently, in 2005, after extensive public consultation enacted its own LLP statute. The objective behind its creation is that the LLP business vehicle will increase the options available to businessmen and investors and also help make Singapore a progressive and preferred place for business.

### AN APPROPRIATE LEGISLATIVE MODEL FOR INDIA

The fact that many jurisdictions have adopted LLP statutes means that there are several models that India can choose to look at while drafting its own LLP

enactment. A few good models to consider would be -

- (a) The UK Limited Liability Partnership Act 2000 ("UK Act") and the Limited Liability Partnership Regulations 2001.
- (b) The US Delaware Revised Uniform Partnership Act ("Delaware Act").
- (c) The Jersey Limited Liability Partnerships Law ("Jersey Law").

However, among these, the model that lends itself to closest consideration is the UK Act. Apart from the fact that India does follow English law (in particular, the commercial developments thereof) closely, more importantly, the general reasons for the introduction of the UK Act are quite relevant in the Indian context. As mentioned in the Explanatory Note to the UK Act -

*"These [partnership] arrangements were generally appropriate when all partnerships were small and the partners were of the same profession working closely one with another. However, unlimited liability for partners has become an increasing cause for concern in the light of:*

- (a) *a general increase in the incidence of litigation for professional negligence and in the size of claims;*
- (b) *the growth in the size of partnerships (since in a very large partnership not all the partners will be personally known to one another);*
- (c) *the increase in specialisation among partners and the coming together of different professions within a partnership; and*
- (d) *the risk to a partner's personal assets when a claim exceeds the sum of the assets and insurance cover of the partnership.*

*Although these concerns arise most acutely in very large professional partnerships they are relevant to partnerships generally.*

*The limited liability partnership goes some way towards addressing these concerns. Its members benefit from limited liability because the LLP is a separate legal person. In general the LLP and not its members will be liable to third parties."*

In fact, it could be stated that the above reasons are sufficiently general as to apply to virtually any jurisdiction contemplating an LLP statute. Further, and for reasons that will be apparent shortly, it is also suggested that the UK Act constitutes a balanced

approach towards the adoption of a legal regime for LLPs in the Indian context. Hence, the focus of this Article will be on the UK Act, although comparative material will also be discussed, where necessary.

### **ARGUMENTS FAVOURING THE INTRODUCTION OF THE LLP IN THE INDIAN CONTEXT**

In the specifically Indian context, the introduction of the LLP would promote entrepreneurship, particularly in relation to the professional services sector and the knowledge-based industries such as the information technology and bio-technology sectors where the need for a large organization is (in the first instance, at least) non-existent or minimal and where (on the contrary) the flexibility afforded by an organization such as the LLP might be ideal. Moreover, the additional option of the LLP can only serve to improve the legal infrastructure for businesses in India. As mentioned in the Naresh Chandra Committee report " *... Since LLPs are now accepted non-corporate entities in developed countries like the USA and UK, it is appropriate to enhance the global competitiveness of our professional firms by ensuring that India's company law is flexible enough to provide mechanisms and instruments which foster growth of large professional firms...* " .

Aside from encouraging foreign businesses to set up operations in India, a wider choice of business vehicles will give Indian businesses some competitive advantage when they venture overseas. Further, there is really no reason in policy or principle why, given the wide acceptability of the Limited Liability Company (" LLC " ), a partnership should not also be given body corporate status and conferred the privilege of limited liability, provided that sufficient safeguards are put in place. In essence, the main difference between the LLP and the LLC is their respective internal organisational structures, and this is a neutral factor in relation to the privilege of limited liability. In fact, in some ways it could be argued that the LLP is more attractive than an LLC as the LLP entity offers features that are particularly attractive for professional firms including, *inter alia*, rights to participate in management, fewer financial restrictions to accommodate distribution of revenues to income-generating partners, greater acceptance by professional licensing agencies, and the ease of conversion to limited liability without having to redraft partnership agreements to fit a new statute. Indeed, an argument could well be made that the LLP might end up as the alternative to incorporation because of its greater flexibility, linkage with a substantial existing body of partnership law, and the generally favorable status of general partnership under tax and regulatory statutes.

Turning to other reasons in favour of the LLP, it has been observed, insofar as professional partnerships are concerned, that (in the UK at least), although professionals have the option to incorporate, few have opted for this route and " *[t]hat may be because it is considered that the structure of a company does not lend itself to successful professional/client relationships, because there may be a conflict between the need to act in the interest of shareholders and the need to act in the interests of a client. It may also be because the particular advantages of the partnerships structure have made firms reluctant to reorganise as a company.* " .

This does not however deter from the fact that professional partnerships do desire access to limited liability. Indeed, the applicable considerations giving rise to concern over the possibility of unlimited liability are also applicable to partnerships generally. In the UK, the idea that there should be the opportunity to organise as an LLP emerged out of a review of the law of joint and several liability. In 1996, the Department of Trade and Industry (" DTI " ) published a feasibility investigation of joint and several liability carried out by the Common Law Team of the UK Law Commission. The investigation focused particularly, but not exclusively, on the joint and several liability of professional defendants, seeking to ascertain whether there was an arguable case for replacing joint and several liability by, for example, a system whereby each defendant might be liable for only a proportionate share of the loss. Although the remit did not extend to the question of joint and several liability within partnerships, the DTI took the opportunity to consult on the distinct but related question whether to amend the law in UK to allow limited liability partnerships. This question was asked in the knowledge that the concept of LLPs was well known in some overseas jurisdictions, particularly the USA. Jersey too was working on implementing its own LLP legislation in response to representations from the accountancy profession, with a view to attracting offshore registrations.

### **THE LLP AS A GENERAL BUSINESS VEHICLE**

Notwithstanding the primary concern of professional partnerships themselves, the UK Act does not restrict the LLP vehicle solely to professionals. This is unlike jurisdictions such as New York where the LLP legislation is confined to firms providing professional services only and the relevant Californian legislation, which is confined to professional law, or accounting partnerships. It is suggested that the present UK approach be followed in the Indian context, *i.e.* that the LLP be extended to all businesses, but with requisite safeguards. If one accepts

the general arguments favouring the introduction of the LLP outlined above, there would be no reason to restrict the LLP to professional or specific businesses. The LLP should be made available as a general business vehicle.

### THE SCOPE OF LIMITED LIABILITY

In general, LLPs have limited liability in all situations. However, this is not always the case as some divergence can be seen in LLP legislation in different jurisdictions. In the UK, every member of the LLP is deemed to be an agent of the LLP. Therefore, third parties dealing with a partner of an LLP contract with the LLP rather than with the individual partner. Section 6(2) of the UK Act provides that an LLP is not bound by the acts of a member if he acted without authority and the third party knew that the member has no such authority to act.

It is suggested that the proposed LLP Act in India should adopt the broadest scope/category of limited liability, such as the UK position given that such course is consistent with the general arguments favouring the introduction of the LLP as outlined above, and there is no reason in principle or policy why such a category ought not to be adopted.

It should also be noted that under most US states LLP laws, the partner is shielded from liability with respect to acts committed by other partners so long as that particular partner did not participate in the misfeasance. For example, in the Delaware statute, a partner of a LLP is not personally liable for claims against the firm arising from negligence or other forms of malpractice, unless the partner was personally involved in the negligence or malpractice. Section 15-306 of the Delaware Code provides that -

#### § 15-306. Partner's liability.

- (a) *Except as otherwise provided in subsections (b) and (c), all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.*
- (b) *A person admitted as a partner into an existing partnership is not personally liable for any obligation of the partnership incurred before the person's admission as a partner.*
- (c) *An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of indemnification,*

*contribution, assessment or otherwise, for such an obligation solely by reason of being or so acting as a partner.*

### POSSIBLE SAFEGUARDS

While the limited liability enjoyed by partners in an LLP is clearly advantageous to its partners, it raises concerns among third parties who deal with the LLP. Unlike a traditional partnership where third parties including clients, business associates, suppliers and possibly consumers have some assurance that their claims would be met by the individual partner's unlimited personal liability, the LLP provides limited assurance in such respect as recovery of claims can only be made against the limited assets of the LLP.

Bearing in mind the limited assets available for distribution, LLP statutes generally incorporate adequate safeguards to protect the interests of third parties. While the specific provisions relating to such safeguards in different LLP statutes may differ, the broad objectives remain twofold -

- (a) preserve the LLP assets which can be claimed by third parties while the LLP is a going concern, and in the course of its winding up, and
- (b) impose sufficient disclosure requirements on the LLPs such that third parties dealing with the LLP are fully informed about the entity that they chose to deal with.

The UK Act provides several such safeguards. These include -

- (a) the requirement that the LLP utilise appropriate words to advertise its status.
- (b) the requirement that the LLP be registered, with its requisite records being kept up-to-date.
- (c) the requirement that the LLP render financial disclosure almost equivalent to that required of companies.
- (d) provision for members of the LLP to be sued for wrongful and fraudulent trading.
- (e) regulations for dealing with insolvency as well as winding-up of the LLP.
- (f) the presence of 'clawback' provisions: members of the LLP may be subject to a clawback inasmuch as the liquidator may apply to the court to recover withdrawals of property of the LLP made by a member within two years prior to the winding-up when the member



concerned knew or had reasonable grounds for believing that the LLP was insolvent or would be made insolvent by the said withdrawal.

Some jurisdictions have gone further and imposed even more stringent safeguards. For example, the Jersey Law requires an LLP to make a financial provision for a sum of £ 5 million to be paid into a bank/insurance company to meet the claims of creditors of the LLP in the event of its dissolution. Failure to do so automatically triggers the removal of the protective shield of limited liability and the partners become jointly and severally liable for the debts of the LLP. Such financial provision requirement also exists in several US state LLP statutes. However, the UK Act does not contain this financial provision requirement. The reason being that such financial provision requirement may prove onerous for smaller firms and that the ascertainment of an adequate amount is difficult. Further, it is felt that such provisions may be insufficient to meet the needs generated by a major insolvency.

The above discussion holds much relevance in the Indian context. The proposed Indian LLP statute must contain adequate safeguards to ensure that the limited liability benefit is not abused. At the same time, policy makers need to ensure that while there should be adequate safeguards, these requirements must not be too stringent. If compliance is too onerous, the utility of the LLP as an alternate corporate structure will be diminished. Policy makers will also need to examine whether the other safeguards mentioned in the preceding paragraphs, in particular, the requirements for financial disclosure, the regulations for dealing with insolvency and winding-up, as well as the 'clawback' provisions, would be sufficient without the further (or alternative) requirement of a bond.

### **IMPLEMENTATIONAL ISSUES**

As the LLP is a hybrid entity combining features of both a company and a partnership, it will also be important to consider the applicability of all other laws on the LLP entity.

Due to its separate legal personality, the LLP should be treated like a company. As such, provisions of the Companies Act dealing with incorporation, registration of business, power to enter into contracts, ability to sue and be sued should all apply to an LLP. On the other hand, a factor to be considered is whether the LLP is an appropriate business vehicle for purposes of taxation. In most jurisdictions, the LLP is treated as a partnership. If this approach were adopted in India, then some

provisions of the Income tax Act would apply to the LLP as if it were a partnership.

In view of the recommendation of the Dr J J Irani Expert Committee and the Naresh Chandra Committee, that a new separate LLP Act be brought about to facilitate LLPs, another important issue that needs to be addressed is how the LLP statute should be structured to deal with every aspect of this new business entity. The UK approach is to have a basic LLP Act dealing with the substantive provisions of the LLP entity and to apply all other relevant legislations to LLPs by way of subsidiary regulations, which state how provisions of other legislations should be modified to suit LLPs. An alternate approach, as taken in Delaware, is to consolidate all provisions applicable to LLPs in one separate complete Act. Both the approaches have their benefits and need to be examined carefully before a decision is taken as to which approach is suitable in the Indian context.

An issue related to the structure of the LLP statute, is deciding which government agency will have responsibility over registration and compliance requirements of LLPs. In this regard, it is suggested that the Registrar of Companies, who has sufficient capabilities in dealing with other business vehicles, should perhaps be given the added task of administering LLPs. The Registrar of Companies has, over the years, built up sufficient capabilities and expertise overseeing the registration requirements of corporate businesses and can now be safely entrusted with this added responsibility.

### **POSSIBLE ARGUMENTS AGAINST THE INTRODUCTION OF LLP IN THE INDIAN CONTEXT**

Like every other business vehicle, the LLP entity too has certain defects that could thwart its adoption. One particular deterrent to the adoption of the LLP vehicle is the disclosure requirement. In the UK, certain portions of the UK Companies Act are applicable to LLPs with appropriate modifications. These provisions impose accounting and auditing requirements on LLPs similar to those for companies. The justification for such disclosure is that they are a price for limited liability and serves as a mechanism to protect third parties who are contemplating dealing with the LLP concerned.

The other proposed safeguards suggested might also give rise to possible criticism. However, the policy makers drafting the proposed Indian LLP Act would be free to either modify or even refuse to accept specific proposals. In any case, it is suggested that the requirement of financial disclosure (considered in the

preceding paragraph) ought to be adopted for the reasons already mentioned.

Another issue that could arise is as to whether or not the proposed Indian LLP Act should allow all professions such as the accounting, company secretaries, legal, medical professions to be corporatised or restrict it solely to small businesses. In this regard, it is suggested that there is no reason in principle why the LLP should not be introduced as an alternative option. More importantly, as has already been suggested, the LLP ought to be extended to all businesses in any event — an approach that has found favour in the UK context.

There are, of course, other considerations, such as prohibitive logistics and compliance costs. However, these are inevitable business considerations that will invariably vary from business to business, and should therefore be left to the businesses concerned for their final decision.

#### **SUMMARY AND CONCLUSION**

The LLP is a new business entity, which seeks to combine the benefits of limited liability with the flexibility of partnership. To ensure that these benefits are not abused, the proposed Indian LLP Act must impose sufficient safeguards to protect third parties who deal with LLPs. At the same time the compliance requirements must not be too onerous to turn businesses away from adopting the LLP vehicle. The challenge for policy makers will be to find the appropriate balance to ensure that the LLP becomes a useful alternative to Indian businesses and professionals.

In conclusion, it should be stated that the recommendation of the Naresh Chandra and the Dr Irani

Committees to introduce LLPs in India has been made with the aim of steering the domestic Indian market towards global integration. Considering the fact that India is progressively making efforts to move up the technological and innovation ladder, and increase its participation in global trade and commerce, the recommendation to introduce LLPs is to be wholly welcomed. The creation of LLPs will add to the variety of business entities available to those wishing to set up business in India. Firms, small businesses and professionals will now have the option of becoming a limited liability entity with the internal flexibility of a partnership. Taking everything into consideration, such a new business environment would only be a positive step for India.

#### **REFERENCES**

- (a) UK Limited Liability Partnership Act 2000 (available at <http://www.dti.gov.uk/cld/llpbill>).
- (b) New York Code, Registered Limited Liability Partnerships (available at <http://caselaw.lp.findlaw.com/nycodes/c81/a11.html>).
- (c) Delaware Revised Uniform Partnership Act, Subchapter X. Limited Liability Partnership (available at <http://www.delcode.state.de.us/title6/c015/sc10/index.htm#TopOfPage>).
- (d) Limited Liability Partnerships (Jersey) Law 1997 (available at <http://www.jerseylegalinfo.je/Law/LawsInForce/default.aspx>).
- (e) Singapore Limited Liability Partnerships Act 2005(available at <http://statutes.agc.gov.sg/>).