Professionals' liability in LLPs: Limits of limitation

Vinod Kothari
Payel Jain

As is common knowledge, the Limited Liability Partnership (LLP) form was devised at the behest of professionals who were looking for means to limit their liability as damages being imposed by courts for professionals' liability assumed great proportions. This article probes the limitation of liability that can actually be achieved by LLPs, and while in the process, it explores the origins and growth of LLPs, and other similar forms of entities. In addition, this article takes the case of auditors' liability to illustrate how effective the LLP form is in protecting professionals.

Since LLPs were almost like "made to order" form of entity, it tries to combine the wish-list of those who might have wanted to have this form of entity.. As a tool of convenience, this form of entity has the best of both the worlds – flexibility of a partnership, yet the benefit of separate existence and limited liability. Though the backbone of limited liability is capital maintenance, LLPs may enjoy limited liability without having to ensure creditors and outsides of any fixed capital. Unlike partnerships, LLPs are bodies corporate and their membership is transferable. Like a partnership, the mutual rights and liabilities of the Partners are governed by agreement and the partnership is run and managed by the partners. It is thus a hybrid between company and partnership.

HISTORY OF LLP LEGISLATION

LLP legislation overseas

In the United States LLPs emerged in the early 1990s, while only two states allowed LLPs in 1992, over forty had adopted LLP statutes by the time LLPs were added to the Uniform Partnership Act in 1996. USA has had other liability limiting vehicles – limited partnerships, and limited liability companies. Some US states have also recognised limited liability limited partnerships which may be called an extended form of limited partnership.

In UK, LLP Act was passed in the year 2000. The campaign for LLPs was initiated by accounting firms (PwC and E&Y) to limit their liability by registering themselves under the LLP statute in Jersey in 1995. Though UK Companies Act did allow professions to register as companies, accounting firms were reluctant to publish accounts, be subject to inspections etc. The argument was first rejected by the Law Commission The accounting firms used their power to have this law passed in Jersey in the midst of political uproar. The statute received Royal Assent in November 1996. There was an element of uncertainty that as to whether the firms would register in Jersey. In its draft Regulatory Impact Assessment, the Department of Trade and Industry made a tentative estimate that around 60,000 regulated firms in UK might eventually become LLPs. In view of the agreements between Jersey and UK, the accounting firms could still do business in UK. This forced the (then) Department of Trade and Industry to put the LLP Bill on the agenda in 1996. After a series of

consultations, the Bill was passed in 2000; with tax clarity, the structure got into offing in April 2001.

The provisions of the LLP regulations in UK are largely based on the Companies Act, 1985. The UK Companies Act 2006 received Royal Assent on 8 November 2006, though some of its provisions are yet to be enforced. The Department for Business Enterprise and Regulatory Reform (BERR) issued a consultation paper in November 2007 setting out its proposal for application of the Companies Act 2006 to LLPs. The consultation closed on 6 February 2008 and the Government Response to the same was published in May 2008. The regulations applying the accounts and audit provisions of the Companies Act 2006 came into effect on 1st October 2008 for financial years beginning on or after that date. The draft regulations applying the remaining provisions of the Act to LLPs have been published for comment. These regulations will come into effect on 1st October 2009, to coincide with the implementation of the Companies Act 2006 for companies However, due to the differences between LLPs and companies, certain provisions are not considered relevant to LLPs, including those relating to narrative reporting, directors and share capital.

The UK move set the ball rolling in other countries too. Canada (Ontario) introduced LLP law in 1998. In Canada, a LLP is usually only available to groups of professionals, such as lawyers, accountants and doctors. Singapore issued consultation paper in 2002, enacted the law in 2005. This legislation draws on both from the US and UK models of LLP, and like the latter establishes the LLP as a body corporate. LLPs were introduced in Japan in 2006. Currently, LLP legislation exists in UK, US, India, Singapore, Japan, China, Canada, Germany, Greece, Poland, Romania in some form or the other.

LLP legislation in India

On the recommendations of the Naresh Chandra Gupta committee and the JJ Irani committee, the Govt had come out with a concept paper and a draft of the LLP bill in late 2005. The Limited Liability Partnership (LLP) Bill, 2006 was introduced in the Rajya Sabha on 15th December, 2006. The Bill was referred to the Lok Sabha Standing Committee on Finance, for examination. The Standing Committee after consulting various chambers of commerce, professional institutes and other experts and also heard the Ministry of Corporate Affairs, submitted its report to the Parliament in November, 2007.

Based on such report the Ministry of Corporate Affairs revised the LLP Bill and the revised LLP Bill, 2008 was introduced in the Rajya Sabha on 21st October, 2008. The Bill was passed by the Rajya Sabha on 24th October, 2008 and by the Lok Sabha on 12th December, 2008. Finally, the bill received President's assent on 7th January, 2009.

The LP Rules 2009 covering the registration and other operational aspects of the Act have been notified in the official gazette on 1st April 2009. The Government of India has also launched a website namely www.llp.gov.in for operationalising various processes under the Rules. The rules with respect to winding up and dissolution of LLPs are still under preparation.

The LLP Act, though is an outcome of agitation of the professionals, does not restrict the benefit of LLP structure to certain classes of professionals only and would be available for use by any enterprise which fulfills the requirements of the Act. Many of its provisions would still take quite some time to be operational, as there are restrictions in the Companies Act for an auditor to be a body corporate.

OTHER FORMS OF BUNISESS ORGANISATION WITH LIMITED LIABILITY

Limited Partnership (LP)

A limited partnership is a form of partnership similar to a general partnership, except that in addition to one or more general partners, there are one or more limited partners (LPs). In such a case, at least one partner is required to be a general partner. Like shareholders in a company, the limited partners in a limited partnership limited liability, i.e., they are only liable on debts incurred by the firm to the extent of their registered investment and have no management authority. In US, these kinds of entities are governed by the United States Uniform Limited Partnership Act, 2001. In UK, limited partnerships are governed by the Limited Partnership Act 1907.

Limited Liability Limited Partnership (LLLP)

Some US states like Texas, Colorado and Delware have recognised another vehicle very much similar to the LLPs namely, Limited Liability Limited Partnership. A LLLP is a form of limited partnership and consists of one or more general partners and one or more limited partners. The management of LLLPs are entrusted to the general partners, while typically the limited partners only have a financial interest. The difference between an LLLP and a traditional LP is with respect to the general partner's liability for the debts and obligations of the limited partnership.

Limited Liability Company (LLC)

A limited liability company is a type of business ownership which combines the features of corporation and partnership structures, however, in effect it is neither a corporation nor a partnership. LLCs are popular because, similar to a corporation, owners have limited personal liability for the debts and actions of the LLC. Other features of LLCs are more like a partnership, providing management flexibility and the benefit of pass-through taxation. Such forms of organizations are commonly found in the UK and the US.

RELEVANCE OF LLP FORM FOR LIMITING LIABILITY OF PROFESSIONALS

The past few years have seen two notable developments – massive corporate failures mostly connected with accounting lapses, and resultantly, huge claims of penalties

and damages on auditors[1] and other professionals including investment bankers, portfolio managers, trustees, solicitors, advisers, and so on.

Accountants, solicitors and recognized professionals are organized as partnership firms. Partnership firms are founded on the principle of unlimited liability which is joint and several, and agent-principal relationship. Every partner is an agent of the firm. Hence, every partner shares a reflection of the liability of other partners. This is exactly what the LLP legislation is trying to achieve. It will not protect the partners against their personal liability, but will grant the most-needed protection of liabilities filtering in due to actions of other partners. The LLP legislations provide that partners will be agents of the LLP, but not of other partners. Hence, vicarious liability for acts of other partners will be shielded against.

We take the case of auditors' liability as an illustrative case – to judge the effectiveness of the LLP legislation. .

Auditors' liability for tort, negligence, etc.

Auditors may be liable on various counts – gross negligence, breach of duty of care and skill, professional negligence, and liablity to third parties in tort. This is in addition to criminal liability of the auditor for a breach of law, or for collusion in a crime, etc.

While criminal liabilities are liabilties of the concerned partner, the civil liabilities are usually the liability of the firm. Civil liability may be brought by the auditee company, the company's liquidator, or shareholders by way of a class action or derivative action.

The auditee company is not the only entity entitled to sue the auditors. Individual shareholders, creditors and even third parties who can establish having placed reliance on reported financial statements and therefore, suffered damages, are entitled to bring action. The grounds on which third party action can be brought vary based on the legal traditions of the country – they may range from intentional negligence, damages, causation, etc.. In most cases, third party liability has been based on tort.

Tort law provides remedies for civil wrongs not arising out of contractual obligations. A person who suffers legal damages may be able to use tort law to receive compensation from someone who is legally responsible, or liable, for those injuries. The damage may be to a person's property, his reputation or his commercial interest. Generally speaking, tort law defines what constitutes a legal injury and establishes the circumstances under which one person may be held liable for another's injury. Therefore, a duty of reasonable care is required to be observed.

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[1] A presentation on http://www.auditanalytics.com by Mark Cheffers shows some very interesting data on liability of auditors, solicitors and other professionals. From 2000 to July 2009 , the total amount of top 50 auditor liability settlements in the USA add up to $ 6.6 billions. In the Madoff scandal itself, there are 25 cases against 8 audit firms. 25 cases have been filed against law firms. Pertaining to the credit crisis, 179 suits have been filed against auditors. In addition, the presentation shows the extent of restatement of accounts, and the reduction in reported earnings by way of such restatements.

Prior to *Ultramares v. Touche* (USA 1931), auditors were relatively shielded from lawsuits brought by third-parties claiming negligence on the part of the auditor. However, the decision in *Ultramares* served as an opening towards the expansion of auditor liability to third-parties for negligent performance of audits. Two relatively new theories of law were introduced in the above ruling: (1) that the plaintiff might be able to claim as a third-party beneficiary of the contract between the auditor and the client, or (2) the auditor's negligence was heedless to such an extent that it amounted to constructive fraud. It therefore appears that the legal liability of auditors might be extended beyond their clients to the third-parties who relied on audited financial statements. In UK, however, thanks to *Caparo Industries Plc v Dickman (supra)* the legal position now seems to be that auditors owe duty to shareholders as a body and not as individuals. In *Esanda Finance v Peat Marwick Hungerfords* (1997) the High Court of Australia ruled that the auditors did not owe a duty of care to a third party but demonstrated such a liability might exist if for example the audit firm knew a particular third party was to rely on their work in relation to a specific transaction

In deciding the circumstances in which the auditors of a company owe a duty of care to a third party with whom they have no contractual relationship, the Courts have been divided in their approach- the test of forseeability, proximity and fairness has been established in *Caparo's* case *(supra)* and the assumption of responsibility test has been laid down in *Hedley Byrne & Co Ltd v Heller & Partners Ltd*[2] and further adopted in *Henderson v Merrett*[3].

In Caparo Industries Plc v Dickman[4], the House of Lords, rejecting the test of reasonable foreseeability for determining the duty of care, held that the duty of auditors is towards the shareholders as a body and not as individuals. Although the auditors' primary duty is owed to the company pursuant to the contract under which they are engaged, they also owe a duty of care under the general law to the shareholders, as a body, who can be expected to exercise their rights and powers in a general meeting on the basis of the audited accounts.

The basis of tort is assumption of responsibility. The question which is required to be addressed is that whether on becoming a partner of a LLP, an auditor shall be relieved of his personal liability. The negligence liability in professional firms was the very issue that the LLP Act set out to resolve, however, the issue concerning limited liability was left to be decided through judicial decision.

Liability to third parties arises in tort. The central question in assessing tortuous liability is whether the auditor owes a duty of care to the particular third party. The decision in *Man Nuzfahrzeuge AG and Others v Freightliner Ltd and Others*[5] has clearly laid down the principles where an auditor will be found to owe a third party a duty of care:

i) the loss must be foreseeable;
ii) there must be a relationship of considerable proximity;

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[2] [1964] AC 465
[3] [1995] 2 AC 145
[4] [1990] 1 All ER 568
[5] [2005] EWHC 2347

iii) it must be fair, just and reasonable in all the circumstances to impose a duty of care;

iv) the auditor must be expressly made aware of the third party's likely reliance on the accounts for the particular purpose; and

v) the auditor should have intended that the third party rely on the accounts for that purpose; absent intention an auditor may still, viewed objectively, be found to have assumed responsibly to a third party.

SCOPE OF LIMITATION ON LIABILITY

Limited liability is a well-established principle among corporations. With the enactment of LLP legislations, the said principle has been extended to partnerships so as to enable professionals to render broad based services and involve in cross-border assignment.

In *Cedric Kushner Promotions, Ltd. v. King*[6], it was observed that the basic purpose of incorporation is to create a distinct legal entity, with legal rights, obligations, powers, and privileges different from those of the natural individuals who created it, who own it, or whom it employs.

Where no acts were alleged against an individual member of LLC, which were not related to his status as a member, naming the member was improper and unjustified. *Page v. Roscoe, LLC*[7],. A partner of a general partnership is not personally liable, directly or indirectly, including by way of contribution or otherwise, for obligations the partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort or otherwise, solely by reason of being a partner. *Lewis v. Rosenfeld*[8].

LLP law and partners' liability limitation

The main idea behind enactment of LLP Act in any region is to limit the liability of the partners on account of the independent or un-authorized actions of other partners, thus individual partners are shielded from joint liability created by another partner's wrongful business decisions or misconduct.

Partners of limited liability partnership are agents of the LLPs, but not of other partners, unlike a general partnership which is based on the rule of agency. LLPs are solely responsible for all obligations arising under a contract or otherwise and partners are not personally liable, whether directly or indirectly, by reason of being a partner. The personal liability of the partners has been excluded under the Act except in case of unauthorized acts, fraud and negligence.

The Report of *the Standing Senate Committee on Banking, Trade and Commerce, Canada* has dealt with joint and several liabilities of the auditors. The accounting profession is facing liability crisis due to application of the rule of joint and several liability. The Canadian Institute of Chartered Accountants submitted to the

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[6] 121 S. Ct. 2087, (June 11, 2001)
[7] 497 S.E.2d 422 (N.C. Ct. Apps. 1998)
[8] 138 F. Supp. 2d 466, 477 (S.D.N.Y. 3/8/01)

Committee a written brief prepared by the Honourable W. Z. Estey Q.C. and entitled *Proportionate Liability and Canadian Auditor,* .outlining the concerns of the auditing profession and recommended that the relevant federal and provincial statutes be amended to bring the following proposal into effect:

> *"The Court in awarding damages for negligence relating to the issuance of financial information by an organization, apportion such damages according to the fault of each defendant and their liability shall not exceed their proportion of the fault."*

The Committee expressed that issue of joint and several liabilities touches every professional, not just the auditors. The Committee released an Option Discussion Paper covering the issue of *Joint and Several Liability and Professional Defendants* in October 1997. The Committee favoured implementation of "proportionate liability regime" for claims for economic (financial) loss arising by reason of any error, omission, statement or misstatement in financial information. The Australian *Inquiry into the Law of Joint and Several Liability* and the U.K. *Feasibility Investigation of Joint and Several Liability* discounted the practical difficulties arising from the implementation of proportionate liability. The Australian study put it this way:

> *"It may, however, be suggested that any practical problems in implementing a regime of proportionate liability are more apparent than real. It has already been observed that the Republic of Ireland has had such a regime for more than 30 years, and no evidence has emerged of any practical difficulties. The Province of British Columbia has also had such a regime for more than 10 years, and there is no indication of practical difficulties. Equally, there has been no suggestion from those States in the United States of America which have adopted one of the various forms of proportionate liability that the change in the law has led to difficulties of applying it in practice."*

Another option contained in the Options Discussion Paper was that the professionals be permitted to incorporate or form limited liability partnerships in order to limit their liability at the partnership level. The Committee recommended in the following words:

> *"The Committee urges the provincial and territorial governments to take the necessary steps to provide for the creation of limited liability partnerships and/or corporations by professionals who wish to practise their professions within such structures."*

A UK LLP's members have a collective ("Joint") responsibility, to the extent that they may agree in an "LLP agreement", but no individual ("several") responsibility for each other's actions. Their mutual rights and duties are governed by an agreement between them or between them and the limited liability partnership. As in case of a corporation, Members in an LLP cannot, in the absence of fraud or wrongful trading or un-authorised acts, not personally liable for the acts and deeds of the LLP.

Statutory limitation of auditors' liability

The government of UK has acknowledged that audit firms need some degree of protection. While unlimited liability cannot be ruled out completely, the government has made provision under the Companies Act of 2006 for companies to decide for themselves if they would like to limit their auditor's liability.

The Companies Act 2006 provides for limitation of auditors liability by agreement. Sections 532 to 538 make provisions enabling auditors to negotiate with companies whose accounts they are auditing to limit liability by contract to an amount that is "fair and reasonable in all the circumstances". One such agreement pertains to only one financial year and is required to be approved by the members before the same can be made effective.

In July 2007 the Financial Reporting Council, UK's independent regulator, at the request of the accountancy profession and after consultation with other interested parties, established an independent working group to guide the directors on the use of agreements to limit the liability of auditors of companies.

In June 2008, the European Commission issued a Recommendation concerning the limitation of the civil liability of statutory auditors and audit firms. The Recommendation states that EU Member States should take national measures to enable auditors to limit their liability and suggests the types of such agreement that should be permissible, which include those contemplated by the Companies Act 2006. The Recommendation also states that agreements should be conditional on receiving shareholder approval and that a description should be included in any financial statements published by the company concerned, as required by the Companies Act 2006 and the accompanying regulations.

The Secretary of State (UK) has framed The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 w.e.f 6th April 2008 which requires complete disclosure in the companies' annual accounts about the fees receivable by the auditors and auditors' associates and also liability limitation agreements that the company make with their auditors.

Conclusion

Thus, the LLP form, as it was meant to be, is an important enactment for professionals. Limiting the liability of partners is expected to go a long way in an age where reliance on professionals' work is ever increasing. This is especially true for audit profession which is bombarded by litigations. In time to come, company secretaries also are expected to play a significant role as socially-relevant corporate governance professionals. Hence, company secretaries may evaluate the option of transforming themselves in LLPs.

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