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LLP restrictive covenants: drafting, disputes and practical handling - for professional and financial services firms

One of the most common disputes we see between an LLP and its members arises in the context of post-termination restrictive covenants. The majority of LLP agreements will include restrictive covenants which are designed to protect the LLP's confidential information; clients, potential clients and referrer connections; workforce stability and goodwill.

The starting point for restrictive covenants, however, is that they are presumed unenforceable unless they are reasonable, protect a legitimate interest and go no further than necessary to protect that interest. In practice, for both LLPs and members, restrictive covenants tend only to come into sharp focus at the point that an LLP member seeks to exit the firm to join a competing firm; at this point attention quickly turns to the drafting and enforceability of the restrictions.

However, unlike the case for employment or traditional partnership relationships, there is no case law specifically relating to LLP restrictive covenants and therefore little guidance available from the courts as to their enforceability and application.

So where does that leave the LLP and its members on their restrictive covenants? In this alert, we have compiled in summary some key legal principles and practical pointers which firms and LLP members should bear in mind when considering an LLP's restrictive covenants and their potential impact and enforceability.

You can find more information on the points below in our paper '*Restrictive Covenants for LLPs and their Members*' co-authored with John Machell QC which deals with the dos and don'ts of restrictive covenants for LLPs and their members in more detail, including the key principles, recent trends in drafting, enforcing restrictive covenants against exiting members, team move scenarios and potential liabilities, together with the commercial approach often adopted in practice. You can download a copy of that paper here.

Key legal and practical principles for LLP restrictive covenants – a summary

1. More onerous restrictions have a greater likelihood of being enforceable against partners and LLP members than employees. Bear in mind that lengthy and wider restrictions are more likely to be enforceable against LLP members than they are against employees - LLP members are generally considered to be sophisticated professionals of equal bargaining strength, more akin to vendors of a business interest, and should generally expect to be bound by the terms to which they have agreed and from which they too will benefit when other LLP members leave.

2. The true status of an individual is key to the enforceability of restrictive covenants. It is important to look beyond the label given to an LLP member and assess an individual's true status by reference to a number of factors, including, for example (without limitation): the extent of their involvement in management and decision making; their remuneration structure;

and any capital contribution. Onerous restrictions are less likely to be enforceable against salaried LLP members, i.e. those who are labelled members but in reality are more akin to employees, - although in practice challenging a member's status in this way is likely to be more of an uphill struggle these days. Status can also impact whether certain employment law rights may also be available to them.

3. LLP members cannot claim constructive dismissal. Unlike the case with employees, the concept of constructive dismissal or equivalent does not apply to LLP members to allow them to claim that the restrictive covenants in their LLP agreement fall away and are unenforceable because of the LLP's fundamental breach of the LLP agreement.

4. Restrictions must be tailored to the specific role and business and in practice tend to last for periods of between 6 months and 12 months, and in some cases up to 2 years post-retirement. It is important for LLPs to consider what legitimate interests they are seeking to protect and for how long protection is required in the specific context of that LLP and its members' activities. Restrictions typically include: prohibitions on the members' ability to join a competitor; dealings with and solicitation of clients, potential clients, referrers and colleagues; and misuse of confidential information, as well as more specific restrictions designed to prevent or limit the impact of team moves.

5. Liabilities and remedies against an individual LLP member in breach can potentially be very significant. LLP members can face costly arbitration or court proceedings in relation to the enforcement or breach of restrictive covenants and of related obligations of an exiting partner, including (without limitation) interim and final injunctions, springboard injunctions (eg for misuse of confidential information or solicitation of colleagues and clients); damages; an account of profits, as well as search orders and delivery up. Firms can often also seek to rely on provisions in their LLP agreement to withhold a defaulting member's capital, unpaid distributions and other balances against losses sustained by the LLP as a result of breaches by a member of their restrictions and other partner obligations.

6. The new hiring firm can also face potentially significant liability and be named as a co-defendant in proceedings, including (without limitation) in relation to procuring and inducing the outgoing member's breach of his restrictive covenants. The hiring firm should take care to avoid the risk of inducing or assisting or conspiring with a member who may be in breach of their restrictions or other obligations, for example by assisting or encouraging an outgoing member in the recruitment of his colleagues.

7. Written indemnities from the hiring firm to the outgoing member in relation to losses suffered are not risk-free. Often an outgoing member will want to have the financial backing of their new firm given the risk of significant potential liabilities for breach of an exiting partner's obligations including their restrictive covenants. There are pros and cons from both parties' perspectives of such written indemnities in this regard, for example it could be potentially used as evidence that the hiring firm is inducing or assisting the member's breaches. These may be difficult to secure in practice but specific drafting and careful practical handling are key in this regard.

8. LLP members may, in certain circumstances, owe fiduciary duties to the LLP over and above contractual duties. There is no general fiduciary relationship between members and the LLP or between the members. However in certain circumstances where a member is acting in his capacity as an agent of the LLP and assuming responsibility for the management of property and affairs of the firm and other members, this can give rise to fiduciary duties – potentially including the duty to report to the LLP their own wrongdoing as well as that of their colleagues.

9. Liability and remedies for breach of fiduciary duties are potentially significant and could in theory include clawback of profit share. In addition to the usual remedies, recent case law suggests that a member could be required to pay back profit share in respect of the period in which they were found to be in breach of fiduciary duties owed to their firm from. It is important therefore to consider from the outset how the LLP agreement will deal with forfeiture. This will include ensuring that any forfeiture is authorised under the LLP Agreement so as to minimise the risk of a potential unlawful deductions claim by the member (in their capacity

as worker), in respect of forfeiture of their profit share without appropriate consent.

10. Beware blue pencilling and restrictive covenants. In light of recent case law[1] in which the Court of Appeal refused to sever unenforceable parts of a restriction to make it workable and instead rendered the entire provision unenforceable, it is increasingly important to ensure from the outset that restrictive covenants are well-drafted and fit for purpose. LLP members also need to understand the extent of their restrictions, enforceability and potential liability, and approach their future career plans accordingly.

Restrictive covenant disputes can result in costly, stressful and time-consuming arbitration or court proceedings which as well as potentially being commercially damaging for LLPs, may also be disruptive to the fabric and culture of the firm. For individual members, such disputes may be reputationally damaging and extremely distracting at the point of an important career move.

While arbitration and court proceedings are often threatened (and preliminary steps in this regard taken), disputes can and will oftentimes be resolved commercially between the parties. Typically this may – depending on the particular facts and restrictions – include: limitations on the scope or length of restrictions being negotiated and carve outs from restrictions being agreed in respect of certain clients or colleagues of the member; or at the more extreme end, undertakings being given by the departing member; or commercial terms being agreed that provide for a proportion of the transferring client fees being paid to the firm for a period of time.

In order to proactively manage the risks associated with any fall-out further down the line, as well as to maximise the chances of achieving a resolution on the most favourable terms possible should a dispute on restrictive covenants arise, it is important that both LLPs and members get advice early on, including when first drafting or agreeing to restrictive covenants, and on departure from a firm.

You can access the full paper on LLP Restrictive Covenants **here.** The paper was prepared by CM Murray LLP, specialist employment and partnership law with kind contribution from John Machell QC, leading partnership and LLP silk at Serle Court.

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[1] Tillman v Egon Zehnder Limited [2017] EWCA Civ 1054

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