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LLPs and Clawbacks

Since the introduction of the Limited Liability Partnership Act 2000, a business that previously operated as a partnership has been able to acquire limited liability by creating a limited liability partnership (LLP).

LLPs are separate legal entities with limited liability for their members. The up-take of LLPs by professional practices was rapid. As the recession continued, a number of large LLP professional practices have experienced financial difficulty resulting in their often very public demise.

The introduction of the **Limited Liability Partnerships Regulation 2001 (SI2001\1090)** saw the application of provisions of the **Insolvency Act 1986** to LLPs. This included references to a director or officer of a company being references to a member of a limited liability partnership. Directors of limited companies are subject to a number of provisions under the Insolvency Act including Section 214 wrongful trading. This enables a liquidator of a company that has gone into insolvent liquidation to seek an order of the Court requiring a director or shadow director to contribute to the company's assets as the Court thinks fit.

With the introduction of LLP's, a new provision was added to the Insolvency Act 1986 under the somewhat innocuous title of Section 214(A) "Adjustment of Withdrawals". This has come to be more commonly known as the Clawback provision. It is very similar to the wrongful trading provisions for companies.

When does it apply?
It only applies where an LLP goes into insolvent liquidation. It will not apply where the LLP goes into administration, becomes subject to a voluntary arrangement, is subject to a solvent restructuring or is dissolved.

Who does it apply to?
The Clawback provisions apply to the members of an LLP. Member is defined as the members who subscribed to the incorporation agreement and those who have become members by agreement with the existing members. It also includes a "shadow member" which means a person in accordance with whose directions or instructions the members of the LLP are accustomed to act.

Relevant period
The provision applies to the two year period immediately prior to the LLP being placed into insolvent liquidation.

What does it apply to?
It applies to property withdrawn by a member of the LLP at any time within the two year period. That includes salary received by the member, any share of profits, any repayment of a loan, payment of interest on any loan or any other withdrawal of property. In short, it applies to any financial benefit received by a member at any time during the two year period.

Who will pursue the members?
The ability to seek recovery of money or property from a member under this provision is restricted to the liquidator. It is not available to any other parties i.e. a creditor.

What must the liquidator establish?
The liquidator must prove to the satisfaction of the Court that at the time of the withdrawal (and each and every withdrawal) the individual member concerned knew or had reasonable grounds for believing that the LLP:

(i) was at the time of the withdrawal unable to pay its debts; or

(ii) would become so unable to pay its debts after the assets of the LLP were reduced by the withdrawal and any other withdrawals made by other members.

Under subsection (5) the Court shall not make an order under the provision unless it is shown that the member knew or ought to have concluded that after each withdrawal there was no reasonable prospect that the LLP would avoid going into insolvent liquidation.

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For the purpose of subsection 5 the facts which a member ought to know or ascertain; the conclusions that he ought to reach; and the steps which he ought to have taken are those that would have been taken, known or ascertained by a reasonably diligent person having both:-

(a) the general knowledge, skill and experience of a person carrying out the same functions as that member and;

(b) the general knowledge, skill and experience that the member has.

The penalty

If the liquidator's claim is successful the Court may order the member to make such contribution to the LLP's assets as the Court thinks proper. However the amount ordered shall not exceed the aggregate of the withdrawals made by that person within the two year period (all withdrawals in respect of which the liquidator's claim is made out).

A member subject to a claim brought by a liquidator under this provision will, on the face of it, only be potentially liable for the payments or property received by that member personally and not by other members. However this is not consistent with the approach to similar provisions applying to directors contained in the Insolvency Act 1986.

Could a claim be brought against a managing partner member for authorising a one-off bonus to all members in circumstances which would be in breach of these provisions? If so would he be liable to repay just his own bonus or the bonuses of fellow members? The qualification under sub-section (4) refers to withdrawals "made" by that person not "received". These are questions that remain to be resolved by the Courts.

Difficulties faced by a liquidator in pursuing a claim

The definition of a member is wide and the number and variety of individuals included within it in a particular LLP may be many. Establishing that a more junior member had the requisite knowledge or access to information which would have enabled them to have concluded that there was no reasonable prospect that the LLP would have avoided going into insolvent liquidation is likely to be difficult, particularly in larger firms. Often in reality more junior members may be as reliant as creditors on the public statements of the firm's managing partner/CEO in determining the firm's financial status. The steps that a junior member should take to "ascertain" the position remain unclear.

As a member – should you be worried?

To date whilst there have been a number of high profile failures of LLP professional practices, there is little evidence of liquidators pursuing claims against members under the Clawback provisions. A liquidator will face considerable hurdles in establishing all the necessary elements to obtain an order for contribution from an individual member.

This may in part be explained by the fact that the procedure of choice for insolvent LLPs trading as solicitor's practices is the pre-packaged administration. The reasons for choosing such a procedure are several fold. They include the fact that any cessation in trading will almost certainly destroy the value of work in progress. A sale of the business will often preserve employment and constitute the purchaser a "successor practice" for professional indemnity insurance purposes thereby, avoiding the necessity to obtain run-off cover. Whilst creditors may often feel aggrieved, the result of a pre-pack is often the only realistic outcome.

Pre-pack – what happens next?

Following an LLP going into administration and after any sale of the business has taken place the administration will in most cases proceed either to a liquidation or dissolution.

Under paragraph 83 of Schedule B1 of the Insolvency Act 1986, where the administrator thinks that a distribution will be made to unsecured creditors, the administration will be converted to a creditors' voluntary liquidation and a liquidator appointed.

Alternatively where the administrator thinks that the LLP has no property which might permit a distribution to its creditors, he may send notice to the Registrar of Companies dissolving the LLP (paragraph 84 Schedule B1 IA 1986).

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Relevance of exit route from administration to Clawback claims
It will only be in cases where an administrator considers that a distribution will be made to unsecured creditors that the LLP will then move into creditors voluntary liquidation. Where no distribution is likely to unsecured creditors then the LLP will be dissolved. The significance of this being that in the case of dissolution, the possibility of any claims being brought by a liquidator under the Clawback provisions will not arise. This will be the case even if the value of the claims against the members under Section 214(A) could potentially give a return to creditors.

It is therefore unsurprising that an announcement immediately following the appointment of administrators that the likely return to unsecured creditors is estimated to be a relatively small sum may be greeted by creditors with a degree of scepticism. If the distribution fails to materialise then dissolution will be inevitable and the prospect of creditors potentially recovering any further sums from the members of the LLP via a liquidator disappears.

In a case where dissolution is proposed and creditors are unsatisfied at the prospect of the LLP being dissolved, some support can be drawn from the decision in **Re Hellas Telecommunications (Luxembourg) II SCA [2011] EWHC 3176 (Ch)**. In that case administrators proposed to serve notice for dissolution. However the creditors objected and the Court decided that the company should be placed into compulsory liquidation, as a liquidator would be better placed to pursue enquiries into the company's affairs. There will be cases where it will be in the interests of creditors that an independent liquidator pursue Clawback claims as well as coordinating a review of the administration.

Conclusion
The provisions of Section 214(A) apply to all payments or property received by a member within the two year period prior to liquidation. Whilst the liquidator must establish a number of elements of the claim before being successful in obtaining an order that the member repay the property withdrawn, the potential for such a claim nevertheless exists.

At present, many of the LLP professional practices that have experienced financial difficulties are being placed into administration and ultimately being dissolved thereby avoiding liquidation and any potential claims under the provision. It remains to be seen how long it will be before creditors successfully challenge dissolution and obtain an order liquidating the LLP in order to pursue enquiries and claims under Section 214(A). Unfortunately R3's recent suggestion that creditors be given the option to appoint an independent liquidator, but only in relation to pre-pack administrations where the sale is to a connected party, does not go far enough.

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