Limited Liability Partnership in India- A Critical analysis of the Naresh Chandra Committee Report on 'Regulation of Small Companies and Partnership'

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Partnership is one of the oldest forms of business relationships. Though limited liability companies have replaced partnership firms in complex businesses, partnerships are still preferred by professionals and small trading and business enterprises in India and abroad.

The Indian partnership act of 1932 provides for a general form of partnership which is the most prevalent form in India, but, over time the general form of partnership has lost its charm because of the inherent disadvantages in it, the most important is the unlimited liability of all partners for business debts and legal consequences, regardless of their holding, as the firm is not a legal entity. General partners are also jointly and severally liable for tortuous acts of co-partners. Each partner has the exposure of their personal assets being appropriated and liquidated to meet partnership dues. These are statutory position, which cannot be altered by contract *inter-se,* though at times subterfuges are resorted to by unscrupulous partners to avoid personal liability. General partnership holdings are not easy to transfer; typically all other partners have to agree. Yet partnership is preferred in India, because of the ease of formation and lack of compliances involved.

The need for LLP

The government has woken up from it slumber has acknowledged the disadvantages posed the general partnership and recognised the need for introducing LLP in India. To this end the government set up a Committee headed by Mr. Naresh Chandra which has come up with a framework for introducing LLP in India. The broad areas of analysis made by the Committee relate to:

1. Application of the LLP Regime;
2. Incorporation, Registration and Number of Partners;
3. Limited Liability;
4. Financial Safeguards; and
5. Tax Treatment of LLPs.

Justifying the need to introduce LLP the Committee states:

> "The Committee feels that with Indian professionals increasingly transacting with or representing multi-nationals in international transactions, the extent of the liability they

could potentially be exposed to is extremely high. Hence, in order to encourage Indian professionals to participate in the international business community without apprehension of being subject to excessive liability, the need for having a legal structure like the LLP is self-evident. Provisions which restrict the number of partners to twenty prevent the growth of professional firms to the large entities operating on an international scale. Such inhibiting conditions have to be removed. Otherwise, Indian professionals may well get excluded from taking their rightful place in the international community, that their skills otherwise entitle them to. The Committee believes that, to encourage greater professionalism and create commercially efficient, vehicles for providing service of the highest quality, it is essential to create a regulatory regime that would govern the formation of such a hybrid entity between the partnership *simpliciter,* or general partnership, and a private limited company, that is, an LLP. Such an entity would provide the flexibility of a partnership (allowing the owners to adopt whatever form of internal organization they prefer), and limiting at the same time, the owner's liability with respect to the LLP. Given the wide acceptability of the limited liability company, a partnership of recognised professionals should be given the choice to opt for a more suitable legal entity, and conferred the privilege of limited liability, especially if sufficient safeguards are put in place."

But does the Committee succeed to make a case for introducing LLP in India? The answer is an emphatic yes; the significant disadvantages in the Indian Partnership Act of 1932 discussed above justify the need for LLP.

How does LLP score over general partnership?

1. The main advantage is that limited partners do not take on personal liability for the obligations of the entire partnership, but only to the extent of the money contributed to the firm by such partners.

2. Further, a partner's liability is not limited when the misconduct is attributable to him or to an employee under the supervision or control of that partner. An LLP only protects a partner, other than a general partner from the liability arising from the misconduct or personal acts of other partners.

3. The members of an LLP would have the option to have a general partner or more with unlimited liability, but it would not shield the partners from legal liability arising out of their own personal acts which are not done for and on behalf of the LLP, that is, any act done beyond the acts and powers of the partners as laid down in the incorporation document.

4. The main benefit in an LLP is that it is taxed as a partnership, but has the benefits of being a corporate, or more significantly, a juristic entity with limited liability.

5. An LLP has the special characteristic of being a separate legal personality distinct from its partners.

6. The distinction between an LLP and a company lies in that a partnership's existence depends on its members because it is a creature of contract, while a limited company is unaffected by such changes being a statutory body.

What then distinguishes a LLP from other forms of business Associations?

Answering this question would be tough at this stage. The Committee report is in the form of recommendations. This being the fact the recommendations do not cast an obligation on the government to implement the recommendations. Moreover, the Committee does not go into the intricacies of LLP structure it merely provides a framework - of the broad contours of LLP. The Committee has submitted a draft bill on LLP to the government which so far is unavailable the public domain, so it becomes difficult to envisage the future of LLP in India and the distinctions between the LLP and other forms of business associations.

The Position in United Kingdom.

The main characteristics of a Limited Liability Partnership Act 2000 are:

- No personal liability on a member for the Limited Liability Partnership's debts and contracts;
- No joint and several liability for the negligence of any member;
- Members' liability to contribute in a winding-up is limited to the amount they agree to contribute in the event of a winding-up as recorded in the limited liability partnership agreement
- Limited liability partnership has fewer compliance and disclosure requirements than companies.
- Disclosure: information [in particular accounts and an auditors' report] must be filed with the Registrar of Companies and becomes public.
- Regulation: auditing and filing requirements are taken care of by the Act.

The Naresh Chandra Committee Report

The Naresh Chandra Committee on "**Regulation of Small Companies and Partnership**" was constituted by the Government of India under the Ministry of Finance and Company Affairs and the Department of Company Affairs on 10th January 2003 to "suggest a scientific and rational regulatory environment, the hallmark of which is the quality, rather than the quantity, of regulation"[1]. This Committee was chaired by Mr. Naresh Chandra and had 8 members and the

[1] Government order No.11/3/2003-CL.V passed by the Government of India dated 10th January 2003.

Institute of Chartered Accountants of India providing secretarial help. The Committee dealt with reforms in Company Act and Indian Partnership Act.
This paper critically examines the recommendation of the Committee on introduction of LLP in India.

Critique of Naresh Chandra Committee report

Recommendation 3.1 : Application of the LLP regime

- Law may be enacted to provide for establishing Limited Liability Partnerships. The LLP form should be initially made available only to those providing defined professional services like lawyers, company secretaries, accountants and the like. To be eligible for this form of partnership, the profession must be governed by a regulatory Act that adequately controls and disciplines, errant professional conduct. Such professions may be notified by the Department of Company Affairs from time to time.
- LLP may be extended, at a later stage, to other services and business activities once the experience gained with the LLP form of organisation has been evaluated and tested.

The Committee limits the application of LLP initially to professional services like lawyers, company secretaries ect. The Committee justifies this on four counts

Firstly, because Indian professional firms are precluded from practicing under any other legal form in view of the restrictions imposed by their respective regulatory laws; trading firms or manufacturing firms, however, have the option to carry on business as a private limited or public company under the Companies Act, 1956

Secondly, as the professionals are also governed and regulated by their respective professional, regulatory bodies, which also control and monitor professional conduct, extending the LLP structure only to professionals minimises the risk inherent in testing new waters.

Thirdly, there is no special advantage that small private companies or SSI units would derive from being an LLP, especially in light of the fact that this Committee itself is simultaneously recommending a considerable easing of regulations on private companies, specially small private companies.

Fourthly, it was felt that extending the LLP structure to professionals, in the first instance, would help evaluate its advantages and risks; and based on such evaluation and experience, the LLP form can be considered for extension to small scale manufacturing and/or trading firms as well in the future.

But there has been a widespread demand by organisations like FICCI which have insisted that LLP be applicable to trading firms at the commencement. But this demand contradicts the Committee’s recommendation that LLP should be applicable only to professional services governed by a regulatory Act and at a later stage it must be extended to other services and business activities as and when notified by the DCA. Such demands are unjustified, as the waters need to be still tested in Indian context. It would not be wrong to test the waters on professional services for reasons given by the Committee.

However, if the capital investment in the forming a LLP would exceed a certain limit, say 5 crore, then should it be made mandatory that such a firm be made a general partnership or any other form a business association? Because in case of loss if the liability would exceed the personal liability of the partners and the insurance coverage may not be sufficient to cover the loss what then?

Recommendation 3.2 : Incorporation, registration and partners

- Two or more professionals who wish to associate for the purpose of providing an identified professional service, may subscribe their names in an “incorporation” document in the prescribed form.
- The relations *inter se* the partners and between the partners and the LLP may be governed by individual agreements between the parties concerned. Such agreement must be filed with the RoC; changes made in the agreement will also have to be filed with the RoC.
- The LLP agreement should contain information as may be prescribed by the Department of Company Affairs.
- No limit be placed on the number of partners in an LLP. Any person may become a partner by entering into an agreement with the existing partners in the LLP. Further, when a person ceases to be a partner of an LLP he/ she should continue to be treated as a partner unless: (a) the partnership has notice that the former partner has ceased to be a partner of the LLP; or (b) a notice that the former partner has ceased to be a partner of the LLP has been delivered to the RoC. A partner having resigned from an LLP would continue to be liable for acts done by him during his tenure as member of the LLP.
- LLPs should be regulated and administered by the Central Government to ensure uniform standards, and since many of the State Governments might not have adequate infrastructure and expertise for ensuring effective regulation.

The recommendation relating to incorporation makes it optional to register. If this provision is allowed then it would result in mushrooming of a large number of unregulated and unadministered LLP's. Further, at later date when LLP would be made applicable to trading firms it would give impetus to unscrupulous partners to start or convert their existing firms into LLP to the disadvantage of the general public. Moreover, as the relations *inter se* the partners and between the partners and the LLP which would governed by individual agreements between the parties concerned the partners might give a false agreement to the public.

For these purposes registration must be made compulsory and a penalty could be imposed for non-registration. Further, the Registrar of Firms must be given the powers to verify the particulars in the incorporation document as it would stop the proliferation of fly- by- night LLP's.

Also, the partners should be restricted to the business they intend to carry or else it will result in the massive diversification into areas of high risks and in case of loss sustained then the nature of the partnership makes it difficult for creditors to claim.

In case of particular ventures the registration fees should be limited and a clause for automatic dissolution of the partnership after the completion of venture. If the venture is extends to a later day's then prior intimation to the Registrar of Firms should be given. The Indian Partnership Act is silent on the question whether prior notice should be given to the Registrar of Firms.

Further, Section's 60, 61, 62, 63 of the Indian Partnership Act, make it optional to partners to inform the Registrar of Firms about changes in the partnership. Partners can get away de to this provision. Notification of changes in the LLP with the Registrar of Firms should be mandatory so as to the to protect the interests of the general public.

The Committee does not place a limitation on the number of partners in the LLP. Such a provision might cause havoc in the working of the partnership and also in the minds of the general public as who is a partner and who is not. It is suggested that there should be a limitation on the number of partners in a LLP.

The Committee also recommends that LLP's should be regulated and administered by the Central Government to ensure uniform standards, and since many of the State Governments might not have adequate infrastructure and expertise for ensuring effective regulation. This seems to be a too trivial reason to hand over the responsibility to the Central Government. In the era of decentralization of powers it seems too retroactive to allow the Centre to take this responsibility. Infrastructure and expertise can be developed overtime; even the Central government at present lacks the requisite infrastructure and expertise, so it becomes an irrational decision to hand over the responsibility to the centre. Further, the responsibility to administer LLP all over India is a burdensome task so there is a need to decentralise the task.

Recommendation 3.3 : Limited liability

- Every partner of the LLP would be an agent of the LLP. However, an LLP would not be bound by anything done by a partner in dealing with a person if (a) the member in fact had no authority to act for the LLP by doing that act; and (b) the person knows that he has no authority or does not know or believe him to be a partner of the LLP.
- Where a partner of the LLP is liable to any person or entity as a result of his wrongful act or omission in the course of the business of the LLP, the LLP would be liable in such circumstances. However, the partner would be liable only to the extent of his/her contribution to the LLP.
- In the event of an act carried out by a LLP, or any of its partners, fraudulently, the liability would not be limited; it would, in fact, become unlimited as provided for in Section 542 of the Companies Act, 1956.
- A partner shall not be liable for the personal acts or misconduct of any other partner.
- The provisions relating to insolvency, winding up and dissolution of companies as contained in the Companies Act, 1956 may be examined and suitably modified to conform to the philosophy of LLPs. The partners may have to contribute to the assets of the LLP in the manner provided for in this regard.

In a LLP a partner is the agent of the LLP an not to other partners, this is done to confer make the LLP a legal entity.

A provision like that of Section 69 of the Indian Partnership Act would be ineffective in case of LLP. For example, if a third party would sue a partner in a LLP for the enforcement of some right as a result of the partner's wrongful act or omission in the course of the business of the LLP, and is awarded some compensation by the court but the limited liability nature of the LLP would make the partner liable only to the extent of his/ her contribution in the LLP (recommendation 3.3), now if the compensation awarded is greater than the extent of the liability of the partner or if the partners deliberately take a insurance policy lesser than the liability of the funds kept aside to satisfy decrees of the court is insufficient to cover the liability then what remedy will such a third party have?

<u>Recommendation 3.4 : Compulsory insurance</u>

- There should be insurance cover and/or or funds in specially designated, segregated accounts for the satisfaction of judgments and decrees against the LLP in respect of issues for which liability may be limited under law. The extent of insurance should be known to, and filed with the RoC, and be available for inspection to interested parties upon request.

The Committee recommendation in this respect is laudable as this would protect the interests of the general public. Further the amount to be kept aside to satisfy Court decrees should be decided before hand according to the nature of the business and must also be made known to and filed with the Registrar of Companies.

RECOMMENDATION 3.5 : FINANCIAL DISCLOSURES

- The standards of financial disclosures would be the same as, or similar to, that being prescribed for private companies subject to privilege already available between a professional and his or her client in maintaining confidentiality.

The committee's intention is definitely laudable, but the benchmark seems to be a little too high. Disclosure of financial information is no doubt essential but it must be at the same standards as that of a unlimited partnership considering the cost implications involved in achieving the high standards set by the committee. A LLP formed for a limited period or limited purpose would not like to spend or may not have as much money as required by a private company for complying with disclosure norms as per the Companies Act, 1956.

<u>Recommendation 3.6 : Tax treatment of an LLP</u>

- The LLPs should be governed by a taxation regime that taxes the partners as individuals, rather than taxing the LLP itself, i.e., the LLPs should be treated in the same manner as the firm under the tax laws.

Section 10 of the UK LLP Act lays down that a trade, profession or business carried on by an LLP, with the view to profit, shall be treated as carried on in partnership by its members and not by the

LLP itself. Thus, any asset held by an LLP, or any tax chargeable on gains made shall be treated as held by the partners, or gains made by the partners, and not by the LLP itself. In other words, an LLP enjoys a **pass-through status** and is not taxable as such; the taxation liability falls on the partners in their individual capacity. In the USA, too, LLPs enjoy a pass through status for the purposes of taxation. The profits or losses of the LLP pass through the business and are reported on each partner's personal returns. The Committee has recommended the same pass through status for LLPs in India.

Conclusion

The recommendation of Naresh Chandra Committee for Limited Liability Partnership in India is a step further to modernization and recognising the needs of changing times. The government has accepted the recommendations with applause. But, it remains to see what the government will do next. The recommendations for LLP is very sketchy and it remains to be seen what changes will be brought forth in future. Until then it will be difficult to predict the future of LLP in India. But if the government goes ahead and implements the suggestion it would be the beginning of a new era in India.