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When the music stops

Common mistakes in LLP agreements

A limited liability partnership[1] is fairly free-form: very little in its constitution is prescribed by law. The members of the LLP have to draw up their own agreement, carefully crafted by their lawyer. But with a few years of experience of LLP's, some fairly basic problems are emerging that could come mean trouble for professional firms established as LLP's.

At first, lawyers asked to draft an LLP agreement had little to go on. The temptation was just to adapt an existing partnership agreement, perhaps with a few clauses added from a company's articles. But LLP's are quite different from traditional partnerships, or from companies. Partnership law does not apply.[2]

Calls, contributions and over-drawing

In a partnership[3], the firm can call on the partners to contribute cash. Even without a power in the partnership agreement, the right is implicit: partners are personally liable for the debts of the firm, and they can recover from each other any outlays they have to make beyond the agreed capital. Losses are shared amongst the partners in an agreed ratio. Many draftsmen, including in some of the commercially-produced precedents, carried this forward into the LLP agreement. They said that members had to share losses of the LLP, and could if necessary be called upon to contribute to them in cash. That may be fine for small sums while the LLP is trading normally, but it potentially drives a coach and horses through the limited liability of the LLP. Say the firm closes and goes into liquidation – it will show a loss equal to the deficiency in its assets. If members are obliged to contribute to losses, the liquidator can ask them for a cheque to cover all the debts.

[1] Formed under the UK Limited Liability Partnerships Act 2000

[2] Section 1(5) Limited Liability Partnerships Act 2000

[3] Governed by the Partnership Act 1890

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On the other hand, if there is no requirement to put in cash, other members can lose out. It's not uncommon for members' accounts to get out of balance with one another, either for good reasons or due to some manipulation or default by a member, who may have over-drawn or failed to contribute his capital. If the LLP cannot claim the money, the other LLP members may lose out. Members of the LLP do not usually expect the limited liability to be used to avoid sharing the pain equally!

Ideally you need limited obligations to put money into the LLP, which might end if the LLP ceases trading or goes into insolvency, coupled with rights between the members so they can recover any inequality in their receipts and contributions from each other. If the LLP goes into insolvency, the members do not have to make up the deficiency to the LLP, but they make payments between themselves to equalise their losses. But in running the LLP, you also have to be aware of the limited liability of the members. An overdrawn current account or capital account may not be recoverable as a debt, and could represent a loss that will end up being shared amongst the other members.

This is all subject to section 214A insolvency Act 1986[4] which makes members of an LLP liable to repay all withdrawals form the LLP in the two years before insolvent liquidation, if they knew or had reasonable grounds to believe that the LLP was unable to pay its debts.

Minority oppression and fiduciary duties

Partners in a partnership owe each other fiduciary duties of good faith. Directors of companies owe similar duties to the company, on behalf of its shareholders. What is the equivalent in an LLP, if the LLP agreement says nothing, or excludes fiduciary duties? It was not clear for the first 10 years of the LLP Act, but *F&C Alternative Investment (Holdings) Limited v Barthelemy* has finally decided that there are no fiduciary duties owed by LLP members to each other, or to the LLP. The members can act purely in their own self-interest, except when they are entering into transactions on behalf of the LLP.

But LLP members who manage the LLP, effectively as directors, can and will have fiduciary duties to the LLP. That is because, as with partners and directors, the fiduciary duty comes from the agency arrangement: a person with control over the affairs or property of someone else, such as a director managing a company on behalf of its shareholders, owes a fiduciary duty.

That still leaves individual members of the LLP exposed, because the fiduciary duties are owed to the LLP, not the members. What if a minority of members is bullied by the majority? Part of the gap should be filled by section 994 of the Companies Act, the "unfair prejudice" remedy, as modified for LLP's. But unlike a company, an LLP can exclude its members' section 994 rights in the LLP agreement[5]. Lawyers acting for the LLP may have done that without thinking about it. That potentially leaves individual members with very few rights to combat oppression.

[4] Inserted by the Limited Liability Partnerships Regulations 2001

[5] Regulation 48 of The Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009

Not having an LLP agreement

Always have an LLP agreement! The issues above are insignificant compared to the problems arising when there is no written LLP agreement. Every active LLP should have one. It is the basic constitution of the LLP: unlike a company, there is no default set of articles that will fill most of the gaps. The default provisions for LLP's are totally inadequate. The recent case of *Eaton v Caulfield* [6] provides a good illustration: full-blown litigation over what the agreed terms of the LLP were, with the judge deciding that in most cases the parties had not managed to exclude the default provisions.

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[6] [2011] EWHC 173, see this article