

Does your LLP Agreement need a healthcheck?



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Introduction

Your LLP agreement may have been drafted several years ago and now be gathering dust in a drawer. Since it was executed many things may have changed. Not only have areas of law been amended but the way your firm carries on business may be different and the internal practice and customs of the firm no longer reflected in the firm's constitutional arrangements. You may want to avoid difficulties enforcing provisions in your LLP agreement and require reassurance that the firm's goodwill is adequately protected. For these reasons it is a good idea to have your LLP agreement reviewed every few years. Set out below is a summary of the main areas which may benefit from a regular update and the reasons why.

Decision-making processes

Most LLP agreements will contain detailed provisions governing how decisions are made. It is important to set out how votes are taken and management conducted otherwise the default rules provide that every member of an LLP may take part in its management. It will be impossible for all members to manage larger firms and it is therefore very common for powers of management to be delegated to either a management committee or managing partner. Such committees or office of managing partner need to be sanctioned by the LLP agreement. As part of any update such powers of delegation should therefore be added particularly if the LLP has grown over the years and those powers were not included originally when the LLP had only a handful of members and was effectively "owner-managed".

At the same time, as part of establishing the delegated authority, consideration should be given to any matter which is so fundamental that either a unanimous or specified vote of the members is required in order to approve it. Such matters may include:

- changes to the scope of the firm's business
- admission of new members
- expulsion of members
- mergers and acquisitions
- increases in capital contributions

If your LLP agreement already contains delegation powers, you should consider whether they are sufficiently clear, or otherwise it may be very difficult to establish whether a particular decision was taken with due authority. Therefore, the following issues ought to be considered:

- Is it clear who can be on a management committee?
- Are the procedures for electing members to the management committee out of date?
- Is there a fair correlation between the representatives of the committee and the main areas of the firm's practice?

Provisions that deal with the convening and frequency of members' meetings are often

matters which do not adapt with time. If the size of the firm has increased, it may be more appropriate to reduce the frequency of members' meetings. Also, thought should be given as to how many members can collectively request that a meeting of all members be held.

Departures and retirements

This is an area which requires careful review in order to protect the best interests of the LLP. Over the last few years, with the increase in movement of partners between competitor firms, firms have used notice provisions, gardening leave and suspension rights as a means of protecting their businesses. A firm will not have such rights unless they have been specifically written into its LLP agreement. In summary, the following provisions are relevant in this context:

Notice Period

Most LLP agreements require a member who wants to depart to serve a period of notice and such periods tend to vary between three and twelve months depending on the seniority of the member. The balancing act will involve keeping a member away from working for a competitor versus the cost of having to pay such member his profit share during the same period.

Gardening Leave

It is now common for members to be placed on gardening leave if they exercise their right to serve notice to depart from a firm. Whilst on gardening leave, a member will be prohibited from communicating with clients or staff and from taking part in any decision-making, thereby giving the firm an opportunity to persuade clients and staff not to follow the member.

Departure Lounge

There have been cases of entire teams of partners resigning at the same time and joining a competitor. This can have a severe impact on the firm's future viability. A departure lounge clause can serve to limit the number of members, say to one or two, who can give notice to retire over a given period of time.



Suspension Rights

It is also common for LLP agreements to provide for the right to suspend a member whilst potential pre-expulsion investigations are carried out.

Mandatory retirement

Mandatory retirement ages are still widely used in LLP agreements. Any mandatory retirement age is potentially discriminatory and will have to be justified as a proportionate means of achieving a legitimate aim. Such criteria may be difficult to satisfy and firms are advised that it would be unwise to place heavy reliance on the mandatory retirement provisions as a mechanism for managing the numbers of members. Therefore, if your LLP agreement has a default retirement age it is important that you seek advice as to the likelihood of such provision being enforceable.

Expulsion

Should you require the right to remove a member from an LLP, again that will need to be written into the LLP agreement. There is no default power of expulsion and therefore the LLP agreement will need to specify whether the power to expel is exercisable following a breach by a member or whether the LLP has the right to exercise such a right at any time provided such removal is in the best interests of the LLP.

Anti-embarrassment clauses

A related issue to retirement, and one that has received attention of late, is the use of anti-embarrassment clauses. The purpose of these clauses is to ensure that retired partners share in the benefit of any sale of the business, or injection of external funding, following their retirement. The rationale behind an anti-embarrassment clause is to ensure that partners, who have contributed to the creation of value, benefit rather than miss out entirely through the timing of their departure. Such a provision would have to be clearly drafted into the LLP agreement and state the number of years following retirement of a partner such provisions would last for.

Restrictive covenants

Restrictive covenants are commonly employed by LLPs as a means of protecting the firm's goodwill. Restrictive covenants are helpful in people-related businesses to ensure that staff do not take steps to compete against the firm or poach clients and/or staff immediately following their departure or retirement. Case law has evolved considerably in this area and, therefore, it is possible that restrictive covenants drafted several years ago may no longer be enforceable or adequate to protect a firm's business today. A review of any restrictive covenants is therefore highly advisable. Also, in order to ensure their enforceability, any restrictive covenants should be set out in separate limbs so that if one limb is unenforceable, the remaining restrictive covenants remain enforceable.

In an employment context, if an employee is placed on gardening leave, a court may be less likely to enforce any post termination restrictive covenants for their full duration. Although there is no automatic right of set-off between the two, the existence of gardening leave may be a factor to be taken into account in determining the validity of any restrictive covenants. For that reason, it is sensible to provide in the LLP agreement that the length of any restrictive covenant is reduced by the time a member spends on gardening leave.

Maternity and parental Rights

Older agreements may have inadequate provisions to deal with maternity, paternity and parental leave rights. Self-employed LLP members do not enjoy statutory maternity or paternity rights and therefore such rights, together with a member's right to receive a profit share during this period of leave (usually a reduced amount) is essential in order to reduce the risk of potential discrimination claims.

Other provisions

Other points that may require further thought as part of any LLP agreement review are as follows:

Dispute Resolution Mechanism

In the absence of a specific provision, the default position is that any dispute between members of

an LLP will be heard by the court. However, if you and your members become deadlocked on an issue or fall out over something, you may wish for such dispute to be resolved behind closed doors and not become something of public record. Alternative forms of dispute resolution, whether arbitration or mediation, will ensure that any disputes remain private.

Removal of old indemnities

Older agreements may contain indemnities which were originally included to address the exposure that an individual member has for a particular liability of the firm (i.e as a guarantor of the LLP's obligations under a lease). These provisions may not be relevant because the landlord no longer requires personal guarantees.

Confidentiality

In most agreements members are generally entitled to require information from their fellow members. This is relatively standard but may be abused by disgruntled members who may use such rights of information to obtain copies of privileged advice given to the management board in relation to partnership issues. It is advisable for a specific carve out to be introduced which provides that a member is not entitled to request to see any documentation over which the LLP has legal privilege.

HMRC Consultation

Finally, to note that on 20 May 2013, the Government published its consultation document on the changes proposed to the tax rules for partnerships and LLPs. We are told that the changes proposed are intended to counter what the Government perceives to be ways in which LLPs are being used to avoid tax. Firstly, the Government proposes to remove the presumption that all members of LLPs are self-employed and introduce a test to determine whether an individual should, for tax purposes at least, be treated as being an employee. Secondly, the Government is looking at LLPs that have a mix of individual members and corporate members because they are concerned that profits and losses are being allocated to different categories of members simply to minimise tax liabilities or maximise tax relief. Of particular concern are arrangements whereby profits are allocated

to corporate entities (avoiding income tax) when those entities are controlled by individual members who ultimately benefit from the profit without paying income tax in full. We await the conclusion of the consultation. It is clear from the consultation document that the Government firmly believes that the proposals are fair and reasonable and that the changes are likely to be introduced. This will necessitate most firms carrying out a review of their LLP agreement and structures. It is reasonable to assume that the changes will be introduced with effect from 6 April 2014 which may not give businesses sufficient time to implement what could be fundamental changes to existing structures or the existing rights and obligations of members.

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