LLPs: limited options by Rebecca Briam

Some of the most common questions about forming an LLP and why it's vital to have everything agreed up front

Limited liability partnerships (LLPs) are attractive structures for accountancy firms as they offer a hybrid business vehicle combining the benefits of limited liability provided by limited companies with the same flexibility and tax benefits of a traditional partnership. It is possible for a limited company to be a member of an LLP, which can bring added scope for tax planning and asset protection.

This article addresses some of the questions that we frequently come across when advising accountancy firms and individual members in relation to creating or updating their LLP agreement and the disputes that arise from them. The key point to remember is that although there is no legal requirement to have a formal written LLP agreement, there can be disastrous consequences for those who skip that stage, as highlighted below.

DOES AN LLP REALLY NEED AN LLP AGREEMENT GIVEN THAT THERE ARE DEFAULT PROVISIONS FOR LLPS?

An LLP does not have to have an LLP agreement. However, if it does not have one, then the LLP and its members are subject to the LLP default provisions. The LLP default provisions are somewhat inadequate and fail to deal with all the issues which will arise in practice. For example, the default provisions do not contain any power to expel a member – no matter how bad his conduct. We would therefore always recommend that an LLP agreement is entered into, even for the smallest firm.

HOW DO WE CONVERT FROM A PARTNERSHIP TO AN LLP?

The process for conversion from a partnership to an LLP is very similar to any business transfer and will involve moving the business and assets of the partnership to an LLP followed by the dissolution and winding up of the partnership. The decision to convert will have to be made by the partnership and, unless the partnership agreement provides otherwise, is likely to require the unanimous approval of the partners of the old firm.

There are important practical matters to consider in converting an accountancy firm from a partnership to an LLP, including deciding on the accounting period, managing the transition of client matters, transfer of employees (as the TUPE regulations will apply), landlord consents, professional consents, changes to IT, accounting, tax codes, banking facilities and obtaining approval from the insurance company regarding professional indemnity insurance. You will need to consider whether the transfer from a partnership to LLP creates a tax charge but, in many cases, a tax liability does not arise. Best advice is to allow twice as much time as you think and work to a checklist.

DO ALL MEMBERS HAVE TO AGREE TO THE APPOINTMENT OF A NEW MEMBER?

If the default provisions apply, then the consent of all existing members will be required for a new member to join. However, the LLP agreement may set out a procedure for a new member joining and the level of consent required. For example, to be workable you may consider 50% or 75% member approval is sufficient. Many accountancy firm LLP agreements specify the qualification requirements for new members and it is important to establish at an early stage that the proposed member meets these criteria.

CAN A MEMBER CHOOSE TO RETIRE FROM AN LLP?

The default provisions provide that a member may leave on “reasonable notice”. This is very ambiguous and could leave you with members departing on very little notice, which is commercially to be avoided. Therefore, most LLP agreements contain express circumstances in which a member automatically ceases to be a member. Most accountancy firm LLP agreements require a member who wants to leave to serve a period of notice before doing so and such notice periods tend to be between three months and one year and coincide with the year end. Some LLP agreements restrict the number of members who may retire in any one given period. As well as tightly drafted restrictive covenants (see below) most accountancy firm LLP agreements also contain gardening leave provisions as such requirements can be very effective in practice in protecting the business and the wealth of continuing members.

HOW CAN A MEMBER BE RESTRICTED FROM COMPETING WITH THE FIRM AFTER HE LEAVES?

There is no automatic restriction on retiring members from soliciting or acting for clients of the LLP or from poaching its employees. However, in a written LLP agreement it is possible to include enforceable post-termination restrictions. Such restrictions should be carefully drafted as they will be interpreted strictly and, where there is ambiguity, it will generally be resolved against the interests of the LLP. In order to be valid and enforceable, the restrictions will need to be no greater than is reasonably necessary in the interests of the LLP and the individual member to protect a legitimate interest of the LLP requiring protection. In drafting the restrictions, careful consideration should be made to the business of the firm they are protecting and to the length of time during which the restriction is to apply, its geographical extent and the categories of clients and staff who may not be poached. Restrictive covenants in accountancy firm LLP agreements tend to impose prohibitions on a departing member for 12 months or more post retirement.

AS MEMBERS ARE NOT EMPLOYEES OF THE LLP, CAN THEY STILL BRING CLAIMS FOR DISCRIMINATION AGAINST THE LLP?

Although genuine members of LLPs do not qualify for many of the employment protection rights, they have similar rights to employees not to suffer unlawful discrimination on grounds of sex, race, disability, sexual orientation and religion or belief. In terms of age discrimination, there are significant differences between the way in which members and employees are dealt with.

IF AN LLP HAS TWO MEMBERS, DOES IT AUTOMATICALLY DISSOLVE IF ONE MEMBER LEAVES?

The LLP legislation requires that there be two or more subscribers for incorporation and envisages that the LLP will continue to have a minimum of two members. However, if there are two members and one member was to leave, the legislation does not require the LLP to cease business and there is no automatic liquidation. Further members may be appointed to bring the number of members back to two or more. However, if the LLP does carry on business with only one member for more than six months, that single member, if he knows that he is the only member, is liable, jointly and severally with the LLP, for payment of the LLP’s debts contracted after the six months have passed and while he is a member.

CAN SOMEONE WHO HAS BEEN DECLARED BANKRUPT BE A MEMBER OF AN LLP?

It is an offence for a person who is an un-discharged bankrupt, or in relation to whom a moratorium period under a debt relief order applies, directly or indirectly to take part in or become concerned in the promotion or formation of an LLP or to subsequently act as a member without the leave of the court. We advise that events such as bankruptcy, criminal offences and loss of professional status trigger automatic “bad leaver” provisions so that the other members are not unnecessarily exposed.

HOW CAN AN LLP BE WOUND UP?

The procedure for winding up an LLP is similar to that for companies and the winding up of an LLP may be either voluntary or by the court. A company may be wound up voluntarily if the company resolves that it be wound up by passing a special resolution. However, unless it is provided for in the LLP agreement, it is unclear whether a member's voluntary winding up in respect of an LLP would require the support of all the members or just a majority of the members. In practice, winding up brings an end to the business and most written LLP agreements provide for the LLP to continue and, if there is deadlock between two members, for mediation to apply to avoid loss.

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