

Risky business

Andrew Hogan examines the due diligence needed before buying or funding firms and caseloads

INTRODUCTION

On 17 June 2024 the Solicitors Regulation Authority (SRA) published a Warning Notice entitled ‘Mergers, acquisitions and sales of law firms’. A cynical reader might think this was, in some respects, the closing of a particular stable door when an errant horse is already three-quarters of the way home. However, with an eye to regulatory consequence, the document is essential reading for anyone in the future thinking of purchasing a law firm, purchasing the work of a law firm, providing litigation funding to finance particular cases run by a law firm, or generally investing in a law firm, on the basis of the (perceived) strength of its book and value of its work in progress (WIP).

THE PROBLEM

It is now many years since the Legal Services Act 2007 became law. In the years since its introduction, the profession of law has become a full-fledged business, and subject to commercial considerations which would have been unthinkable two generations ago.

In particular, due to empire building, rationalisation and the deployment of ‘hot money’ in the legal services sector, it is now common for firms to acquire other firms, or to acquire the work of other firms, or to seek external investment in their work or the firm itself. On the one hand, this could be seen as a welcome and necessary development to ensure continuous investment and economic rationalisation in the legal sector.

On the other hand, it allows all the worst excesses of capitalism into the sector including the potential for fraud, economic inefficiency and the subordination of the consumer interest to those of the service provider.

These concerns are not theoretical: in the last decade there have been numerous high-profile collapses of law firms, where the value of their book of cases has proved illusory and where lenders have been left with little by way of security when a firm ceases trading. It is against this context that the warning notice has been issued.

THE WARNING NOTICE

The notice warns: ‘We are concerned that some mergers and acquisitions involve behaviours – on the part of those involved on either side of the transaction – that undermine public trust and confidence in the solicitors’ profession and in the provision of legal services.’

And further states: ‘We are also concerned that clients’ interests are not always paramount during such transactions and that, as a result, they may suffer significant detriment either during or after the merger or acquisition.’

It goes on to identify ‘... examples of the behaviours we have seen from firms on both sides of a transaction that might mean there are breaches of our regulatory arrangements.’

These examples include failing to safeguard client interests in particular ways:

- treating client files as a commodity that can be bought or sold irrespective of what the clients want to do or who they want to represent them going forward.
- failing to obtain properly informed consent from clients and failing to give them a reasonable amount of time to decide about where they want their file, documents, or money to go prior to transfer to an acquiring firm.

- having acquired a firm, failing to identify urgent client matters such that important deadlines are overlooked, impacting on clients’ interests.
- selling will banks (sometimes to unregulated entities) without the testators’ knowledge or consent.
- failing to have a plan and funding for the secure, long-term storage, and thereafter confidential destruction, of archive client files.
- not ensuring that client money is properly reconciled, and that client account is intact before any transfer.

But the notice also warns about problems with due diligence:

- undertaking no or inadequate due diligence on the firm being acquired and failing to consider, prior to acquisition, whether you have the competence, systems, staffing or capacity to do the work you will be getting.
- as a seller, failing to investigate concerns about the acquiring firm’s competence, systems, staffing or capacity to act in your clients’ best interests going forward.

It is these latter issues of due diligence which are perhaps of most concern, as they raise systemic questions as to whether a particular merger of firms or acquisition of cases make economic sense at all; or whether a particular case or tranches of case are worth funding, as well as the fundamental question as to whether a particular firm is worth investing in.

There have been surprising failures in due diligence in recent years. The consequence has been that funders have lost money, solicitors’ firms have become insolvent, clients have suffered, and unpicking the mess can involve huge expense over several years.

DUE DILIGENCE

Due diligence can take many forms. A useful maxim to bear in mind is that if something appears too good to be true, it may well not be true; and to consider acquisition prospects or investment proposals with a sceptical eye.

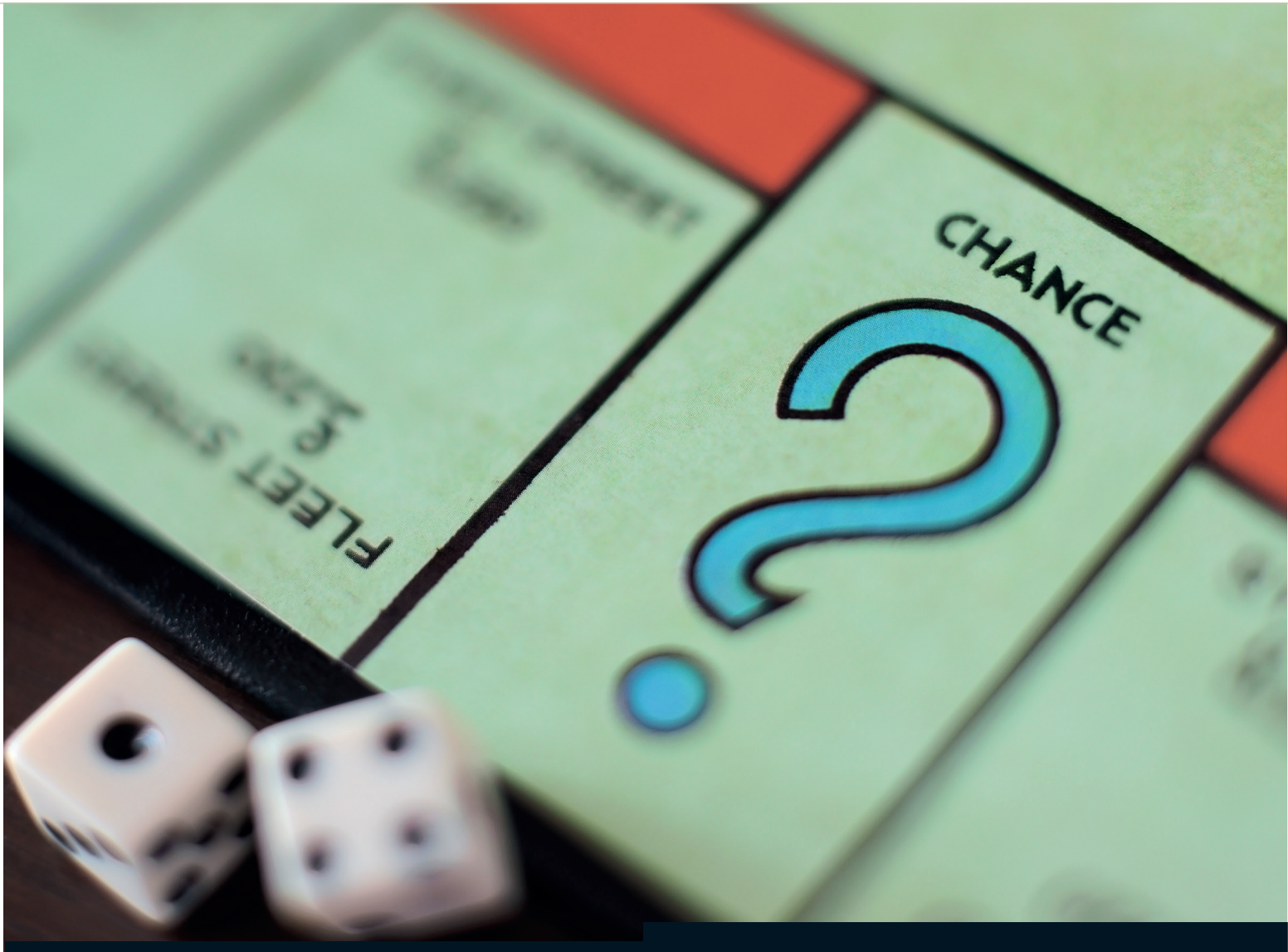
In essence, due diligence is asking hard questions and carrying out comprehensive investigations to establish the merits of the investment case. As a minimum an exercise in due diligence will need to consider the following matters.

The most basic question when taking on a caseload funded by ‘no win no fee agreements’ of whatever kind is to ascertain the likelihood of winning or losing the cases. In this respect it should be noted that certain case types are easier to assess than others: personal injury claims have a long pedigree and are usually based on the clear fact of injury. Other types of claim, particularly so-called consumer type claims, may not be so readily capable of assessment.

Reviewing case files may be necessary but also insufficient: as well as examining the individual case files in detail, consideration must be given to the strength of the evidence, the quality of legal arguments, and perhaps above all to the experience and track record of the handling solicitors, and in particular whether they are settling the individual claims, and what their record is like for succeeding at trial.

In this sense, past performance can be a particularly useful guide to future performance. It would be prudent to ask for and review historical data on the firm’s success rates for similar types of cases. If such data is not available or at least not forthcoming, then that might underpin the novelty or speculative quality of the work in question.

It can be worth obtaining expert opinion, engaging an independent



expert to review cases where the success or failure of the case may depend on matters which fall within particular expertise, and to examine at least a sample of the caseload. Otherwise, a case that has a supportive expert's report may appear to have the benefit of supportive evidence, which may not stand up to forensic challenge.

Another useful source to obtain a view on the quality of the cases and the quality of how the firm deals with its clients, is to speak to current and past clients to understand their expectations and satisfaction (or lack of) with the firm's handling of their cases.

Due diligence must also include consideration of the likelihood of settlement with known opponents: the probability of settlement versus going to trial, as settlements may result in lower but quicker and more certain recoveries. Further, as part of the overall valuation of the caseload there should be a cost-benefit analysis which involves evaluating the costs incurred and future costs required to pursue each case versus the potential recovery.

All solicitors' firms should have detailed time records to assess the amount of work already performed, which need to be checked for accuracy and completeness. Are those records robust? If the firm has been dumping time in the files, that should sing out on the time records and be a cause for concern.

Similarly, the firm may sign clients up to a conditional fee agreement for a piece of county court litigation, with hourly rates of £500 per hour, but those rates are going to be heavily discounted on assessment: and it begs the question of why those rates are being charged in the first place?

Conditional fee agreements (or other no win, no fee retainers) add a further layer of complexity to the exercise. All such agreements should be checked as a minimum for compliance with the formality requirements imposed by the Courts and Legal Services Act 1990,

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the Conditional Fee Agreements Order 2013 and Damages Based Agreements Order 2013; but evidence should also be looked for that shows that the clients were fully informed about the terms of the CFA, including success fees and potential costs shortfalls.

A DEEPER LOOK

Looking further into the matter, although these are headline considerations, questions of due diligence run rather deeper than a checklist might suggest. In particular, the problems of taking on a caseload funded by conditional fee agreements or other contingency fee arrangements should not be underestimated.

In a sense the starting point is that where a solicitor wishes to sell her business, the key point is that she is not going to perform the conditional fee agreement to its end. In a sense, at the point of sale, the work in progress and the agreement it is made under is worth nothing.

Because of the contingent nature of the retainer, a solicitor must both completely perform the retainer and achieve 'success' in respect of it in order to have a right to be paid. Parting company with the client means that the solicitor is not going to perform the contract. Such a scenario might be described as a breach of contract, or if the reason for the sale is insolvency, then this might be argued to be a frustrating event.

But in either of those two scenarios, the starting point is that a client does not owe the solicitor anything, as she has not performed the contract. In order to displace this consequence, careful redrafting and balancing of retainers, novating them into fresh agreements, are required to avoid the consequence that the solicitor's fees are worthless, as she has not performed the conditional fee agreement.

A transfer of instructions also can have other effects: the transfer has

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the potential to affect the client's insurance cover if they have after-the-event insurance. And the position of counsel, themselves instructed on a CFA basis, needs to be considered carefully in order to see where the liability for counsel's fees may lie.

CONCLUSIONS

I have no doubt that the current run of mergers, acquisitions, disposals and investment funding will continue: investors perceive good profits in funding litigation, and solicitors would like their funding.

The implementation of fixed costs has upset the business models of many firms, and many firms have either withdrawn or are withdrawing from markets where their fees would be fixed. This creates both opportunity, and the chance of further disaster.

I suspect that the SRA's warning notice will do little to stem the oncoming tide.

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