Regulation and application of LLP and LLC

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Summary

1. The Dutch Ministry of Justice aims to develop a more effective company law. In that respect, the question came up whether the introduction of new legal forms can cater for a more effective company law. The Ministry commissioned the Van der Heijden Institute of the Radboud University in Nijmegen to examine the regulation and application of new legal forms in other countries, as well as the implementation of new legal forms within Dutch law. The study concentrates on the Limited Liability Partnership (LLP) in the United States and the United Kingdom, and the Limited Liability Company (LLC) in the United States.

2. The main conclusion of the study is that the Dutch company law can be improved without introducing new legal forms. The researchers advise to further develop the flexibility of company law and to research the combination of limited liability and fiscal transparency in one legal form. Limited liability refers to the situation where the members of the legal form are not liable for the debts of the entity and fiscal transparency refers to taxation on profits at the level of the members and not the entity. The combination of limited liability and fiscal transparency is not fully available in the current Dutch legal system.

3. The structure of the report is as follows. The first chapter sets out the issues and the research method. The second chapter describes the LLP in the United States and the United Kingdom, and the LLC in the United States. The LLC
does not exist in the United Kingdom. The application of these legal forms is described in chapter three. The fourth chapter compares the LLP and the LLC to the partnership under Dutch law (personenvennootschap) subsequent to the introduction of the new Title 7.13 of the Dutch Civil Code, and to the private limited company (besloten vennootschap) as it will most likely look subsequent to the completion of the current process of making company law more flexible. The fifth chapter contains the conclusions. The research was carried out between August 2006 and February 2007. It was conducted through a study of legislation and law literature and statistical data. Furthermore, interviews were made with about 20 experts from the United States and the United Kingdom.

4. The LLP was introduced in the United States at the end of the 1980s. The LLP was introduced especially to meet the demand for limited liability for professionals (accountants, lawyers, etc.). The LLP is a form of partnership (personenvennootschap). A particularity of the LLP compared to other partnerships is that the members of the LLP are, in principle, not liable for the obligations of the LLP. There are certain exceptions. The main exception is that a member of the LLP is liable for his own negligence. Under certain circumstances, members can also be liable if they have made unauthorised payments at the expense of the equity of the LLP, if they have voluntarily accepted liability and in other cases prescribed by law. The LLP is required to be recorded in a public register. The registration usually concerns details which aim to enable the LLP to do business (name, corporate seat, representation, etc.).

5. The United Kingdom introduced the LLP in the year 2000. The background of the introduction is essentially the same as in the United States. In the United Kingdom, the LLP is not a partnership, but a company (kapitaalvennootschap). The LLP Act states that the Companies Act 1980 is applicable to the LLP. In addition to this, the LLP Act contains some specific rules for the LLP. An LLP is based on an agreement between two or more members. The agreement governs the relationship amongst the members themselves and their relationship with the LLP. The Act contains succinct provisions for the situation where the agreement requires supplementation. The LLP is required to be registered in a public register. The details that need to be recorded are, as in the United States of America, limited. The members of the LLP are, in principle, not liable for the obligations of the LLP. Nonetheless, a member is liable, stated briefly, for his own wrongs caused in the course of the business of the LLP. Members can also be held liable when they are guilty of causing the LLP to become insolvent.
6. The first LLC legislation was introduced in the United States of America in 1977. The reason for the introduction was the wish to have available a legal form with limited liability combined with fiscal transparency. Until the 1990s there was a lack of clarity on the fiscal position of the LLC, in particular with regard to the conditions for fiscal transparency. The Internal Revenue Service developed criteria to determine whether an LLC was to be taxed as a partnership (fiscal transparency) or as a corporation (not fiscal transparency). However, the application of these criteria did not establish the necessary certainty. As from 1997, these criteria have been replaced by the “check-the-box” system. Under this system, an LLC may choose whether it wishes to be treated as a transparent entity. The introduction of this system has caused a substantial increase in the use of the LLC.

7. The LLC is based on an agreement between the members of the LLC (operating agreement). It is also called an operating agreement when the LLC has only one member. The LLC is required to be recorded in a public register. The articles of association, but not the operating agreement, must be recorded. Members enjoy great freedom in structuring the LLP at their discretion. There are hardly any mandatory requirements in respect of controlling rights, division of profits and losses, management by members or managers, etc. The statutes contain extensive additional provisions in case the operating agreement does not provide for certain matters. Members are, in principle, not liable for the obligations of the LLC. Liability may arise in the case of negligence by a member or imputable insolvency of the LLC.

8. The new forms are used to a varying degree. In the United Kingdom, the LLP is used much less than the private company. As at the end of 2006 more than 21,000 LLPs were registered, compared to well over 2.25 million private companies. The researchers were unable to collect sufficient data to make reliable statements on the use of the LLP in the United Kingdom. A better picture of the use and the meaning of the LLP and the LLC in the United States were gained through data from the Internal Revenue Service. The LLC is used significantly more often than the LLP. As of 31 December 2004 approximately 1,270,000 LLCs were registered, compared to 89,000 LLPs. The increase in the number of LLPs is accompanied by a decrease in ordinary partnerships. Since 2004, the LLC is the legal form most used for small and medium sized enterprises, directly behind the sole proprietorship. Measured by the total profits of the businesses carried on by these legal forms, the Limited Partnership (comparable to the Dutch ‘commanditaire vennootschap’) was slightly more important than the LLC in terms of economic significance ($119 billion compared to $104 billion). In all likelihood, in 2005 the economic
importance of the LLC was greater than that of the Limited Partnership. In the United States, the LLP is mainly used in the services sector. Well over 80% of the profits of all LLPs in 2004 were earned by professionals.

9. It is not easy to characterise the legal forms investigated and to compare them to Dutch legal forms. The LLPs and LLCs vary greatly in the United States. Every state has its own legislation for these legal forms. The legislation is more uniform for the LLP than for the LLC. Both legal forms have a rather hybrid character. They possess features of a Dutch partnership and a Dutch private company. The LLP and the LLC have in common with Dutch partnerships the fact that the relationships among the members between themselves and between the members and the LLP are governed by an agreement. Another common characteristic is the flexibility. In contrast to Dutch companies, there are no mandatory corporate bodies, share capital, etc. The LLP and LLC have in common with private companies the fact that they have legal personality. It is the LLP and the LLC that take part in legal transactions, not the members. All in all the features of a Dutch partnership prevail in the LLP. The LLC can perhaps best be characterised as a hybrid form between a Dutch partnership and a Dutch private company. In the United Kingdom the legislation on companies is applicable to the LLP, but in contrast to the companies the LLP does not have a structure of corporate bodies or share capital.

10. The study draws the conclusion that, in order to make Dutch company law more effective, it is better to further liberalise the existing legal forms rather than to introduce new legal forms. The researchers recommend continuing the current process of making company law more flexible. They make a few recommendations based on the experiences in the jurisdictions researched. They recommend offering more freedom to the users of the legal forms to structure the legal form at their own discretion. In regard to the B.V. (private company) legislation, they feel that there is a need to reconsider the basic assumption that this legislation is, in principle, of a mandatory nature (Article 2:25 Civil Code). The researchers also suggest leaving greater freedom to enter into agreements on the organisation of a company, outside the articles of association. According to the researchers, greater freedom of organisation does not necessarily lead to abuse of legal forms. To conclude, the researchers recommend further investigation into the combination of limited liability and fiscal transparency in one legal form. In the current Dutch legal system the limited partnership (commanditaire vennootschap) is the legal form that best combines limitation of liability and fiscal transparency, but the combination has various restrictions which makes Dutch law less effective.