

## E-ALERT | Employment Law Briefing

February 2012

### LIMITED LIABILITY PARTNERSHIPS AND EMPLOYMENT LAW

The limited liability partnership ("LLP") is a corporate vehicle - formed under the Limited Liability Partnerships Act 2000 ("LLPA") - that combines the corporate benefits of limited liability with the taxation benefits and commercial flexibility of a partnership.

The distinction between the employees of an LLP and its partners, or members, is legally significant in a number of respects. This client alert considers recent case law on the approach to determining the status of partners, and explains the key legal consequences of that determination.

#### FULL-EQUITY, FIXED-EQUITY, SALARIED PARTNER OR EMPLOYEE?

The recent decision of the Employment Appeal Tribunal in *Williamson & Soden Solicitors v Briars* (2011) confirms that - regardless of the label attaching to the relationship - it is for the Tribunal to decide the true nature of the relationship after a careful examination of the facts of the case.

Members of an LLP might be full-equity, fixed-equity or salaried partners. It is well established that full-equity partners are not employees (*Cowell v Quilter Goodison Co Ltd & anor* (1989)). And salaried partners are typically regarded as employees. The status of fixed-equity partners can be more difficult to ascertain.

Fixed-equity partners often have only a small stake in the business, in terms of profits and voting rights, and therefore seem to have more in common with salaried partners than with full-equity partners. The EAT has held previously that a fixed-equity partner was an employee (*Briars*) - although the facts of the case were unhelpful for the firm because not much had changed in practice between the individual and the firm after his appointment to the partnership from the employee ranks.

However, last week, the Court of Appeal held that a fixed-equity partner who enjoyed limited voting rights and profits was not an employee (*Tiffin v Lester Aldridge LLP* (2012)). The CA suggested that if there is a contribution to capital, share in profit and involvement in management, then this should be sufficient for the individual to be classed as a partner. The intentions of the parties at the time of entering into the partnership agreement will also be a determining factor.

So it seems that, if a fixed-share partner contributes to the capital, shares in the profits and is involved in the management of a firm (even if only to a limited extent) he/she will likely be regarded as a partner, not an employee.

#### Indicators of employee/partner status

Several factors will be taken into account when determining whether an individual is a partner or an employee, including:

- The intention of the parties at the time of entering into the partnership agreement.

- Whether the individual receives a fixed remuneration payable irrespective of the firm's profitability.
- Whether the individual receives an express or implied indemnity against debts and liabilities of the firm from other partners, or merely a contribution towards those owed to third parties.
- Whether the individual is required to make a capital contribution, or is entitled to any share of the firm's surplus assets.
- Whether the individual is entitled to participate in management decisions, management meetings and partnership votes.
- Whether the individual is subject to the direction and control of the partnership.
- Whether the individual's name appears on all partnership documentation.
- Whether the individual has the right to hire and dismiss the firm's employees and authority to sign cheques on behalf of the firm.
- Whether the individual is responsible for his/her own pension arrangements.

## DISTINCTION BETWEEN MEMBERS AND EMPLOYEES

### Employment rights

Members who are not employees do not enjoy the same level of employment protection as employees; for example, they cannot claim unfair dismissal or statutory redundancy pay. Members are also not entitled to statutory parental rights (for example, the right to maternity leave, paternity leave, adoption leave and parental leave) - although LLPs may include equivalent or otherwise enhanced family leave rights in the LLP agreement.

Members are, however, entitled to protection under the Equality Act 2010 in respect of discrimination, harassment and victimisation (although, the level of protection is lower than that provided to employees). Members may also fall within the ambit of certain E.U.-derived U.K. legislation - for example, the Working Time Regulations 1998 and the National Minimum Wage Act 1998.

In addition, members have certain rights and duties that employees do not have, such as the ability to dissolve the LLP, to receive a share of surplus assets in the winding up of the LLP or to apply to court if their interests are being unfairly prejudiced by the LLP or the other members.

### Tax advantages

Although a separate legal entity from its members, the LLP is treated for tax purposes as a partnership and the members are taxed as partners, each being liable for tax on his/her share of the income or gains of the LLP.

#### **The key tax benefits of the LLP are as follows:**

- No employer's national insurance (currently 13.8%) on payment of members' drawings.
- No tax charge on the acquisition of a membership interest for less than market value (in contrast with the acquisition of shares in a company by an employee where the difference between price paid and market value is subject to an income tax charge).
- Potentially no capital gains charge if profit/capital sharing ratios are changed (in contrast to a change in profit/capital sharing rights in a company which would often involve a disposal of shares thereby triggering a capital gains tax charge.) This makes it easier to incentivise key staff with an interest in the business.

- A number of anti-avoidance measures that apply to employees do not apply to members making it potentially easier to reward members in a tax efficient manner.
- Members of the LLP may be able to apply their share of the LLP's trading or professional losses against general income or profits.

### Restrictive covenants

Typically, LLP agreements contain restrictive covenants restricting the activities of members following their retirement from the partnership. Enforcing post-termination restrictions against employees is notoriously challenging in the UK, because of the need for employers to demonstrate that the provisions do no more than is necessary to protect certain legitimate business interests, including confidential information, a stable customer base, and so on.

However, courts have proved far more willing to enforce post-termination restrictions against partners than against employees, on grounds that partners are not as disadvantaged as employees in terms of their bargaining power. In *Bridge v Deacons* (1984) the courts upheld a five year non-dealing restrictive covenant that prevented a former partner from acting as a solicitor in Hong Kong for any client of the firm or any person who had been a client within the three years prior to his departure. The same restrictive covenant in an employment contract would almost certainly have been unenforceable because it included numerous clients with whom or which the partner had no dealings while with the firm. The case suggests that firms wishing to take steps to protect their business interests will have a much more sympathetic hearing at court if their restrictions bite on partners rather than employees.

### Conclusion

The Court of Appeal decision in *Tiffin* is to be welcomed by partnerships that have tiered classes of membership where some members have limited management rights and opportunity to share in the profits of the partnership. The ruling suggests that it will be more difficult for a fixed-equity partner or HM Revenue & Customs to maintain that he/she is in fact an employee (thereby making the partnership accountable for employer's national insurance and statutory employment liabilities and the individual subject to all employment tax provisions). Therefore, partnerships that have resisted different tiers of membership may now want to reconsider, in the light of the potential tax benefits, reduced risk of a successful challenge by HM Revenue & Customs and reduced risk of certain statutory employment claims.

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Those interested in a more detailed discussion concerning the content of this client alert should contact any of the following:

**Christopher Walter**  
**Robin Wolfenden**  
**Guy Dingley**

T: +44.(0)20.7067.2061  
T: +44.(0)20.7067.2117  
T: +44.(0)20.7067.2026

[cwalter@cov.com](mailto:cwalter@cov.com)  
[rwolfenden@cov.com](mailto:rwolfenden@cov.com)  
[gdingley@cov.com](mailto:gdingley@cov.com)

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