Negotiating a legal minefield: law firm insolvency

In Practice

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KEY POINTS

- It is frequently the case that a transfer of the business is usually the best route to achieving best value for creditors as it preserves the regulatory position as well as the value of work in progress and debtors.

- One of the crucial factors will be the influence of the heavy regulation that solicitors face.

As highlighted by the recent downfall of firms such as Halliwell LLP and Dewey & LeBoeuf LLP, law firms no longer stand independently of downturns in the economy and face the same challenges as commercial businesses. As with any other enterprise, law firms have seen a downturn in their business, particularly if they are firms which have practice areas heavily focused on deteriorating markets. Law firms are subject to the same factors affecting any trading business, including a decline in consumer demand, the lack of availability of finance, high property costs in a poor market and the ever increasing price of professional services.
indemnity insurance.

Dealing with the collapse or restructuring of law firms can be troublesome due to the regulated nature of these practices, and the diverse range of business structures that they operate and the difficulty in preserving and getting in the receivables (usually the greatest asset of the law firm). This feature considers some of the issues that advisors and insolvency practitioners should be aware of when advising on the insolvency of legal firms.

**CHARACTERISTICS OF A LEGAL PRACTICE**

Law firms do not follow a standard model. They range from sole practitioner, partnerships, Limited Liability Partnerships (LLPs) and Limited Companies. Some have one historical structure that has evolved over time into a new entity (for example, a sole practitioner to a partnership, to an LLP). As such, there are a number of insolvency options to consider for any firm. A summary table of the typical structures and applicable insolvency procedures is at FIGURE A, p 192.

Anyone reviewing restructuring options for a law firm will need to give consideration to the unusual nature of the business. Whilst there may be some standard assets such as interests in property and other tangible assets, the majority of the value will be its work in progress and debtors. Assuming an advisor can surmount the obstacle of client confidentiality, the next step is to attempt to place a value on work in progress. The usual difficulties of valuing work in progress can be further complicated by the nature of the work that a practice undertakes. For example, if a practice undertakes significant conditional fee arrangements or legally aided work, the value that can be placed on the work in progress of the firm is difficult to assess and can be impacted by any landmark changes to government regulation or cases on those fee arrangements. In those cases, there may also be a significant exposure to disbursements (experts or counsel and insurance premiums) that may need to be paid before the work in progress can be converted if it is ultimately successful.

It is frequently the case that a transfer of the business is usually the best route to achieving best value for creditors as it preserves the regulatory position as well as the value of work in progress and debtors. This will require the buy in of existing staff (who may be essential to preserve value and to secure future work), the consent of clients of the firm (this is usually required to transfer the work and to make information available to acquiring firms, there is also a risk that clients will not be required to pay if a firm is deemed to have terminated its retainer), the support of any funders (particularly if professional practice loans are in place with individual partners who propose to continue to practise) and the support of the professional regulator of solicitors, the Solicitors' Regulatory Authority (SRA).

**REGULATION**

One of the crucial factors in a restructuring of any practice will be the influence of the heavy regulation that solicitors face. Solicitors are regulated by the Solicitors Act 1974 and associated legislation, and are subject to the governance of the SRA. Some of the key duties that any type of solicitors' practice must be mindful of are below:

**Money laundering** -- Solicitors have stringent compliance requirements with the UK anti-money laundering and counter terrorist legislation. As solicitors routinely handle significant sums of client money, they must ensure that comprehensive money laundering safeguards which comply with legislation are in place.

**Handling Client Money** -- All monies must be held by solicitors in compliance with the SRA Accounts Rules 2011 which are designed to ensure that all client monies are safe and always used appropriately.

**The Duty of Confidentiality** -- The duty is to keep the affairs of clients confidential unless disclosure is
permitted by law or the client consents. The solicitor’s duty of confidentiality can permeate into all aspects of an Insolvency Practitioner’s appointment and is an important consideration for any advisor. It will limit the extent to which an advisor is able to review files, paperwork or information relating to a client engagement and the level of information that can be provided to potential purchasers of the business.

**The Duty to Act in the Best Interests of a Client** -- Solicitors have a wide range of duties to their clients to treat them fairly, avoid conflicts and to provide a competent and timely service to clients. The SRA’s role is to ensure that solicitor firms are acting in the best interests of their clients and so where clients’ interests, or funds, may be at risk in an insolvency situation, it is likely that the SRA will become involved (see further below). It is essential that anyone assuming control of a practice acts at all times in accordance with these duties and that clients are not prejudiced as a result of the involvement.

**THE ROLE OF THE SRA IN INSOLVENCIES**

In some circumstances the SRA is able to commence an "intervention". This is the process of acquiring possession of a firm’s practice papers and money and distributing them to those entitled. If the SRA intervenes this can signal the end of the practice as the SRA would freeze the practice’s accounts and files would be distributed to successor firms by an agent appointed by the SRA. As a consequence of this, the potential value of the assets would be reduced and the appointed agent’s fees would be deducted from any value achieved.

- The Solicitors Act 1974 allows the SRA to intervene where: an individual solicitor is made bankrupt or making a composition or arrangement with creditors;

- in respect of LLPs and Limited Companies where:

  i. a winding up order; or a resolution for voluntary winding up has been passed (other than for reconstruction or of its amalgamation with another body corporate);

  ii. it enters administration;

  iii. it has a receiver or manager appointed over its property; or

  iv. an administrative receiver is appointed.

Given the potential impact of an intervention on value, the SRA encourage those considering the insolvency of a solicitors’ practice to work constructively with the SRA when firms are facing financial difficulty but are otherwise acting in accordance with all of their duties, with a view to achieving an orderly transfer of the business to an appropriate alternative party. This consultation may enable the firm to avoid an intervention.

In this situation the key driver is to demonstrate to the SRA that client monies are protected; that client service is being maintained; that public confidence in the delivery of legal services is maintained and that the firm will meet its regulatory requirements throughout.

The SRA has provided details of the type of information that it would expect to receive as part of the consultation process. Any briefing to the SRA should consider:

- indemnity insurance and whether a successor practice is intended;
- how money held with regards to untraceable clients will be dealt with;

- the nature of proposed contractual arrangements between the firm and any acquiring firm;

- the filing of any future accountants' reports or cease to hold reports;

- the storage of files and forwarding of post and other communications;

- how existing clients will be kept informed and supported;

- any unsettled undertakings; and

- whether solicitors within the firm intend to practice in the future.

Once it has this briefing information, the SRA is able to consider whether or not it is required to intervene or if it is satisfied that adequate protection is provided for and that the restructuring can proceed without intervention. The expectation from the SRA will be for the incoming appointee to report in to the SRA and update them on the progress of the practice and to provide regular confirmations that all regulatory compliance is continuing.

CONCLUSION

In any type of restructuring or insolvency of a law firm, the interests of the firm's clients must be adequately protected. An insolvency of a law firm involves a minefield of regulatory and solicitor and client issues and a strong understanding of the regulatory framework that solicitors work within is essential as is the engagement of the SRA in the process. The success of a restructuring proposal will be significantly enhanced if it is possible to achieve the cooperation of the existing stakeholders and their willingness to engage time in finding a solution which benefits not only personal interests but also those of their clients and those of their colleagues.

When handled correctly, clients' interests can continue to be protected, almost without interruption, leaving an insolvency practitioner to work with the SRA and the solicitors to maximise value on a transfer of files to a new practice and getting the best possible price for remaining assets.

(2012) 5 CRI 190 at 192

FIGURE A

<table>
<thead>
<tr>
<th>TYPE OF PRACTICE</th>
<th>INSOLVENCY PROCESS</th>
<th>COMMENTS</th>
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<tr>
<td>SOLE PRACTITIONER</td>
<td>BANKRUPTCY IVA</td>
<td>If a solicitor is made bankrupt their practising certificate is automatically suspended. In an IVA, the SRA has a discretion as to whether to suspend a certificate. If the practice is to continue, it will need to be disposed of to another qualified solicitor (subject to client consent) or could be continued with an IVA if approved by the SRA. It is unlikely that a sole practitioner would be per-</td>
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mitted to continue to practice alone if they are subject to an IVA, so it may be a question of joining forces with another firm.

**PARTNERSHIP ADMINISTRATION WINDING UP RECEIVERSHIP (IF APPLICABLE) PVA IVA/INDIVIDUAL INSOLVENCIES LIQUIDATION**

Governed by the Insolvent Partnerships Order 1994. The partners should have a detailed partnership deed which will regulate affairs between partners. A copy of any such deed should be reviewed before any decisions on strategy are taken and at the earliest opportunity. Subject to the terms of the partnership deed, historical partners are likely to also be liable for the debts of the partnership.

A voluntary arrangement does not automatically trigger an intervention by the SRA. In any administration, the SRA advise that they would expect the administrator to be a solicitor or for a solicitor manager to be appointed. There are solicitors’ firms who specialise in this type of management. Any such firm should preferably be one that is known to the SRA for undertaking this kind of work, or who regularly undertakes similar work for the SRA.

**LLP ADMINISTRATION PVA RECEIVERSHIP (IF APPLICABLE) LIQUIDATION**

Governed by the Insolvent Partnerships Order 1994 and the Limited Liability Partnership Regulations 2001. Subject to any partnership deed, the liability of the members is limited. In the absence of a partnership deed, a member has an indemnity from the LLP for liabilities incurred in the ordinary course of business of the LLP. Section 214A of the Insolvency Act 1986 provides a form of equivalents to wrongful trading liability -- members are liable to repay withdrawals in the two years prior to the LLP winding up if they knew or had reasonable grounds to believe that the LLP was insolvent at the time of the withdrawal, or they ought to have known of this position. A voluntary arrangement does not automatically trigger an intervention by the SRA.

**LIMITED COMPANY ADMINISTRATION RECEIVERSHIP (IF APPLICABLE) CVA LIQUIDATION**

Subject to the regulatory restrictions identified in this article, the procedure is as for any other limited company.