**LIMITED LIABILTY PARTNERSHIP:
IS MALAYSIA READY?**

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Abstract

In Malaysia, the traditional types of business vehicles are sole-proprietorships, partnerships and companies. The sole-proprietor and partners are liable for the debts incurred in their respective businesses. For a company, the shareholders are liable only for the amount unpaid on their shares. They are thus, not liable for the debts of the company. In April 2008, the Companies Commission of Malaysia proposed a framework for limited liabilities partnership ("LLP") to complement the existing forms of business vehicles. It is a hybrid between the traditional partnership and company, for it enjoys the benefits of both forms. Just as in an incorporated company, the liability of the partners of an LLP will be limited. Further, the LLP will enjoy a separate legal entity from its partners, and thus will not be affected by any changes in its constitution. The LLP will also enjoy the management style of a partnership, for it

will not be subject to the strict management procedures of an incorporated body. The reasons given for the proposal are to spur the growth of SMEs against the backdrop of the international business environment and the enhancement of domestic business activities. This paper will discuss the proposed framework for Malaysia in relation to the rights of a creditor and a member of the public against the LLP and its partners.

***Keywords**: contractual liability, professional liability, insurance, accountant*

1. Introduction

In Malaysia, the traditional types of business vehicles are sole-proprietorships, partnerships and companies. The sole-proprietor and partners are liable for the debts incurred in their respective businesses. For a company, the shareholders are liable only for the amount unpaid on their shares. They are thus, not liable for the debts of the company.

In April 2008, the Companies Commission of Malaysia ("CCM") proposed to change the business landscape in Malaysia. According to its consultative document, a form of business vehicle which is flexible in terms of its formation, maintenance and termination, and also dynamic, is required to enable the country to be more competitive in the era of globalisation. A sole proprietor or a partner of a firm may not agree to expand the firm's business activities, for he is liable for the debts of the firm. Moreover, a change in the partnership's constitution terminates the partnership unless the partnership agreement provides otherwise. On the other hand, an incorporated company, though a separate legal entity from its members, may not be attractive due to its strict management procedures. Further, incorporating a company is not a solution if the law regulating his business prohibits it as in the case of the accounting profession.[1]

Thus, the CCM proposed a framework for limited liability partnership ("LLP") to complement the existing forms of business vehicles. It is a hybrid between the traditional partnership and company, for it enjoys the benefits of both forms. As its name indicates, the liability of the partners of an LLP will be limited. The LLP will enjoy a separate legal entity from its partners, and thus will not be affected by any changes in its constitution. The LLP will also enjoy the management style of a partnership, for it will not be subject to the strict management procedures of an incorporated body. The CCM targets to introduce the LLP as a new business vehicle in Malaysia by 2009.

This paper discusses the rights of the creditors and a member of the public who has legitimate claims against an LLP. The following section discusses the liability of a partner in a traditional partnership and in the proposed LLP model by the CCM. This will be followed by an examination on the rights of a creditor and the rights of a member of the public against the LLP and its members. This paper will conclude with some recommendations to be considered by the relevant Malaysian policy makers.

2. Limited Liability

Under the traditional partnership, every partner is an agent for his other partners for the purpose of the business of the partnership. Thus, if he does any act in carrying out in the usual way business of the kind carried out by the firm, the other partners are bound. If a debt or obligation is incurred, the partners are jointly liable (section 11 of the Partnership Act 1967). If a partner commits a tortious act, he and his partners are jointly and severally liable for damages to the wronged party (section 12 of the Partnership Act). Even if a partner retires, he remains liable for the debts incurred before his retirement (section 19(1) of the Partnership Act). He also will be liable for the debts incurred after his retirement unless he has given the appropriate notice to the third party. To the third party who had

[1] Section 18(b) and (c) of the Accountants Act 1967.

dealings with the firm before his retirement, he has to give express notice that he is no longer a partner of the firm. To the rest of the world, an advertisement in the government gazette is sufficient.[2]

The CCM's proposed LLP model changes this. The liability of the partners of an LLP is limited. He will not be liable directly or indirectly for an obligation of the partnership solely by reason of his being or acting as a partner. In other words, the obligation of the partnership is that of the partnership, and not that of the partners. However, the partner who commits a wrongful or tortious act, is personally liable, for his liability is not affected or extinguished merely on the basis that the acts or omissions were carried out in his role as a partner of the LLP.

In the following sections, the writers will discuss the position which may be taken by an outsider when dealing with an LLP.

3. Creditor

A business entity when carrying on its trade, will incur liabilities to its suppliers who supply goods on credit. It may also obtain financing for the purpose of carrying on its business. A prudent financier will assess the financial capacity of the debtor before giving credit. Where the debtor is an individual, the financier may request for proof of his income and assets. Where the debtor is a company, he may require a copy of the company's audited accounts to evaluate the company's financial position. However, due to the following, a financier may deem the LLP as a higher risk debtor (Morse, 2002) compared to a partnership borrower or even a limited liability company borrower.

As the financier will usually contract with the LLP, the financier may only enforce the contractual obligation against the LLP. As the LLP is a separate legal entity from its partners, a partner of the LLP is not personally liable for the debts incurred by the LLP unless he has personally agreed to be bound.

Although the financier may request the LLP to provide its accounts, such accounts may not be audited. It may not be prepared in accordance with the approved accounting standards. According to the proposal by the CCM, an LLP is not required to have its financial statements audited or filed with the Registrar of LLP. Although this may be mitigated by the requirements that first, the LLP is required to keep proper accounting records that will enable true and fair financial statements to be prepared; and secondly, the LLP is required to file an annual solvency or insolvency statement with the Registrar, there is no independent party to confirm the accuracy of the financial statements or the solvency statement.

In view of the above, it is pertinent that a financier takes measures to ensure the repayment of its loans. The following are some options. First, he may require the partners of the LLP to give a personal guarantee and indemnity. In the event the LLP fails to fulfil its contractual obligations, the financier may claim from the partners under the guarantee and indemnity.

Secondly, as the LLP is a separate legal entity and may own assets in its own name, he may require the LLP to create a charge over its assets in his favour. In this respect, it is pertinent that there must be a registration system similar to that applicable to an incorporated company. The LLP or any person interested in the charge created by an LLP should be required to register the charge with the Registrar of the LLP. The registry is important, for a third party dealing with the LLP, for example a financier, may make a search at the registry to ascertain whether the LLP has created a charge over its assets in favour of its creditor.

Thirdly, the financier may require the LLP to have its accounts prepared in accordance with the approved accounting standards and audited. This will enable the financier to evaluate the financial

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[2] Section 38 of the Partnership Act 1967.

standing of the LLP based on the statements prepared by and audited by independent and competent parties.

4. Client

Section 3 above discussed the liabilities of a partner of an LLP where there is a breach of contract by the LLP. This section discusses his liability where there is a breach of duty by a co-partner of the LLP.

In *Donoghue v. Stevenson* (1954) the House of Lords held that a person who has no contractual relationship with the wrongdoer, may sue the wrongdoer if first, the wrongdoer owed a duty of care to him; secondly, the wrongdoer breached his duty; and thirdly, the person has suffered damage as a result of the wrongdoer's breach of duty. In 1963, *Hedley Byrne & Co v. Heller & Partners Ltd* extended the wrongful act that gives rise to an action in tort to include negligent advice, and widened the scope of damages to include economic loss. The application of the principles in *Donoghue v. Stevenson* (1954) and *Hedley Byrne* (1963) to a practising professional means that a person who is affected by the services provided by the professional, may sue the professional for his financial losses. He may be the professional's client or a member of the public. It is no longer material that he does not have a contractual relationship with the practising professional.

Under the traditional partnership, the partners are severally liable to the person who suffered injury as a result of the breach of duty by a partner of the firm. However, under the model LLP proposed by the CCM, only the partner who commits a wrongful or tortious act and the LLP are liable to the victim. The other partners are not personally liable. This makes the proposed LLP an attractive business vehicle to professionals. Unfortunately, this also gives rise to a few issues.

First, to preserve his personal assets, a partner may not assist his co-partner particularly in a high risk case or cover his co-partner during his absences (Finch and Freedman, 2002). Secondly, the partners may be reluctant to set up internal monitoring system for fear of being implicated for any breach of care committed by a co-partner (Finch and Freedman, 2002). Thirdly, a partner who handles or deals with the LLP's clients may insist on larger share of the profits, for he incurs a higher risk. If there is a fall-out with a client, the client may sue him but not his co-partners. The co-partners will at the most, lose their contributions and shares in the assets of the LLP, whereas his personal properties are also at stake. These may result in lack of co-operation among the partners of an LLP, thus making the LLP vulnerable to breakups. At the end, the thread that holds the partnership together is its brand name.

Due to the feature of the LLP which does not impose liability on partners who did not commit the wrongful or tortious act, it can be forecasted that some, if not all firms offering professional services may convert to LLP. To protect the public who have legitimate claims for damages against a professional who has breached his duty of care, the CCM has proposed that a professional LLP should be required to effect an insurance policy. However, as discussed in Chan, Ng and Lee (2007), generally, a member of the public has no enforceable right under the policy. This is due to the application of the doctrine of privity which is still applicable in Malaysia. According to this doctrine, a person who is not a party to a contract cannot sue on the contract. As the member of the public is not a party to the insurance policy effected by the LLP, he cannot sue the insurer under the insurance policy even though he has established a claim against the LLP or a partner of the LLP. Thus, it is of utmost importance that the proposed LLP Act expressly requires the insurance company to pay the insured sum to the member of the public who has established his claim against the insured professional.

The CCM did not propose a blanket minimum amount applicable to all members of the profession. Instead, the CCM proposed that the minimum insured amount should be determined by the appropriate professional body governing its practising members. It must be stressed that the main basis for the minimum amount should reflect the real risks faced by the professional or his client (Chan, 1997).

One group of professionals who will benefit from the introduction of the LLP form of business vehicle is the practising accountants. It is noted that currently, the Malaysian Institute of Accountants ("MIA") requires its members in public practice to obtain a professional indemnity insurance policy. According to its website, www.mia.org.my, the MIA has appointed Marsh Insurance Brokers (Malaysia) Sdn Bhd as its broker and consultant. Like most, if not all, professional liability policies, the professional policy brokered by Marsh is written on a 'claims made' basis, rather than on an 'occurrence basis'.[3] This means that the policy covers a claim which is made against an insured and notified to the insurer during the tenure of the policy. It is immaterial that the conduct that gives rise to the claim occurs or the cause of action accrues before the effective date of the policy. It is also immaterial that the claim will be settled or the legal proceedings for the claim will be initiated after the expiry of the policy (Hodgin, 1999)

An important feature of a professional indemnity policy is the sum recoverable from the insurer, which is dependent on the sum insured and the base excess imposed on the claim. It is observed that the current MIA insurance scheme prescribes the minimum sum insured. A 'one member practice' must effect a minimum coverage of RM100,000. The compulsory limit increases up to RM5 million.

It is also noted that the main basis for the minimum sum insured and the excess imposed, is the number of members practicing in the firm, which is not reflective of the real risk faced by a practising accountant or a client. Weightage should also be given to the nature of work carried out by the firm. A 'one-member practice' could be handling high end work and should be insured accordingly. At the other extreme, there could be a firm with many partners, handling general and simple audit work.

To further compound the problem, an excess amount is imposed on each claim. The excess depends on the gross fees collected and whether the claim arises from work for a public or non-public listed company. The base excess is RM1,000 if the firm's gross fees does not exceed RM200,000, and gradually increases to a maximum of RM10,000 for a firm which gross fees exceeds RM2,000,000. If the claim arises from work for a public listed company, a different scale of base excess ranging from RM5,000 to RM30,000, is imposed. The writers submit that there should not be a different scale applicable for claims made with respect to the work for a public listed company. The nature of work is similar. The same standard of care imposed on the insured applies.

5. Creditors' Protection

A pertinent issue is whether there is any recourse against a partner of an LLP who withdraws his contribution or property from the LLP and thus prejudices the LLP's creditors. It is noted that for a company, there are statutory protections found in the Companies Act 1965 which confer rights on the creditors of the company in the even the company becomes insolvent. Sections 303(3) and 304(2) provide that an officer of the company who knowingly contracts a debt with no reasonable ground of expectation of the company being able to pay the debt, may be personally liable to pay that debt. Under section 365, an officer who wilfully pays or permits to be paid any dividend out of what he knows is not profits, is personally liable to the company's creditors to the extent by which the dividends exceed the profits.

Similarly, the creditors of the traditional partnership are protected by section 52 of the Bankruptcy Act 1967. As the partners of the traditional form of partnership is liable for the debts of the partnership and also for the damages caused by a wrongful act of a co-partner, the creditor and the wronged party may sue them in their individual capacities. If a partner becomes a bankrupt, the Director General of Insolvency may trace any voluntary settlement of property which is made by the partner within two years before he becomes a bankrupt. It is immaterial that the partner was solvent at the time of the settlement. The same section also provides that a voluntary settlement made within

[3] In an 'occurrence' basis policy, "the insurance in force at the time of a negligent act occurred is the policy which will respond to any claim made in respect of that act".

five years of the partner's bankruptcy is also void unless it can be proven that the partner could pay off his debts without the aid of the property comprised in the settlement.

The CCM has also proposed a claw-back provision requiring contributions from partners and former partners who have withdrawn property from the LLP if it can be shown that the LLP was insolvent at the time of the withdrawal or that the partners know or have reasonable grounds for believing that the LLP was or would not be able to pay its debts. This is a step towards the right direction, for a partner who stripes the LLP will be liable to reimburse the value of the assets siphoned off the LLP.

6. Conclusion

The introduction of the LLP form of business vehicle as an alternative to the traditional types of business vehicles, is much awaited particularly by businesses offering professional services. However, to ensure there is a balance between creditor protection and the advantages offered by the LLP, care must be taken to educate the creditors and also in the drafting of the new LLP Act.

Creditors who have been dealing with the traditional form of partnership, must be informed that the liabilities of the partners of an LLP are limited. Thus, they must take precaution to bind the partners. As in the case of an incorporated company where a creditor may require joint and several guarantee from certain members and officers of the company before it extends a credit line to the company, the creditor may wish to obtain a joint and several guarantee and indemnity from the partners of an LLP. In the event the LLP fails to fulfil its obligations, the creditor has recourse against the guarantors.

Similarly, a client of a professional firm will not have recourse under the professional indemnity insurance policy effected by the firm. This is due to the application of the doctrine of privity which does not permit a third party to take action against the insurance company under the insurance policy. Thus, it is of utmost importance that the new LLP Act provides not only the mandatory insurance coverage by a professional firm, but also requires the insurance company to pay the insured sum to the person who has established a claim against the insured professional. Further, steps should be taken to ensure that a professional is appropriately insured. The sum insured should be reflective of the real risk faced by the insured.

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