# CORPORATE MEMBERS OF LIMITED LIABILITY PARTNERSHIPS

## 1. INTRODUCTION

1.1 This note, prepared on behalf of the Company Law Committee of the City of London Law Society ("**CLLS**"), relates to BIS' request for views as to whether the proposed prohibition of corporate directors (subject to limited exemptions) should be extended to limited liability partnerships (**LLPs**). We understand that such extension would mean that corporate members of LLPs should also be prohibited (presumably also subject to some exemptions).

1.2 This issue was raised by BIS in the Government "Transparency and Trust" response paper dated 16 April 2014 at paragraph 169. It was also discussed in a meeting between BIS and CLLS on 20 May 2014, at which BIS requested CLLS's views and, in particular, descriptions of "legitimate" uses of corporate members of LLPs of which CLLS was aware. This note therefore focuses on such descriptions, while also giving our high level comment on the proposal as a matter of principle.

1.3 As discussed at our meeting, while we are very pleased to have been asked to submit this paper to BIS, we also believe that if a change was proposed in relation to the legislation governing LLPs (whether a prohibition of corporate members or a different proposal relating to the members of LLPs or the management of LLPs) it should be subject to a formal consultation process. We believe that there are a number of parties who would wish to comment on any proposal and some of those are unlikely to be aware that BIS has requested views on this issue, or to become aware of it other than through a formal consultation process.

1.4 CLLS represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees.

## 2. BACKGROUND

2.1 We consider that it is important to bear in mind that under the Limited Liability Partnership Act 2000 and applicable Regulations, a member of an LLP is both an "owner" and a "manager".

2.2 This is because the nature of a membership interest in an LLP is that it gives the member economic rights (e.g. to share in the profits of the LLP and to share in a capital distribution on a winding up) and management rights (e.g. to vote at members' meetings and to manage the day-to-day activities of the LLP or to appoint those who do so). Similarly, there are economic obligations (e.g. the obligation to contribute capital to the LLP) and management obligations (e.g. the obligation to devote time and attention to the LLP's business). The precise nature of a member's rights and obligations varies considerably from member to member and LLP to LLP because the members of each LLP are free to agree between them how their mutual rights and obligations and those of the LLP will be structured[1].

2.3 In addition, a member of an LLP has various statutory rights and obligations, principally under (i) the Limited Liability Partnerships Act 2000, (ii) parts of the Companies Act 2006 which have been applied to LLPs in amended form and (iii) parts of the Insolvency Act 1986 which have been applied to LLPs in amended form. There are also certain rights and obligations existing at common law.

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[1] The "default regime" set out s7 and s8 Limited Liability Partnerships Regulations 2001 (as applied by s17 Limited Liability Partnerships Act 2000) applies in the absence of any agreement to the contrary, but is typically excluded via an express members' agreement or limited liability partnerships agreement.

2.4 We note that, in relation to the application of parts of the Companies Act 2006 to LLPs[2]:

(a) only a minority of the provisions of the Companies Act 2006 have been applied to LLPs;

(b) Part 10 of the Companies Act 2006 relating to Directors has not been so applied; and

(c) while a number of provisions of the Companies Act 2006 have been applied but amended such that a reference to a member of an LLP has been substituted for a reference to a director of a company, equally a number of provisions have been applied but amended such that a reference to a member of an LLP has been substituted for a reference to a member of a company (i.e. a shareholder)[3].

## 3. PROHIBITION, AND REQUIREMENT TO UNWIND, WOULD BE COMMERCIALLY UNREASONABLE

3.1 Against this background, we do not believe it is correct to treat a member of an LLP as equivalent to a director of a company, nor to work on an assumption that proposals relating to directors of companies should be applied to members of LLPs. In this case, the prohibition of corporate members of LLPs would prevent any company or other body corporate (presumably including another LLP) from owning an interest in an LLP, which we believe would be an unparalleled restriction with no equivalent in relation to the various forms of company, body corporate or partnership which exist under English law.

3.2 In particular, we have serious concerns in relation to:

(a) Unwinding existing arrangements

Unwinding existing arrangements will be very complex. If an existing corporate member can no longer hold its membership interest, it will need to transfer it. However:

(i) LLP or members' agreements very frequently restrict the introduction of new members and transfers of interests and the required consents from other members (which often would require unanimity as an amendment to the existing agreement) may not be forthcoming;

(ii) the underlying owners of the corporate member may not be individuals or, if they are, may not wish to become a member (noting that it brings management rights and obligations as well as economic ones) and the other members may not be willing to allow the underlying owners to become members, or only on different terms to the current LLP or members' agreement;

(iii) there may be no third party who would want to acquire the interest at the relevant time; and

(iv) transfers or other restructurings of existing arrangements may well be difficult for the corporate member to achieve and would be likely to give rise to new tax liabilities[4].

To give a simplified example, suppose there is an LLP with four members, who share profits equally and have agreed that most management decisions require a simple majority of them and certain

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2 See in particular the Limited Liability Partnerships (Application of the Companies Act 2006) Regulations 2009.

3 See for example Part 12 of the Limited Liability Partnerships (Application of the Companies Act 2006) Regulations 2009 which applies the provisions of the Companies Act 2006 relating to arrangements, reconstructions and mergers to LLPs.

4 For example, a corporate member which was a UK company could not make a distribution of the relevant membership interest to its owners if it did not have sufficient distributable reserves. A transfer at book value would also be restricted if the corporate member had negative distributable reserves and might also be a transfer at an undervalue for Insolvency Act purposes. A transfer at market value would have to be financed by the underlying owners, who might then be restricted from extracting the consideration paid from the corporate member for similar reasons, and would also be likely to give rise to a taxable gain in the hands of the corporate member despite no "external" proceeds being received.

material decisions (including introducing new members or amending the agreement) require unanimity between them. One of those members is a corporate member, which in turn has four individual owners. Transferring the membership interest of the corporate member to those individual owners would require:

(A) each of the other three members to consent (noting that if they did not, presumably the corporate member would have to offer to sell to them, possibly at a depressed price);

(B) each of the four individual owners of the corporate member to sign the LLP or members' agreement and to sign the appropriate Companies House forms agreeing to become a member (accepting the contractual, statutory and common law obligations which then arise); and

(C) a full renegotiation of the LLP or members' agreement, because the members will no longer have equal interests and it is very unlikely that the three original members would be happy to leave the previous management arrangements in place, as they would give disproportionate power to the four new members (e.g. they would form a majority in number so could carry ordinary decisions and any one of them could block a material decision) and because the profit sharing arrangements may no longer work correctly (e.g. if they refer to members receiving "equal shares" of profits); and

(D) if any of the new members would not have management control rights then a detailed analysis of the collective investment schemes regime would also be required.

This is a very simple example. In many cases (e.g. a corporate member owned by a widely held corporate or a fund, or an LLP used in a covered bond) unwinding would be considerably more complex.

(b) Reduced flexibility for businesses

LLPs were introduced into the UK legal framework in 2000 as a new form of legal entity. This was generally seen as a very positive step, recognising that the modern business environment required additional flexibility and a further method for organising a business in addition to the "traditional" forms such as the limited company, limited partnership or general partnership. In particular, an LLP is a body corporate with separate legal personality to its members, is tax transparent, has limited liability and offers internal constitutional flexibility, effectively offering a "blend" of the characteristics of a partnership and a limited company.

We believe that prohibiting corporate members of LLPs would greatly limit their use and would therefore be a retrograde step, reducing the flexibility of the UK legal framework for businesses.

(c) Foreign investment

We have two concerns in relation to foreign investment:

(i) overseas investors into an LLP are likely to invest via a corporate member. In our view, prohibiting this is likely to mean that overseas investors would be much less likely invest in any business operated as an LLP; and

(ii) in our experience, changes to the manner in which investments can be made and/or property held, especially when made on short notice, can have a serious negative impact on the perception of a jurisdiction by overseas investors. This goes beyond overseas investors who have existing interests in LLPs or are actively considering investing in an LLP in the UK. Overseas investors frequently survey the regimes of different jurisdictions for planning purposes and historically one of the great advantages of the UK is the stability and predictability of the UK legal regime. Further other jurisdictions have LLPs (often following the UK model) and so it is likely to push investors who like the LLP model into establishing elsewhere.

3.3 We also note that the Transparency and Trust proposals relating to beneficial ownership apply to LLPs and (quite correctly) treat members as owners in that context. Full disclosure will therefore apply to corporate members which hold material interests in an LLP (and their ultimate beneficial owners, if relevant)[5]. In addition, even a corporate member which holds a non-material interest in an LLP will be disclosed at Companies House as a member under the current regime, with information being provided to the "director" not "shareholder" standard in that filing (using companies as the comparator) under the existing LLP regime.

3.4 Finally we note that HM Revenue & Customs introduced changes to the taxation of LLPs and partnerships with effect from 6 April 2014 following its paper "Partnerships: A review of two aspects of the tax rules"[6]. These included provisions applicable to LLPs and general partnerships with "mixed memberships", which includes LLPs with both members who are natural persons and corporate members. These provisions are intended to tackle a risk that certain structures could be used to achieve inappropriate tax advantages. We suggest that in the light of these very recent provisions, any concern in relation to tax matters and corporate members of LLPs have already been addressed.

## 4. EXAMPLE INSTANCES INVOLVING CORPORATE MEMBERS OF LLPS

4.1 As requested, we set out below a number of instances in which we have seen corporate members of LLPs. We consider each of these to be entirely "legitimate". Please note that these are examples only and there will inevitably be further instances, in particular in relation to SMEs who may not typically use City lawyers for their legal work.

### 4.2 Start-ups / Investment

The founders of a new business will typically consider the various different legal forms which are available to use when the business is started up. This will include an LLP. An LLP will be selected if it is the most suitable to the relevant founders and their business.

There will be a number of reasons to select an LLP but, in addition to constitutional flexibility[7], capital flexibility and tax transparency, the nature of an LLP and a membership interest in an LLP, including specifically the lack of distinction between "owners" and "managers", is often attractive to new start-ups where the founders are central to the business and will work directly for it (e.g. a recruitment agency, a fund manager, a professional firm or a consultancy business).

New businesses will often require outside investment, whether at the initial start-up stage or later as the business develops and grows. Any equity finance provided to a business established as an LLP will, by definition, involve the investor obtaining a membership interest in the LLP. The typical providers of such finance would be an existing company, so resulting in a corporate member[8]. Even

5 In addition, any corporate member which is itself a company or LLP incorporated in the UK will be subject to the new disclosure rules in its own right.

6 https://www.gov.uk/government/consultations/a-review-of-two-aspects-of-the-tax-rules-on-partnerships

7 In an LLP the members are free to agree the LLP or members' agreement which suits them, for example what decisions require what level of majority. By contrast in a limited company the Companies Act prescribes what decisions need a shareholder resolution and what type of resolution (and so what level of majority) is required. In a closely held company this often means that the Articles have to be supplemented by a shareholders' agreement setting out the commercial provisions that the parties wish to agree to, which then has to be considered alongside the Articles. By contrast, in an LLP there can be a single constitutional document

8 As well as professional investors (PE, VC, business angels etc) we have also seen examples where a former employer has taken a stake in an LLP set up by ex-employees.

if the investor was not an existing company, a company would often be used as the investment entity (e.g. to segregate the investment and potential liabilities from other assets).

It is worth noting that investments may well be of a minority interest (indeed many investors will not take control as a matter of policy) and so any group-based exemption, as has been suggested for corporate directors, would not apply. A group based exemption only for "large" groups would also not apply to SMEs.

We would also note that if corporate members were prohibited this would impact any LLP which might consider future outside investment, as well as those where such investment has already occurred. In our view, it would probably have the effect that most new businesses would be much less likely to consider structuring as an LLP at all and many existing LLPs would be likely to examine options to restructure.

### 4.3 "Conversions"

There is no statutory mechanism to "convert" a limited company into an LLP. Therefore "conversions" typically occur via a business transfer from the limited company to the LLP. This would frequently be structured via the limited company receiving a membership interest in the LLP as consideration for the transfer (i.e. rather than being paid in cash, which typically would be avoided in an internal reorganisation)[9]. This would result in a corporate member of the LLP.

It is worth noting that:

(a) businesses which have carried out such "conversions" include businesses which were established prior to 2000 and so could not utilise an LLP from the outset, but "converted" once the LLP was available as a legal form as it was the most suitable for the type of business (e.g. owner managed businesses); and

(b) in many cases the shareholders of the corporate member and the other members of the LLP would be different, or will diverge over time. For example, the "next generation" of management would frequently become members of the LLP, but would not become shareholders of the corporate member which would remain owned by the original owners. This would make unwinding existing arrangements to remove the corporate member potentially very complex.

### 4.4 Restricted Remuneration

For LLPs operating in the financial services sector, particularly those which are or will be Alternative Investment Fund Managers (**AIFMs**) under the legislation implementing the Alternative Investment Fund Managers Directive, there is often a desire or a legal requirement to restrict the remuneration of certain individuals. The usual regime is that significant proportion of remuneration is awarded but only "vests" after a period of some years subject to forfeit if certain events arise during that period. Such regimes frequently use a corporate member to "warehouse" the relevant awards for the vesting period.

Many LLPs with such structures have very recently updated and amended them in the light on the new tax rules which took effect on 6 April 2014. In particular, the new tax rules include a specific regime for AIFMs and so many will have restructured their arrangements in accordance with this new regime. To have to restructure again within a short period is likely to be unwelcome.

[9] This route can also assist if certain assets are difficult to transfer or will only transfer over a period of time (e.g. contracts requiring counterparty consent or leases).

### 4.5 Mergers and Acquisitions

Businesses which operate as LLPs are involved in mergers and acquisitions in the same way that other businesses are. The counterparty would frequently be a company (as the most popular legal form) and if it were the "buyer" then it would be common to buy a membership interest in the LLP, itself rather than the business and assets of the LLP[10]. This would result in a corporate member of the LLP.

If the transaction was to acquire 100% of the target LLP then a group company of the buyer would typically become a second corporate member to fulfil the requirement to maintain two members, with the previous members resigning. If the transaction was to acquire less than 100% (e.g. the interest of only one existing member), then the buyer would become a member alongside some or all of the existing members.

Again a group-based exemption would only assist if the buyer was taking control of the target LLP, which would not always be the case. A group based exemption only for "large" groups would also not apply to SMEs.

We also note that if corporate members were prohibited this would impact any LLP whose members might consider a possible sale, as well as those where a sale has already occurred. As with the investment example above, in our view it would probably have the effect that new businesses would be much less likely to consider structuring as an LLP at all and many existing businesses would be likely to examine options to restructure.

### 4.6 Joint Ventures

It is relatively rare for joint ventures to be structured using an LLP as the joint venture entity, with limited companies remaining the most common entity used[11]. However, there have been some examples such as a property development joint venture between a land owner and a developer, structured by an LLP owned 50 : 50 between the two (both being existing companies and so participating as corporate members) with the land owner contributing land into the LLP and the developer cash. In that example, it was important to one of the parties that a tax transparent entity was used (as it was itself a tax transparent entity) and an LLP was preferable to a limited partnership because (i) both parties could participate in management of the LLP; and (ii) the LLP could own the land, borrow money, grant security and contract in its own name, which are not possible, or are considerably more challenging to achieve, if a limited partnership were used.

In addition, some start-ups which involve entrepreneurs and one or more investors jointly founding an LLP are, in many ways, a joint venture and we have seen a number of these (see above).

### 4.7 Professional Practices

A number of international professional practices (e.g. law firms, accountancy firms, management consultancy firms), perhaps even a majority, are structured using different legal entities in different jurisdictions. An LLP is a very common choice of legal form of the UK entity, either for practising in the UK only or the UK and also other jurisdictions (e.g. jurisdictions (often within the EEA) which do not require a local entity under their regulatory regime). Sometimes one of the other entities in the network may have an ownership interest in the UK LLP, whether directly as a member or via a partner acting as bare trustee, and frequently the overseas entity will be a corporate entity. In other structures there may be separate UK LLPs operating in separate jurisdictions, but with one of

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10 This would be for various reasons, including the likely need to obtain individual third party consents to transfer assets such as contracts and leases.

11 Please note that it may be more common in relation to SMEs

the LLPs being a member of the others (i.e. effectively one LLP acts as the "holding company" in the structure, meaning the other LLPs have it as a corporate member).

In addition, multi-disciplinary practices are now permitted in the UK following recent legislative reform. We understand that a number of those which have been established operate via an LLP which has one or more corporate members.

## 4.8 Covered Bonds

Covered bonds are full recourse debt instruments typically issued by an authorised deposit-taking entity such as a bank or a building society that are fully secured or "covered" by a pool of high-quality on-balance sheet collateral (e.g. residential or commercial mortgage loans or public sector loans). As dual-recourse instruments, covered bonds offer investors general recourse to the credit institution issuer as well as specific recourse to the assets that constitute the collateral or cover pool.

The majority of European covered bonds are issued under specific legislative frameworks which implement the defining characteristics of covered bonds set out in Article 52(4) of the EU UCITS Directive[12]. To support further development of the UK covered bond market, the UK Government introduced a special legislative framework in 2008 (which regime was reviewed and confirmed in 2011)[13]. The Government has indicated that it believes that covered bonds can be a valuable source of stable funding for banks and building societies[14].

UK covered bonds are issued based on a structured model whereby the collateral pool is transferred to a special purpose vehicle and is segregated by operation of structural features and legal principles. Use of this model is required by the UK legislative framework and the corresponding regulations indicate that the owner of the collateral pool must be either a company or an LLP[15]. We note that the 2011 white paper "Review of the UK's regulatory framework for covered bonds"[16] expressly notes (see para 2.17) that an LLP is typically used to hold the collateral pool. In keeping with this, to our knowledge, every UK covered bond programme has in fact utilised an LLP rather than a company, due to the tax transparent nature of an LLP and the ability to appoint an administrative receiver in respect of an LLP (which is important for the credit and rating analysis of the programmes, as to which see further below).

Such LLPs will have exclusively corporate members, being:

(a) the issuing bank or building society (in its capacity as seller of the loans to the LLP)[17]; and

(b) the "liquidation member", which is a special purpose vehicle and is vital to the structure, as in an insolvency of the issuing bank or building society (in its capacity as a seller to the LLP) such entity can be removed as a member of the LLP and the liquidation member can take steps to appoint a second member and to ensure that the collateral pool owner can continue to function as intended (including ensuring that the covered bonds are serviced to their original maturity). This, together with the ability to appoint an administrative receiver

12 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF

13 This framework has been implemented via The Regulated Covered Bond Regulations 2008 (2008/346) (linked below), as amended by The Regulated Covered Bond (Amendment) Regulations 2008 (2008/1714) (linked below), The Regulated Covered Bond (Amendment) Regulations 2011 (2011/2859) (linked below) and The Regulated Covered Bond (Amendment) Regulations 2012 (2012/2977) (linked below) (together, the Regulated Covered Bond Regulations). http://www.legislation.gov.uk/uksi/2008/346/contents/made
http://www.legislation.gov.uk/uksi/2008/1714/contents/made
http://www.legislation.gov.uk/uksi/2011/2859/made
http://www.legislation.gov.uk/uksi/2012/2977/contents/made

14 https://www.gov.uk/government/consultations/the-uks-regulatory-framework-for-covered-bonds

15 See s21(1) of the Regulated Covered Bond Regulations 2008 (as amended)

16 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81309/consult_review_uk_reg_framework_covered_bond.PDF

17 In some cases there would be more than one, as some banking groups contain multiple banks. For a list of the various UK credit institutions with covered bond programmes, please see the link below.
http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-register

of the LLP (which is not possible for a limited partnership), is a core feature of UK structures and operates to protect the collateral pool owner against events which might otherwise operate to restrict or delay the recourse that investors have to the collateral pool. In practice, investors would never accept a natural person fulfilling this role, as such a person might become incapacitated or die and so be unavailable to fulfil this role when needed. Further, the collective investment schemes regime under the Financial Services and Markets Act 2000 and relevant regulations, in effect, prevents a natural person participating in such an LLP.

While at the outset the LLP would be a subsidiary of the relevant bank or building society, on insolvency this would cease to be the case and so again any group-based exemption would not be sufficient.

To give an idea of scale, according to the European Covered Bond Fact Book in September 2013 there were 12 regulated covered bond issuers in the UK with a total programme volume of EUR 280 billion with total outstanding of EUR 106 billion[18]. We note that covered bonds proved to be an essential source of funding for UK credit institutions during the financial crisis and, as indicated above, the Government has expressed its general support for the development of the UK market. Any requirement to change existing arrangements would be highly disruptive, may give rise to new tax issues for existing transactions and is likely to create confusion for investors.

## 5. CONCLUSION

5.1 We believe that the example scenarios set out above demonstrate that:

(a) corporate members of LLPs are used in a wide variety of completely "legitimate" scenarios; and

(b) prohibiting corporate members of LLPs would be a very disruptive move, requiring the unwinding of a large number of existing arrangements and very significantly reducing the ways in which LLPs were used in the future.

5.2 As noted above, CLLS would be very happy to discuss the points raised in this note with you if that would be of assistance.

**Stephen Mathews, Allen & Overy**
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[18] 8th edition September 2013 published by the European Covered Bond Council (available at http://ecbc.hypo.org/Content/Default.asp?PageID=501 ) – see pages 490 and 491. The typical structure using an LLP is shown on page 494.