Limited Liability Partnership

Protection to Bankers / Lenders

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Generally, it has been evident that bankers feel more protected while lending funds to a Company form of enterprises rather than Partnership Firms of Sole Proprietorship concerns. The latest form on enterprise is Limited Liability Partnerships (LLP). The extent of protection provided to bankers / lenders in an LLP form of enterprise, as against a Company, can be reviewed in the following paragraphs.

1. A CHARGE ON SECURITY

1.1. As per provisions of Section 125, 127, 135 and 138 of the Companies Act, 1956 the registration of every charge created/ modified or satisfied on the property of the Company, with the Register of Companies, is mandatory. This registration is required within a period of 30 days. Thus, information becomes available on public domain as early as within a month from the date of Agreement. In case of default in registration of charge, the charge is void against liquidator.

1.2. The Registrar of Companies provides for a facility of online and physical search for inspection of charge related information on a payment of minimal fee of Rs. 50/- only. The Index of Charges facilitates complete transparency to bankers / lenders while deciding the feasibility while granting loans to a Company against a given security.

1.3. However, in case of an LLP, there are no such requirements as to registration of charge. The exact encumbrances and liens on the leveraged assets of an LLP become available on public domain only when the Annual Return is filed with the Registrar on yearly basis, thereby creating a long time gap. Thus it becomes difficult for the Bankers to get immediate first hand information about charges created, as in case of a Company, thereby limiting transparency of information in LLP form of enterprise.

2. STABILITY FACTOR OF CAPITAL vs. CONTRIBUTION

2.1. Capital once brought in a Company cannot be returned back, otherwise than in exceptional circumstances like buy-back under Section 77A, redemption under Section 80 or reduction of capital under Section 100 of Companies Act, 1956. Even in these circumstances, Companies need to comply with all the legal procedures mentioned under the Companies Act. Thus, it is very difficult and rigid for a Company to repay back the capital to its shareholders.

2.2. There are also minimum paid-up capital requirements prescribed in case of private and public companies, which need to be fulfilled even before a Company is incorporated. Thus, the capital, more often termed as owned funds, are of stable nature.

2.3. As against this, the contribution in an LLP is very flexible in nature. A partner is free to bring in contribution which may be extended even till the liquidation of the Company. In the absence of provisions like section 100, 77A, in the LLP Act, there are no limitations on withdrawal of contribution by the partner.

2.4. In case of a Company form of enterprise, the Bankers can ensure that at least margin money for any project is contributed by the Company, which is indirectly backed up by the stable nature of capital. In case of an LLP form of enterprise, due to highly flexible nature of contribution, the bankers have no guarantee that the Partners would retain contribution money in LLP account.

3. DIVIDEND

3.1. Companies are required to follow the procedure mentioned under Section 205 of the Companies Act, 1956 for arriving at a figure of profits available for dividend, i.e., out of profits for the year, writing off of previous years' losses, if any, transfer to reserves and providing for depreciation.

3.2. The payment of dividend by Companies is also regulated by the Companies (Transfer of Profits to Reserves) Rules, 1975, which ensure a balance situation between plough back and distribution of dividend in a Company. Dividend Distribution Tax is also payable on the amount of distributable dividend. All these regulations ensure that funds do not flow out of the Company at the cost of the lenders.

3.3. However, in case of an LLP, there is no concept of dividend. This makes a way for free and unrestricted distribution of profits to partners.

There is a free movement of Funds Flow in an LLP form of enterprise. This may not be in the interest of Banker/ Lender.

4. **RELATED PARTY TRANSACTIONS**

4.1. The related party transactions of a Company are regulated by various provisions like Sections 295, 297, 299, 314, 269, 309, Schedule XIII of the Companies Act, and AS 18 of the Accounting Standards prescribed by the Institute of Chartered Accountants of India. The implication of all these regulatory requirements is that any transaction proposed to be entered into by the Company in which any director has an interest is subject to various regulatory approvals.

4.2. In some cases, the approving authority is the Board of Directors, some cases require approval of shareholders, and some are subject to approval of the Central Government. These regulatory checks help in ensuring that the funds of the company are not being mismanaged thereby satisfying the personal interest of any of the Directors at the cost of external stakeholders, and good corporate governance practices can also be established.

4.3. However in case of an LLP there are no such provisions governing the related party transactions. There are no prohibitions / limitations on transactions where partner(s)/ designated partner(s) are interested. Thus LLPs enjoy full flexibility to enter into business with as many related parties as the partner(s)/ designated partner(s) wish, and to any desirable extent.

4.4. This freedom enjoyed in an LLP form of enterprise might lead to decisions detrimental to the interest of the enterprise. Here, there is no regulatory authority to safeguard public interest of the stakeholders. Hence, the bankers / lenders can safeguard their interests only if they install their own systems of control and protection.

5. **CONSOLIDATED ACCOUNTS**

5.1. Section 212 of the Companies Act, 1956 mandates the Companies having inter-investments exceeding 51% of the paid up capital or voting rights of that other Company to attach the Annual Accounts of such subsidiaries to the Holding Company's Annual Accounts and are also required to prepare Consolidated Accounts.

5.2. These additional requirements for Companies holding investments in subsidiary Companies ensure that Companies do not block their funds in fraudulent or unproductive assets, and are directed in productive and efficient projects.

5.3. No such provisions are applicable to LLP form of enterprise. Thus, it is very difficult to keep a track as to whether the investments of the Company are profitable for the Company or not.

6. **AUDITOR'S REPORT**

6.1. Finally, auditor's report is an essential tool to ensure whether all material financial information is properly reported to all the stakeholders or not. A specific format of Auditor's Report has been prescribed, so as to ensure that material information is checked and commented upon by the Auditors. The Companies (Auditor's Report) Order, 2003 also prescribes certain additional matters to be commented upon by the Auditors, in case of certain special type of Companies.

6.2. The Auditors Report addressed to the shareholders is filed with the Registrar of Companies. If the Auditors are not satisfied on certain matters, they can qualify their Report to that extent. Thus, the Auditors have a forum to report their observations and discrepancies.

6.3. However in case of LLP form of enterprise, audit is basically exempted if the LLP is covered under certain prescribed criteria. There is no specific format of Auditor's report and it need not be submitted along with the Annual Accounts of an LLP. Thus, there are limited chances of any discrepancies in audit becoming publicly known by way of a qualification in auditor's report, in case of an LLP.

Based on above comparison, it can be observed that the existing provisions applicable to an LLP are not sufficient to provide protection to bankers / lenders providing loans to an LLP. Hence, the lenders need to put in place, their own systems of control for safeguarding their interest.

Unless more stringent provisions are made applicable to an LLP, it is very difficult for an LLP to seek financial support from reputed banks or financial institutions, thereby limiting the extent of leveraging by an LLP. Hence, unless the regulatory framework is changed drastically, LLP would be a form which might not be useful for ventures which depend on borrowed funds.

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