

Practice questions for Chapter 18 – Unincorporated business structures

Essay question

'The Limited Liability Partnerships Act 2000 was passed in order to benefit professional firms and, as such, the limited liability partnership is not a suitable business structure for small businesses in general.'

Discuss.

Introduction

- This question will discuss the limited liability partnership (LLP) and to what extent it is a suitable business vehicle for small businesses. This will involve a discussion of the background to, and history of, the Limited Liability Partnerships Act 2000 as well as the operation of LLPs themselves.

Background to and origins of the Act

- The concept of the limited liability partnership originated in Texas in 1991, inspired by government litigation against law and accounting firms that had done work for failed savings and loan associations. The claims were against all partners including many who had nothing to do with the failed associations, highlighting the joint and several liability of partners for each other's conduct. The prospect that all of the members in a partnership of lawyers or accountants may be exposed to hundreds of millions of dollars in liability was a strong incentive for the development of mechanisms to limit the vicarious liability of partners. The LLP was the mechanism created to achieve that objective. It proved to be very popular and in a short space of time, all US States had enacted some form of LLP legislation.
- The LLP first crossed the Atlantic when, in September 1996, Jersey approved controversial legislation that would allow the UK's 'Big Six' accountancy firms to register as LLPs. Immediately, the Big Six started campaigning for similar legislation in the UK. The option of registering in Jersey was seen as lending urgency to UK accountants' demands, which were further fuelled by the Law Commission's negative reaction to calls for reform of the current regime of joint and several liability of professional defendants. In response to the accountant's demands for action, the Department of Trade and Industry published two consultation documents containing proposals for a new form of business association to be known as a limited liability partnership. Unusually for the UK, the consultation procedure was a long and protracted one taking over three years to produce a Bill. The Limited Liability Partnership Bill eventually passed through Parliament and received Royal Assent in July 2000. It came into effect on 6th April 2001.

The 'real' reasons behind the Act

- There has been debate for some time as to whether the limited company adequately suits the needs of small businesses. Many argue it does not and that a new legal form is required. Some proponents of this view claimed success following the introduction of the LLP. However, as we are going to see, the LLP was not introduced because the company is inadequate to the needs of small businesses. As we shall see, the LLP is equally unsuited to the needs of many small businesses. If anything, the Act was introduced not because of the inadequacies of company law, but due to the inadequacies of partnership law.

- The call for the LLP came almost entirely from professional firms (e.g. lawyers, accountants etc). Most professional firms prefer to use the partnership as their preferred legal form of organization due to its flexibility, favourable tax treatment and less onerous regulation. However, existing partnership law provides that all partners are agents for the firm and each other and so are liable to the full extent of their personal assets for the firms' debts and liabilities.
- In a typical trading partnership liability of each partner for the obligations of the others reflects the relationship of trust which forms the basis of the organization. However, the growth of accountancy and law firms means that such firms may have thousands of partners worldwide. This means that partners are liable for the negligent acts of other partners that they may never have met.
- The real problem here is not that the company is inappropriate for these professional firms, but that the partnership is. Indeed, in such firms, the management structure resembles that of a company rather than that of a traditional partnership.
- Such firms have faced a sharp increase in the number and size of negligence claims which has resulted in a sharp increase in their costs and a deterioration in the terms on which they can obtain indemnity insurance, which has in turn resulted in an increase in the fees charged to clients. One case in particular,¹ which concerned the audit work of a leading firm of accountants, has promoted a widespread fear that professional firms face a real risk of extinction from a 'doomsday claim' (that is, a claim that is so large that it will result in the bankruptcy of the firm.)
- There is a real concern that it is only a matter of time before one the Big Four is brought down by such a claim. If this were to happen, it would have serious implications for the economy and for the wider public interest in providing professional services. Accordingly, many professional firms believe that this upward trend in negligence claims coupled with their joint and several liability imposed an unfair burden.
- There existed basically, two ways in which professional firms could obtain greater protection. The first was to produce a change in the law governing their liability either by way of a cap on their liability or by abandoning joint and several liability. The Law Commission refused to examine this (although auditors are now allowed to limit their liability under the Companies Act 2006). Accordingly, the professional firms had to take the second option, which was to persuade the government to change the law of business organizations to permit the introduction of LLPs.
- Initially, the Government resisted such a proposal. However, once Jersey enacted its LLP laws, it became apparent that professional firms would be prepared to go offshore to exploit this medium. The consensus soon emerged that it would be preferable for English law to offer the option of LLPs and maintain its regulatory grip.
- Accordingly, the Limited Liability Partnerships Act 2000 came into being due to the pressure of one minority interest group. It was not enacted due to the inadequacies of the limited company.

The LLP in the UK

- The members of a LLP are agents of the firm, not of each other. Accordingly, they are not liable for each other's acts, although of course, the firm is still liable for acts committed by its members in the ordinary course of business.
- The LLP will be a body corporate² so, like a company, it will have separate personality. Like companies incorporated under the Companies Act 2006, LLPs are to have unlimited capacity.³ Persons who form a LLP are to be known as 'members,' not partners.
- Notably, the Act states that unless otherwise provided by the Act, an LLP will not be governed by partnership law, but by company law.⁴ What this means is that many of the disclosure and other

¹ *ADT Ltd v BDO Binder Hamlyn* [1996] BCC 808.

² LLP Act 2000, s 1(2).

³ *Ibid*, s 1(3).

burdens that limited companies have to comply with will also be required from LLPs. Disclosure is the price to pay for limited liability. LLPs and their members will be subject to the provisions relating to fraudulent and wrongful trading. Those managing a LLP will be subject to disqualification under the Company Directors Disqualification Act 1986.⁵ For the purposes of insolvency and winding up, the LLP will be treated like a registered company.⁶

- The point to note is that LLPs closely resemble companies. If the company is to be regarded as unsuitable for small businesses, then the LLP must also be regarded as unsuitable for many small businesses. This is borne out in that, as of the end of May 2014, there were only 59,671 LLPs registered in the UK.

Conclusion

- The LLP debate was not about whether or not we need a new company structure for the small business. It was about catering to the needs of the narrow interests of certain professions. However, the issues and implications involved are of broader importance. There is a real danger that the LLP was formulated without reference to the needs of the business community as a result of the undue focus on professional liability. The LLP has been created so as to cater for the needs of a dominant voice. This does not ensure for equitable legislation. It is certainly not the new business structure for the small business that many thought it would be.
- We have seen that for most professions, incorporation is a possibility and it would appear that that would limit their liability more effectively than the LLP in its current form. Arguably, the professions' main reason for becoming a LLP is to acquire the tax benefits.
The question is why should the professions have access to tax concessions that are not available to trading firms.
- Many of the requirements placed upon companies will also be placed upon LLPs. Accordingly, the main arguments for a new legal form for small businesses have not been answered by the LLP, but then again it was not designed to be a new legal form for the small business. This may be a good thing. Creating a specialist limited liability legal form for small firms, or a less regulated form of incorporation, might encourage inappropriate use of the limited liability regime.
- Because of the potential abuses that can arise from LLP type forms, they tend to be more regulated than private companies. Accordingly, it can legitimately be argued that the LLP is not a new form of business organization for the small business.
- Both the UK and America are currently experiencing an enthusiasm for limited liability and this may be resulting in it being spread to areas where it should not be spread. The UK should not be trying to make limited liability even easier to obtain simply because other jurisdictions are doing so. It is already relatively easy to obtain by incorporation. Limited liability has its limits. It should not go beyond those limits.

Problem question

Discuss the following:

- In May, Card & Co, a firm of solicitors, undertakes to recover a debt for Vincent. In July, Shane becomes a partner of the firm. In November, Vincent informs Card & Co that it will be impossible to recover the debt as the debtor has become insolvent. Had the firm acted more quickly, Vincent might have been able to recover the money owed. Vincent alleges that the firm has been negligent

⁴ Ibid, s 1(5).

⁵ Limited Liability Partnerships Regulations 2001, reg 4(2).

⁶ Ibid, reg 5.

and commences proceedings. Does Shane face any liability?

- Helen is a partner in a firm of accountants, Grimwood & Co. Her sister, Emma, asks her if she would audit her company's accounts as a personal favour. Helen conducts the audit using her firm's premises and staff, but does not charge Emma a fee. The audit is negligently conducted and Emma sues Helen's firm. Are the firm and Helen's co-partners liable?
- Rhian and Martin decide to set up a partnership, the aim of which is to locate a piece of land and build a number of houses upon it. A partnership agreement is drawn up. A piece of land is located that is ideal, but Rhian informs Martin that the council has refused to grant planning permission to build on the land. In fact, the land has already been granted planning permission. Rhian purchases the land without informing Martin and develops a number of houses on it. She then sells them for a considerable profit. Martin discovers this and seeks your advice regarding what action to take next.

In May, Card & Co, a firm of solicitors, undertakes to recover a debt for Vincent. In July, Shane becomes a partner of the firm. In November, Card & Co informs Vincent that it will be impossible to recover the debt as the debtor has become insolvent. Had the firm acted more quickly, Vincent might have been able to recover the money owed. Vincent alleges that the firm has been negligent and commences proceedings. Does Shane face any liability?

- The issue here is to what extent is a new partner liable for acts done prior to his joining the firm. The PA 1890, s 17(1) provides that '[a] person who is admitted as a partner into an existing firm does not thereby become liable to the creditors of the firm for anything done before he became a partner.'
- However, in our case, the issue is more complex as the firm entered into the contract prior to Shane becoming a partner, but engaged in the allegedly negligent conduct following Shane joining the firm. Does the phrase 'anything done before he became a partner' refer to entering into the contract or the act of alleged negligence?
- It depends on whether the act in question is a single continuous act, or a number of repeated acts. The act of recovering a debt is likely to be regarded as a single act and, in such cases, the phrase 'anything done' will refer to entering into the contract.⁷ Accordingly, Shane will not be liable as the relevant act occurred before he became a partner.

Helen is a partner in a firm of accountants, Grimwood & Co. Her sister, Emma, asks her if she would audit her company's accounts as a personal favour. Helen conducts the audit using her firm's premises and staff, but does not charge Emma a fee. The audit is negligently conducted and Emma sues Helen's firm. Are the firm and Helen's co-partners liable?

- The issue here is whether or not Grimwood & Co and/or Helen's co-partners are liable for Helen's alleged act of negligence. The relevant provision is the PA 1890, s 10 which provides that the partnership and each partner is vicariously liable for the wrongful acts or omissions of another partner, provided that the partner was acting within his authority, or the act was done whilst in the ordinary course of the firm's business.
- The firm will try to argue that, as Helen was conducting the audit as a personal favour to Emma, then it was not done whilst in the ordinary course of the firm's business. In *Dubai Aluminium Co Ltd v Salaam*,⁸ the House of Lords stated that whether an act is within the course of the firm's business will depend on the closeness of the connection between the act of wrongdoing and what the partner is authorized to do.

⁷ *Court v Berlin* [1897] 2 QB 396 (CA).

⁸ [2002] UKHL 48.

- There is little doubt that Helen is authorized to audit the accounts of companies, and as this is closely connected to the act of wrongdoing, it would appear that the firm and Helen's co-partners could be liable for her negligence.
- However, the courts have indicated that an act may not be within the ordinary course of a firm's business if the partner commits the act in a personal capacity – the case of *Chittick v Maxwell*⁹ provides a good example. Certainly, Grimwood & Co and Helen's co-partners would argue that, in auditing Emma's company, Helen was acting in a personal capacity.
- Accordingly, it could be argued that the negligently conducted audit was not within the ordinary course of the firm's business. However, as s 10 applies to acts within the ordinary course of the firm's business, or acts within the partner's authority, Grimwood & Co and Helen's co-partners may still be liable if the alleged act of wrongdoing was within Helen's authority.
- The authority that Helen has will depend upon the contents of the partnership agreement. We are not told anything about the contents of the partnership agreement, so it cannot be stated with certainty whether or not Helen's actions are within her authority.

Rhian and Martin decide to set up a partnership, the aim of which is to locate a piece of land and build a number of houses upon it. A partnership agreement is drawn up. A piece of land is located that is ideal, but Rhian informs Martin that the council has refused to grant planning permission to build on the land. In fact, the land has already been granted planning permission. Rhian purchases the land without informing Martin and develops a number of houses on it. She then sells them for a considerable profit. Martin discovers this and seeks your advice regarding what action to take next.

- The partnership agreement constitutes a contract, but it is a special form of contract known as *uberrimae fidei* ('utmost good faith'). Contracts of utmost good faith impose a number of fiduciary duties upon the parties and these can be found in the PA 1890, ss 28, 29 and 30. The relevant duties can be found in ss 29(1) and 30. Section 29(1) states:

Every partner must account to the firm for any benefit derived by him without the consent of the other partners from any transaction concerning the partnership, or from any use by him of the partnership property name or business connexion.

- Basically, s 29(1) places a duty on the partners to account for any secret profits they make. The case of *Bentley v Craven*¹⁰ provides a good example of a situation where a partner was required to account for the secret profit he made. In order for the duty contained in s 29(1) to be breached, the profit must be made through some asset belonging to the firm. It could be argued that the opportunity to purchase the land was one that belonged to the partnership as the land was discovered whilst engaged in the business of the firm. Accordingly, Rhian used this asset of the firm in order to make a profit and, in order to keep the profit secret, she has lied to Martin. Therefore, it is likely that Rhian will be required to account for the profit she made.
- Section 30 may also be of relevance and there is a considerable overlap between the duty found in s 29 and the duty found in s 30. Section 30 states:

If a partner, without the consent of the other partners, carries on any business of the same nature as and competing with that of the firm, he must account for and pay over to the firm all profits made by him in that business.

⁹ (1993) 118 ALR 728.

¹⁰ (1853) 18 Beav 75.

- It could be argued that Rhian, in purchasing the land herself, has engaged in competition with her firm. A partner who competes with his own firm is clearly not acting in good faith and will be required to account for any profit made whilst competing with the firm.
- Therefore, it appears that Rhian will be required to account, either under s 29 or s 30. It is important to understand the relationship between s 29 and s 30. Many cases (including ours) involve a breach of both duties, but there is a distinction to note. In order for a breach of s 29(1) to arise, the partner must make a secret profit using an asset of the firm, but there is no need to establish that the partner was competing with the firm. Conversely, in order for a breach of s 30 to arise, the partner must have made a profit whilst competing with the firm, but there is no need to show that the partner used an asset of the firm.