

LIMITED LIABILITY PARTNERSHIPS – EMERGING BUSINESS VEHICLES OF GROWTH FOR INDIA INC.

Vijay Kumar Khurana*
M L Maurya**
Rohit Garg**

* Professor, Gitarattan International Business School

** Professor, Institute of Economics & Finance, Bundelkhand University

** Associate Professor, Hindu Institute of Management, Sonipat



ABSTARCT

World War II (1940-44) led to emergence of two distinct political & economic blocs of countries. While NATO bloc countries, led by USA, pursued capitalism i.e. free market system; Warsaw bloc countries, led by then USSR (Soviet Russia), pursued socialism i.e. state-controlled market system. Decade of 1980s saw economic & political collapse of Warsaw bloc; and emergence of USA as sole political & economic super power. The message was clear that States cannot and are not supposed to run the business. It would be better that States confine themselves to regulatory and supportive role; and running of business should be largely left to private sector. Next decade i.e.1990s had been witness to big winds of change across the world. The world is becoming a small global village. The fast-changing, increasingly inter-connected, globalized and ever-increasing competitive environment is creating the necessity for exploring new ways of doing business. As a result, Limited Liability Partnership (LLP) business entity have been introduced & encouraged by many countries during the last 10-15 years. This paper examines the need for LLPs in India. The paper also explores the salient features of LLP legislation in India and benefits of doing business through LLP business structure. The paper emphasizes the likely contribution of LLP business format to growth of small and medium scale enterprises and growth of India Inc. as a whole.

INTRODUCTION

Business is, sometimes, presumed synonymous with running a company. This is not the case. There are many types of business entities, which

have been nurtured by the legal systems, business practices & customs of various countries. Table 1 shows various alternative forms of business structure, which are being commonly used by entrepreneurs / business men in India.

Table 1
Types of Business Structures Commonly Used in India

S No	Types of Business Entity	Number of Owners / Partners / Shareholders	Covered by the Act	Liability of Owners etc. towards Business Losses, Debts, External Parties etc.
1	Sole Proprietorship	Single (1)	General business legislations*	Unlimited
2	Partnership	Min 2- Max 20 (Max 10 in the case of banking business)	Indian Partnership Act, 1932	Liability is joint & several and is unlimited. Example: Kankhal Investments and Trading Company of RIL Group
3	LLP (Limited Liability Partnership)	2 or more	The Limited Liability Partnership Act, 2008	Liability is limited. Example: Aravali Polymers of EIH Group
4	HUF** (Hindu Undivided Family)	2 or more from the same family	General business legislations and Hindu Law such as Mitakshara, the Dayabhaga etc	Liability is limited to the extent of member's interest in the family property; unlimited for adult members who sign a contract for HUF
5	Cooperative Society***	15 or more	Multi State Cooperative Societies Act, 2002 & respective State Co-operative Societies Act	Liability is limited. Example: AMUL products offered by the Kaira District Milk Union which has 1026 primary District Cooperatives and 577, 728 members
6	Pvt. Ltd. (Private Limited Company)	Min 2- Max 50	The Companies Act, 1956	Liability of the members is limited; Shares are held privately and cannot be offered to public. Example: Osram Industries Pvt Ltd
7	Ltd. (Public Limited Company)	7 or more	The Companies Act, 1956	Liability of the members is limited; Shares can be offered to public and are easily transferable. Examples: Tata Motors Ltd., Reliance Industries Ltd (RIL), Etc.
8	Public Sector Unit (PSU) or Public Sector Enterprise (PSE)	Largely owned or controlled by State or Central Govt., Board / public ownership	Special Legislation or the Companies Act, 1956, as applicable	Liability is limited Examples: SBI, BHEL etc

* (General business legislations like Indian Contract Act, 1972, Payment of Minimum Wages Act etc apply to every type of organization / business entity.)

**{HUF is a Business owned by a joint family belonging to Hindu religion. Even though Jain and Sikh families are not governed by the Hindu law, they can still form a HUF.}

*** [A Cooperative Society (also known as co-operative; often shortly referred to as a co-op) is a business organization owned and operated by a group of individuals for their mutual benefit.]

Initially most of the private sector business was done through sole proprietorship or partnership form of business structures. Most of these are small & medium scale enterprises. There have been frequent ups & downs in the economic fortunes of such organizations, facing occasionally bankruptcy, as these business entities have unlimited liabilities towards business losses, debts & external parties etc. Due to smaller financial base, their risk taking capabilities for big, risky or new innovative projects is lesser; thus adversely affecting their expansion & growth. Usually these business forms are not suitable for large scale operations. These business forms facilitate slow and small economic growth.

It is rightly said that necessity is mother of invention. Economic & business necessity led to evolution of limited liability concept during 15th century. As the limited liability concept strengthened & gained momentum, Limited companies emerged as an economic / business unit during 19th century. The concept facilitated development of large business organizations and spread of MNCs across the world.

These three business forms namely sole proprietorship, traditional partnership firm and limited company have been commonly used till the end of 20th century. The decade of 1990s had been witness to big winds of change, initiating process of Liberalization, Privatization and Globalization across the world. The world is becoming a small global village due to fast & continuous information, communication and technology progress. The ever-changing, increasingly inter-connected, globalized and ever-increasing competitive environment created the necessity for exploring new ways of doing business. Led by the changing circumstances & economic necessity, the limited liability concept has been extended by many nations to LLPs (Limited Liability Partnerships) during the last 10-15 years, so as to stimulate faster development of small & medium size organizations and to spread distribution of benefits of economic progress.

HISTORICAL PROGRESS OF LIMITED LIABILITY CONCEPT

The Concept

Limited liability is a concept whereby a person's financial liability is limited to a fixed sum, most commonly the value of a person's investment in a company or partnership with limited liability. If a company with limited liability is sued, then the plaintiffs are suing the company, not its owners or investors.

A shareholder in a limited company is not personally liable for any of the debts of the company, other than for the value of his investment in that company. By contrast, sole proprietors and partners in traditional partnership firms are each liable for all the debts of the business (unlimited liability).

Although a shareholder's liability for the company's actions is limited, the shareholder may still be liable for his own acts / commitments. For example, the directors of companies (who generally are also shareholders) are often required to give personal guarantees to the lenders of the company in respect of the company's debts. In the event that the company cannot pay back its debts, then they will be liable for those debts, although the other shareholders will not be so liable.

Criticism & Justification of the Concept

Initially there was a degree of public and legislative distaste for a limitation of liability, with fears that it would cause a drop in standards of probity. It is quite likely that some of fraudulent, reckless, dishonest or unscrupulous promoters / businessmen may hide their irresponsible actions behind the corporate veil of separate legal entity & limited liability; and they may exploit investors, creditors, consumers and society at large. There have been calls to restrict limited liability to only non-managing investors but, these have been resisted. The general legal response to such concerns has been to make directors liable in the event of any dishonesty.

It has also been argued that it distorts the free market by allowing the entrepreneur to externalize some risk and impose it on society at large. Further present structures favour large creditors who are in the position to negotiate secured terms, whereas small creditors' debts are

left unsecured. There has always been a debate that limited companies may lead to creation of monopolistic privileges at the expense of state, society & taxpayers.

Limited companies are not at all monopolistic privileges. They are free associations of individuals pooling their capital. In the purely free market, such individuals would simply announce to their creditors that their liability is limited to the capital specifically invested in the corporation, and that beyond this their personal funds are not liable for debts, as they would have been under a partnership arrangement. It then rests with the sellers and lenders to this corporation to decide whether or not they will transact business with it. If they do, then they proceed at their own risk. Thus, the government does not grant corporations a privilege of limited liability. Anything announced and freely contracted for in advance is a right of a free individual, not a special privilege.

There is evidence that shares in public companies would be at a disadvantage if liability were unlimited or shares are held as largely unpaid. The experience of partly-paid shares in the nineteenth century seems to confirm this. Promoters being insiders are always aware about internal state of the company. If they are holding unlimited shares or largely unpaid shares, & the company is facing any trouble, then they may dispose them off in the market, thus causing loss to un-informed investor.

Evolution & Growth of the Concept

By the 15th century, English law awarded limited liability to monastic communities and trade guilds with commonly-held property. In the 17th century, joint stock charters were awarded by the crown to monopolies such as the East India Company. The Joint Stock Companies Act of 1844 (UK) facilitated incorporation of a joint stock company, although investors in such companies carried unlimited liability until the passing of Limited Liability Act 1855.

The Limited Liability Act 1855 allowed limited liability to companies of more than 25 members (shareholders). Later-on, the minimum number of members necessary for registration as a limited company was reduced to seven by the Companies

Act 1856. Limited liability for insurance companies was allowed by the Companies Act 1862.

Similar statutory regimes were in place in France and in the majority of the U.S. states by 1860. By the end of the nineteenth century, most of European countries had adopted the principle of limited liability.

In India, the Companies Act, 1956 covers the working of limited liability companies. In 1989, the European Union enacted its Twelfth Council Company Law Directive, requiring that member states make available legal structures for individuals to trade with limited liability. Limited companies in England and Wales now require only one member.

EMERGENCE OF LLPs

During the last 10-15 years, the limited liability concept has been extended by many countries to limited liability partnerships.

In the United States, Limited liability partnerships emerged in the early 1990s. While only two states allowed LLPs in 1992, over forty states had adopted LLP statutes by 1996; the time when LLPs were added to the Uniform Partnership Act in 1996 in USA. In the United Kingdom, LLPs are governed by the Limited Liability Partnerships Act 2000 (in Great Britain) and the Limited Liability Partnerships Act (Northern Ireland) 2002 in Northern Ireland. In Singapore, LLPs can be formed under the Limited Liability Partnerships Act 2005. This legislation draws on both the US and UK models of LLP. Limited liability partnerships were introduced to Japan in 2006.

Many nations have enacted LLP legislations during last 10-15 years. There are many differences in LLPs created in different countries. Thus generalization is difficult. Broadly speaking, a Limited Liability Partnership (LLP) is a business entity in which some or all partners have limited liability (depending on the jurisdiction of country). It therefore exhibits elements of partnerships and corporations. Thus LLP can be called a hybrid between a company and a traditional partnership firm.

NEED FOR LLPs IN INDIA

The number of companies in India has risen tremendously from about 30,000 companies in 1956 to now over 7 lakh companies. Indian companies are mobilizing resources at a large scale, continuously entering into and bringing new activities into the fold of the Indian economy. This has led to massive growth of Indian Economy. Many Indian companies have become global in nature. Tata Steel's acquisition of Chorus and Tata Motor's acquisition of Jaguar are prominent examples.

Indian companies are making huge contribution to Government's Revenue i.e. Tax Collections by way of direct & indirect taxes. Indian companies are also spending huge sum of money on Research & Development. Launch of Nano car by Tata Motors drew attention of entire world to India. Most of the big projects are being executed by limited companies. These companies are stimulating and spreading the growth of stock exchanges, financial intermediaries and financial markets across India. These companies are also providing source of earning to shareholders / investors through dividends and capital gain appreciation. Thus Limited Companies have been torch bearers of economic progress of Indian Jumbo.

However, there are many limitations / problems / pitfalls associated with limited companies. These are briefly discussed as under:

- Registration process for limited companies is long and requires stringent legal requirements.
- Their working is subject to stringent and large compliance requirements related to the Companies Act, 1956, SEBI, Listing Conditions of Stock Exchanges etc
- Large membership / shareholders leads to large cost for servicing the shareholders viz. sending annual reports, Dividend distribution, Holding AGM, Listing expenses etc.
- These are required to pay additional taxes like Minimum Alternate Tax (MAT), Dividend Distribution Tax (DDT) & Surcharge on Income Tax @7.5% if total income exceeds Rs. 1crore.

- Sometimes, there is clash of interest between groups of shareholders viz. One promoter vs other promoter, Promoters vs rest, Majority vs minority; which in turn adversely affects the decision making and smooth functioning of the company. The spat between Ambani Brothers of Reliance Group for division of assets continued for many years, drawing national cabinet including Prime Minister into the picture.
- They become mammoth in size. Their proper handling & management requires dedicated teams of professionals and management. Large numbers of stakeholders are dependent on their successful functioning. Failure of one or few companies can shake entire national economy. For example - failure of Satyam in India, Daewoo in Korea & Enron in USA shook the national & international financial markets.
- Limited companies, with huge resources at their command, have been sometimes found to use un-ethical or heavy advertising campaigns to kill competition. Sometimes, these have been found to encouraging bribery and corruption to push through their projects or gain new contracts / projects. Sometimes, these have been found to interfering with political system and disturbing political stability of a nation / state. Sometimes, these have been found to pursuing own business priorities and ignoring national priorities, environmental & social concerns.
- Limited companies are dominating national economic scene, thus leading to concentration of economic wealth in the hands of few players. The Competition Act, 2002 has been enacted & enforced to remove the anomaly. But still corporate businesses dominate national economic scene leaving lesser scope of business & growth for small & medium enterprises. This is against the spirit of Article 39 of Constitution of India, which requires that State shall direct its policy towards securing
 - that ownership and control of the material resources of the community are so distributed as best to subserve the common good;

- that operation of the economic system does not result in the concentration of wealth and means of production to the common detriment.

- The limited company business structure is less suitable for small & medium scale businesses.

As discussed above, limited company business structure has variety of problems / limitations / pitfalls. Thus, for a long time, a need has been felt to provide for a business format that would combine the flexibility of a partnership and the advantages of limited liability of a company at a low compliance cost. The desirability of LLP form has been expressed **in the context of small enterprises** by:

- **Bhat Committee** (1972)
- **Naik Committee** (1992)
- Expert Committee on Development of Small Sector Enterprises headed by Sh. **Abid Hussain in 1997** and
- Study Group on Development of Small Sector Enterprises (SSEs) headed by **Dr. S P Gupta (2001)**.

Following **Committees set up by Ministry of Corporate Affairs (MCA)**, have also recommended for legislation on LLPs:

- Committee on Regulation of Private Companies and Partnerships headed by Sh. **Naresh Chandra (2003)**
- The Committee on New Company Law (Dr. **J.J. Irani Committee**) (2005)

At the Confluence of IIM Ahmedabad in 2007, Chairman of Essar Group Sh. Shashi Ruia said that "India needs more entrepreneurs to meet the growth challenge in the coming years and take the country forward". In the words of current Prime Minister Sh. Man Mohan Singh, India needs large number of entrepreneurs to attain & sustain high economic growth rate and gain economic leadership in the world. Many new institutions are being set up to promote entrepreneurship in India. LLP model is expected to encourage more entrepreneurship in India.

According to the Ministry of Corporate Affairs (MCA), Government of India, an LLP is an alternative business vehicle that provides the benefits of limited liability, and allows its members the flexibility of organizing the internal structure as a partnership firm based on a mutual agreement. The LLP format has been introduced to enable professional expertise and entrepreneurial initiative to combine, organize and operate in a flexible manner. This format would be quite useful for small and medium enterprises in general and for the enterprises in services sector in particular. LLP is an alternative corporate business form that gives the benefits of limited liability of a company⁸ and the flexibility of a partnership.

OVERVIEW OF LLP ACT 2008

The Limited Liability Partnership Act 2008 was published in the official Gazette of India on January 9, 2009 and has been notified with effect from 31 March 2009. The rules have been notified in the official gazette on April 1, 2009. The first LLP was incorporated in the first week of April 2009.

The provisions of Indian Partnership Act, 1932 are not applicable to LLPs. A minimum of two partners will be required for formation of an LLP. There is no limit to the maximum number of partners. The LLP can continue its existence irrespective of changes in partners. It is capable of entering into contracts and holding property in its own name. A body corporate can become a partner of an LLP. At least two "Designated Partners" must be appointed for all LLPs. "Designated Partners" shall also be accountable for regulatory and legal compliances, besides their liability as 'partners, per-se'.

The LLP is a separate legal entity, is liable to the full extent of its assets but liability of the partners is limited to their agreed contribution in the LLP. Further, no partner is liable 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. Mutual rights and duties of the partners within a LLP are governed by an agreement between the partners or between the partners and the LLP as

the case may be. The LLP, however, is not relieved of the liability for its other obligations as a separate entity.

A brief comparison of LLPs with traditional partnership firms & limited companies has been carried out below to gain better understanding of scope and use of LLPs.

a. Comparison between LLP & "Traditional Partnership Firm"

Under "traditional partnership firm", every partner is liable, jointly with all the other partners and also severally for all acts of the firm done while he is a partner. Under LLP structure, liability of the partner is limited to his agreed contribution. Further, no partner is liable on account of the independent or un-authorized acts of other partners, thus allowing individual partners to be shielded from joint liability created by another partner's wrongful acts or misconduct.

b. Comparison between an LLP & a Limited Company (LTD)

A basic difference between an LLP and a joint stock company lies in that the internal governance structure of a company is regulated by statute (i.e. the Companies Act, 1956) whereas for an LLP it is regulated by a contractual agreement between partners. The management-ownership divide inherent in a company is not there in a limited liability partnership. LLP have more flexibility as compared to a company. LLP have lesser compliance requirements as compared to a company. The essential requirement for setting LLP is 'carrying on a lawful business with a view to profit'; hence these cannot be set up for charitable or 'not for profit, purposes. Minimum Alternate Tax (MAT), Dividend Distribution Tax (DDT), Income Tax Surcharge etc are not applicable to LLPs.

Since LLP contains elements of both 'a corporate structure' as well as 'a partnership firm structure' LLP is called a hybrid between a company and a partnership. Due to above reasons promoters / entrepreneurs are looking to LLPs as alternative holding vehicle for variety of reasons as below:

1. Advantages of separate legal entity & limited liability

2. More risk taking ability
3. Flexibility in set-up and exit
4. Flexibility in ownership pattern
5. Planning for future succession
6. Availing tax benefits like non applicability of MAT, DDT, and Surcharge etc.

FUTURE AHEAD

India has witnessed considerable growth in services sector and the quality of our professionals is acknowledged internationally. It is necessary that entrepreneurship knowledge and risk capital combine to provide a further impetus to our impressive economic growth. The services sector promises an economic opportunity similar to that provided by information technology over the past few years. It is likely that in the years to come Indian professionals would be providing accountancy, legal and various other professional / technical services to a large number of entities across the globe. In view of above, the LLP framework could be used for many enterprises, such as:

- Persons providing services of any kind
- Enterprises in new knowledge and technology based fields where the corporate form is not suited.
- For professionals such as Chartered Accountants (CAs), Cost and Works Accountants (CWAs), Company Secretaries (CSs) and Advocates, etc.
- Venture capital funds where risk capital combines with knowledge and expertise.
- Professionals and enterprises engaged in any scientific, technical or artistic discipline, for any activity relating to research production, design and provision of services.
- Producer Companies in Handloom, Handicrafts sector.
- Small Scale Enterprises (including Micro, Small and Medium Enterprises)

As many as 8651 LLPs have been registered in India with Registrar of Companies till 03.04.2012. Western region accounted for 4086 registrations including 3471 registrations of Maharashtra, where our financial capital Mumbai is located. However, In India, legal framework for LLPs is at evolution stage. There are certain grey areas that need clarity. For example, as per ASSOCHAM, RBI needs to clarify FDI norms for LLPs.

CONCLUSION

Before the LLP model being introduced in India, it has been accepted in countries like U.S.A, U.K, Australia, and Germany etc. LLP is a form of business entity, which allows individual partners to be restricted from joint liability of partners in a partnership firm. The Liability of the partners incurred in the normal course of business is that of LLP and it does not extend to the personal assets of the partners. This is a great relief to the partners, particularly professionals like Company Secretaries, Chartered Accountants, Cost Accountants, Advocates and other professionals. These professionals may also form multi-disciplinary LLPs to meet the needs of changing economic environment. The introduction of LLPs in India is a good beginning towards a long journey. The hybrid structure of LLP will facilitate entrepreneurs, service providers and professionals to organize and operate in an innovative and efficient manner for effectively competing in the global market. The LLP format is expected to stimulate faster development of small and medium scale organizations and growth of national economy as a whole.

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