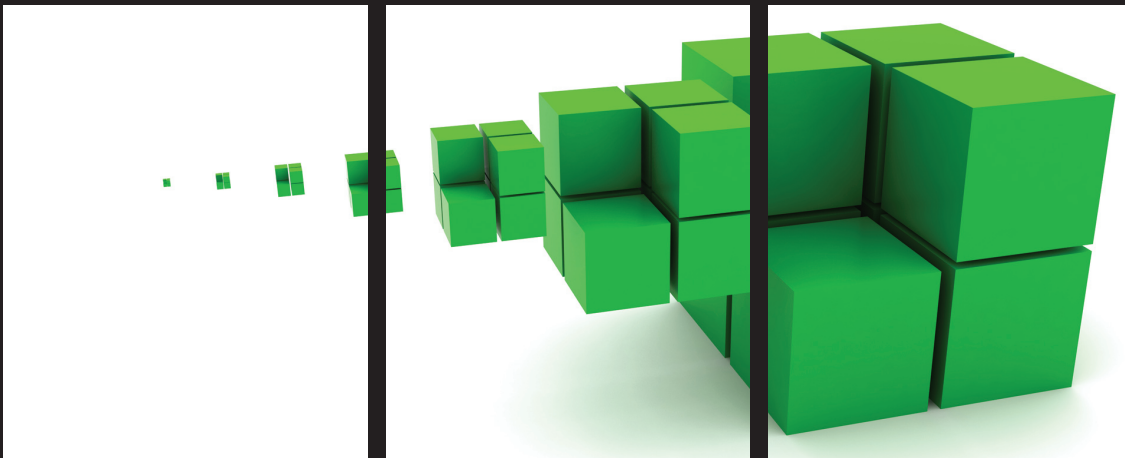


LLP Conversion for Law Firms

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Chapter 1: Introduction

The definition of an LLP conversion

The conversion of a partnership to a Limited Liability Partnership (LLP) does not, in practice, mean a conversion at all. What actually occurs is that an entirely new entity – the LLP – is created, the business of the partnership is acquired by the new LLP and the partnership is then dissolved. The distinct steps involved in a conversion need to be analysed in some detail to ensure compliance with the legal and regulatory framework, and to obtain the benefits which are intended to flow from the Limited Liability Partnership (LLP) Act 2000. It is this which this report covers, as well as forming the LLP, drafting the LLP agreement and transferring the partnership business to the LLP.

Tax neutrality on conversion will result if the whole of the business of the partnership, together with its assets and liabilities, is transferred to the LLP and the members of the new LLP are the same and have similar proportionate shares, as was the case in the partnership. There are various reasons why it may not be practical for conversion to take place in precisely that manner, for example, because a partner does not wish to become a member of the LLP.

Unless the partnership agreement contains a clause permitting conversion, it will normally be necessary for a unanimous decision of partners to be reached because, under Section 24(8) of the Partnership Act 1890, only ordinary matters connected with the partnership business may be dealt with by a simple majority. Conversion

involves the transfer of the partnership's business and assets to the LLP while the partnership is still in existence and not upon dissolution. Partners' balances, including capital balances, will be transferred from the partnership to the LLP, and there is likely to be a fundamental change in the internal rights and responsibilities of the former partners to each other when they become members of the LLP. Additionally, there will be a relationship between the LLP and its individual members, which does not exist in a partnership.

The trend towards LLP conversion

The LLP Act 2000 was brought into being partly in response to the globalisation of legal services, with some foreign firms already able to operate with limited liability, and partly because of the increasing threat of litigation for alleged negligence against those with the deepest pockets. Accountancy firms have for many years limited their liability for much of the advice they have provided, but this has not been a trend until recently among law firms. For smaller firms it is not even possible, because a firm may not limit its liability to a figure below that which it is obliged to insure for. For partnerships that is, at present, £2m and for LLPs, it is £3m. Therefore, the first firms to convert tended to be those with large commercial or international practices, or those with niche or high-volume markets. More recently, the prospect of being bankrupted by discrimination claims or the recession,

the inability to attract new partners willing to accept unlimited liability, the regulatory emphasis on corporate rather than individual responsibility and the prospect of investment into Legal Disciplinary Practices (LDPs) have persuaded more medium and smaller-sized firms to consider conversion.

This trend is likely to increase for two reasons. First, any firm contemplating Alternative Business Structures (ABSs) might be advised to convert to an LLP well in advance. Although some firms may move directly to ABSs, it is to be anticipated that most firms will, as LLPs, ready themselves for LDP status before contemplating ABSs, because the LDP status requirements are already in place. An LDP may have an approved person who is not a solicitor as a member or partner, provided that at no time does that person or body (or any combination of non-solicitor members or partners) hold more than 25 per cent of the voting control or investment in the LDP. The SRA has regulations to cover the approval of those non-solicitors who want to join an LDP.

Second, firms must continually recruit new talent to replace those who are retiring, even if the business is not expanding. Many firms feel that they need to expand in order to support the structures necessary to comply with modern regulation. Therefore, recruitment of people who are, or who will be, at partner level, is what most firms have to consider very seriously. Younger entrants to the profession have shown a marked reluctance to become partners in small or medium-sized firms, particularly if they understand the responsibilities and potential liabilities that they are being asked to undertake. An LLP is much more attractive to most newer recruits to the profession because it offers the possibility of a limited investment risk. To some, there is the added attraction of being able to attract outside

finance to reduce the need for personal investment in the firm. Since the advent of student loans and the opening up of the profession to a far wider group, the ability of potential partners to fund an acquisition of a share in the partnership and their willingness to borrow more money when they are probably already highly indebted, have diminished dramatically. The traditional method of rewarding retiring partners by paying them annuities is, like the final salary pension, unlikely to be available to anyone starting their career in law. It is therefore generally much more attractive for newer recruits of partnership calibre to join an LLP rather than a partnership.

As more firms convert to LLPs (and it is becoming the norm in the high street as well as in the City), it is likely to be met with less resistance as was once the case and, therefore, more firms will consider it prudent to convert to an LLP than to remain as a partnership.