LIMITED LIABILITY PARTNERSHIPS

By Simon Greenley and Simon Goldring

The Limited Liability Partnership Act 2000 ("the Act") became law on 6 April 2001, creating of a new type of legal entity in Great Britain; the Limited Liability Partnership ("the LLP").

This is a very significant development in the law and this article discusses its effect on the Insurance Industry.

What are LLPs?

LLPs are outwardly very distinct from partnerships. They are separate legal entities with limited liability and therefore have the ability to enter into contracts with third parties and sue and be sued in their own right. This has two important consequences. First, the LLP will be unaffected by any change in its membership, whereas a partnership dissolves when a partner joins or leaves. Secondly, the members are not jointly and severally liable for the others' debts and liabilities and so their personal assets are protected, provided that they are innocent from wrongdoing.

The LLP is a body corporate and not, despite the name, a partnership. Consequently, the underlying legislative approach was to draw upon the principles enshrined in the treatment of companies and so the principal provisions of the Companies Act 1985, Insolvency Act 1986 and the Company Directors Disqualification Act 1986 apply to LLPs.

However, the LLP has a hybrid quality, so that whilst outwardly it resembles a corporation, inwardly, at least in respect of its flexible management structures and tax status, it resembles a partnership.

Impetus for change

The fundamental problem that the Act addresses is the perceived anachronism of Partnership Law and in particular the concept of joint and several liability. The Partnership Act 1890 was a codification of nineteenth century jurisprudence and was founded upon the assumption that each partner intimately knew and trusted his other partners. However, the nature of partnerships has changed beyond recognition since then, particularly in the last fifteen years. "Mega-partnerships" have emerged in some professions with several hundred partners, often personally unknown to one another, undertaking different disciplines in offices across the world. The Department of Trade and Industry (DTI) argue that the growth and success of such partnerships is hampered by the fear of unlimited liability, which puts partners at risk of bankruptcy for the negligence of others over whom they have no control or knowledge.

The claim of *ADT Limited -v- BDO Binder Hamlyn*, cited in the evidence to the Trade and Industry Select Committee, nicely illustrates this point. In this case, the misstatement of one audit partner gave rise to a judgment of £65 million. Since this sum greatly exceeded the insurance cover, every partner (even those "innocent" of any wrongdoing) was jointly and severally liable for the entire shortfall, or at the very least a contribution, representing over £150,000 each.

The Law Commission is currently reviewing proposals for the modernisation of Partnership Law, but their final report is not yet available. Also, the DTI is conducting a comprehensive review of Company Law, and their preliminary recommendations are due later this year. This Act is not intended to displace this process but was "fast-tracked" in response to the threat from some of the major professional firms that they would incorporate elsewhere (for example Jersey), because such moves off-shore would be publicly damaging and would have encouraged others to follow.

Will LLPs be popular?

The DTI state that this Act addresses a real commercial need and so the introduction of a new and alternative business entity has real merit. It estimates that approximately 10% of the 650,000 partnerships in Great Britain will convert to LLP status, but this percentage rate will not be uniform across different types of business. For example, certain industries, such as rail, manufacturing, catering and health, have shown little interest in converting to LLP status. By contrast, certain professional sectors (most notably accountancy) have actively lobbied for the introduction of LLPs and four out of the largest seven accountancy firms have immediate plans to convert to LLP status. The DTI anticipates that in addition to accountants, lawyers, actuaries, surveyors, architects and engineers will also be attracted to the LLP vehicle.

The experience of other jurisdictions also shows that LLPs are likely to be popular among professionals. For example, in Texas, more than 1,200 law firms, including virtually all of the state's largest firms, elected to become LLPs within one year of its introduction.

The projected popularity of LLPs cannot be explained solely in terms of the limitation of liability. This is because professionals are already able to limit their liability, by incorporating as private companies, but very few firms have elected to do so. For example, accountancy and law firms have been permitted to incorporate for about 10 years, but only around 20 law firms and 100 accountancy firms have done so. This is because partnerships fear that they would lose their distinctive culture, flexible management structure and their favourable tax and national insurance regime on incorporation. However, as we have seen, these concerns do not apply to LLPs and it is this hybrid quality that is likely to be attractive to professional firms.

Comparisons with other jurisdictions

Many other jurisdictions have LLPs. The concept arose in the United States of America in response to large suits brought against law firms in the wake of the collapse in the 1980s of many US banks and savings and loan associations. The first statute was passed in Texas in 1991 and now virtually all states in North America have LLP status, many providing a broader shield of limitation of liability of partners than originally envisaged, together with some sort of minimum bond or insurance agreement. Other jurisdictions, including Australia and Canada, Germany and Jersey, have also recently introduced LLP vehicles.

Insurers will no doubt have a number of questions relating to the effect of this Act on their business. For example, will it undermine confidence in the audit process, will it affect the level of cover taken out by professionals, and will it affect the nature of cover required? Regrettably, the DTI did not undertake a detailed analysis of the lessons learned from other jurisdictions. This is because there are so many different variants of LLPs each bearing little comparison to each other and because the environment in which they operate and the problems which they were intended to address are different from those in Britain.

How will the introduction of LLPs affect the insurance industry?

The insurance industry as institutional investors and consumers

The Association of British Insurers (the "ABI") gave evidence to the Trade and Industry Select Committee, concentrating on the impact of the Act on Insurers in their capacity as institutional investors and consumers of professional services.

The ABI's 450 members have approximately £800 billion of assets under management including £350 billion invested in the equity and other securities of UK companies and so they are major providers of long term capital to the UK corporate sector. Therefore, they have a strong interest in ensuring confidence in the audit of these companies, to which they ascribe particular importance.

The ABI expressed concern that audits undertaken by Limited Liability Partnerships are unlikely to command confidence in third parties. This is because there is no requirement that the LLP has any minimum capital backing, such as bonds, minimum capital assets or members' guarantees. This means that a third party who relies upon a negligent audit may be in a worse position when enforcing a judgment against an LLP compared to a corporation (which has prescribed minimum capital requirements) or a partnership (whose partners are jointly and severally liable). For this reason, the ABI say that this regime "would appear to provide not for "limited liability entities" but "no liabilities entities". The ABI argues that a firm should have a capital base appropriate to its work so that "if it is auditing a £600 million firm ... it should have adequate capital backing". In the absence of adequate capital backing, the ABI says that accountancy LLPs are unlikely to command the confidence of their clients and other interested parties, because the burden of risk shifts onto them, away from those who had caused it.

In addition, the insurance industry is an important consumer of professional services, spending millions of pounds each year on legal advice and accountancy services. The ABI appears to have similar concerns to those above; namely that insurers in their capacity as clients will not have confidence in their advisors if they have inadequate capital backing.

In response to those concerns, the DTI essentially make three points.

First, the underlying rationale of the Act that personal assets of innocent members should not be at risk is widely accepted and professionals would incorporate offshore in the absence of legislation in Great Britain. This will inevitably shift the risk from individual partners onto the consumers and interested third parties and so one has to look at other methods of protecting them, such as insurance, bonds and minimum capital requirements.

Secondly, creditors of corporations do not have any additional protection compared to creditors of LLPs in practice. This is because the minimum capital requirements of corporations (£1 for private companies and £50,000 for public companies) are irrelevant in reality where creditors are owed millions of pounds. Also, while large companies tend to have share capital greatly in excess of the statutory minima, the limits remain small compared to the company's debts and do not in practice translate into the availability of funds in the event of insolvency.

Thirdly, the DTI says additional protection for the creditors of LLPs is either impractical or unnecessary. First, no level of bonds or capital maintenance would give protection (especially to unsecured creditors) without having a detrimental effect on the firm's ability to set up in and carry on business. Secondly, sophisticated clients (such as the client of the £600 million firm referred to by the ABI) do not require legislative protection because they would make contractual relationships conditional upon the LLP providing financial information and/or other assurances, such as having adequate insurance cover.

Therefore, the DTI rejects the ABI's concern that audits undertaken by LLPs are unlikely to command the confidence of insurers either in their capacity as institutional investors or as clients. However, this tacitly assumes that LLPs are willing and able to purchase appropriate levels of insurance and this is discussed below.

LLPs - reduction of insurance cover?

The ABI believe that LLPs will continue to be able to find cover in the open market at similar rates to those offered to partnerships.

However, there is a theoretical argument that LLPs will carry less insurance than their partnership equivalents. This is because partnerships have an incentive to carry high levels of insurance, because in its absence, the individual partners face bankruptcy. It could be argued that one potential consequence of limiting liability, thereby removing the threat of bankruptcy, is that LLPs have less incentive to maintain high levels of professional indemnity insurance because of its cost, so levels of insurance will fall.

However, the Trade and Industry Select Committee concluded that there was no evidence, particularly from the experience of the few firms that had incorporated, that LLPs would carry less cover than partnerships. Indeed, we consider that LLPs have the following incentives to retain equivalent levels of insurance as partnerships.

First, notwithstanding the limited liability status of the LLP, individual members will continue to be personally liable for their negligent advice in certain circumstances. Secondly, members will not wish to see their practice wound up as a consequence of under-insurance, as they would lose their livelihood and face potential claims from the liquidator or upon personal guarantees, for example on the lease. Thirdly, sophisticated clients will insist that their advisors carry appropriate levels of insurance. In those circumstances, we do not envisage that LLPs will reduce their cover on incorporation.

The obligation to take out professional indemnity insurance will also apply to LLPs and for some professions, the minimum levels will actually be higher for those operating as an LLP, in order to protect their clients. For example, the Law Society insists that an LLP carries top up insurance of £500,000 on an each and every claim basis or £2 million on an aggregate basis in addition to the minimum terms required of a partnership. Therefore, small LLPs may carry higher levels of insurance than their predecessor practices and it will be interesting to see whether this deters change. However, these minimum terms will not affect the amount of cover carried by the larger practices and will not provide any protection to clients with high value claims against their advisors.

Since there is no evidence that LLPs will purchase levels of insurance that are higher than their partnership equivalents, with respect to "doomsday claims", such as the claim against BDO Binder Hamlyn mentioned earlier, the burden of risk will shift away from those who have caused it, onto those who have suffered loss.

Nature of cover required

The insurance requirements for LLPs depend upon their "outward facing" characteristics. As we have seen, LLPs outwardly resemble corporations in the sense that they have a separate legal personality with limited liability and that the principal provisions of the Companies Act and Insolvency Act apply to them and to their members. Therefore, the Act superimposes the regime that governs the liability of companies and their directors on to LLPs and their members, so that the insurance carried by partnerships that take on LLP status will need to be converted to a form closely resembling corporate E&O coverage with D&O extensions.

Whilst the concept of joint and several liability for individual members of LLPs will be a "thing of the past", they will nevertheless require insurance for two reasons.

First, the recent Court of Appeal decision of *Merrett -v- Babb* confirms that individual members (and any employees for that matter) may be sued for negligent advice where they have assumed personal responsibility to a third party who has reasonably relied upon this. The Court of Appeal, by a majority, found that in this case the individual surveyor had assumed a personal responsibility to the purchasers even though they had no idea of his identity and he had not communicated directly with them. Given the uncertainty as to what factual circumstances will constitute an assumption of personal responsibility members will also require costs cover against ultimately unmeritorious claims.

Secondly, and perhaps more importantly, individual members will now be exposed to liabilities similar to those faced by the directors and officers of corporations. The following are examples of claims that will require coverage:-

- The members' costs of defending numerous offences under the Companies Act 1985, such as the failure to lodge annual accounts. These offences are generally punishable by fines, which will typically be excluded from cover.

- The members' costs of defending an action under the Company Directors' Disqualification Act 1986. The number of disqualification actions has increased significantly in recent years and so this type of cover is particularly important. For example in 1986/7 there were only 72 disqualification orders, rising to 1,219 in 1996/7 and to 1,540 in 1999/2000.

- The members' costs of defending certain actions under the Insolvency Act 1986. For example, the LLP's liquidator can bring a claim against a member to contribute to the debts of the LLP where he allowed it to continue trading when he knew or ought to have known that insolvency was inevitable. Furthermore, because there is no prohibition on distributing capital, the Act imposes an additional safeguard for creditors so that withdrawals over two year period from the commencement of liquidation can be clawed back from members in certain circumstances. Whilst the members will insist upon costs cover for such claims, insurers should consider excluding indemnity for any order to contribute to the LLPs assets.

- Internal claims, whether brought by the LLP itself, alleging breach of fiduciary duties, or from other members, for example under s459 Companies Act 1985 alleging that their interests had been unfairly prejudiced, although insurers should consider excluding such "inter-assured" claims altogether.

Therefore, whilst the Act restricts the members' personal liability on the one hand, in the sense that they are no longer jointly and severally liable, it opens up their liabilities on the other to the extent that they now largely mirror those faced by company directors.

A typical Directors & Officers Liability Policy will reimburse the company for any claims that that they have paid on behalf of their directors, but the Companies Act

1985 significantly limits the circumstances in which this indemnity is permitted. However, care will need to be given to providing entity reimbursement for an LLP because unlike the position governing companies, there do not appear to be any provisions limiting the circumstances where they are entitled to indemnify their members, and so such a clause may provide unintended indemnities.

What should the Insurance Industry do?

As we have seen, the DTI considers that there is a real commercial need for the LLP vehicle, which they predict will be embraced by professional firms. However, it appears that the majority of firms (other than the largest partnerships) have not yet formally elected to convert. Therefore, in the context of a competitive market, individual insurers and brokers interested in insuring LLPs have the opportunity of increasing their market share by customising their products and educating their potential clients.

Long term trends

We have already seen that the DTI is undertaking a comprehensive review of company law and the Law Commission is finalising its recommendations on reforming Partnership Law. However, the Act should not be taken as any indication of future developments since the genesis of the Act has not emerged from nor been referred to either of the major reviews now under way. The DTI has also confirmed that any changes to company law in the future will be read across to LLPs.

Whilst the Act creates an alternative type of corporation where members do not have joint and several liability as between themselves, it does not introduce proportionate liability. The LLP will continue to have joint and several liability in so far as third parties are concerned and so a LLP can be liable for 100% of a claim even though it is only 1% to blame. Whilst some observers view the introduction of Limited Liability Partnerships as a precursor to proportionate liability, the Law Commission recently rejected a proposal to reform joint and several liability, primarily because such a scheme would shift the burden of risk on to those who had suffered loss away from those who had caused it.

Conclusion

The introduction of the LLP is an important development since it limits the liability of its members, provided that they are innocent of any wrongdoing. Since partnerships taking on LLP status will need to change the nature of their insurance, it also represents an opportunity for enlightened insurers to increase their market share in this sector. It remains to be seen whether the limitation in liability will cause LLP's to reduce their level of cover or whether the ABI's concern that it will undermine confidence in the audit process is justified. In any event, in view of the ongoing reviews of Partnership and Company Law, this Act marks the beginning and not the end of reform over the next few years.

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