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SOLICITORS

Death row and other traps for the unwary

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Solicitors' mergers and acquisitions: insurance issues

"Availability and cost of insurance has brought about the demise of many law firms in recent years."

Life and death issues may arise a little infrequently in law firm mergers and acquisitions, but all will be revealed. Meanwhile we shall look at some aspects that need lawyerly attention – because they impact on the due diligence and the drafting – so cannot simply be delegated to insurance brokers, though expert input from specialist professional indemnity brokers will also be essential. Availability and cost of insurance has brought about the demise of many law firms in recent years.

Here are ten points to think about, but there are plenty more besides.

Successor practices

Most solicitors in this field are now aware of 'successor practice' risk arising under the Solicitors Regulation Authority's Minimum Terms and Conditions of Insurance, which can in many circumstances render the acquiring practice liable to cover the risk and cost of insuring another firm where it acquires all or part of that firm; this can be fatal if the target has claims issues rendering it uninsurable. If there is no successor practice, the closing firm must take out six years' run-off cover; the cost can be substantial, and insurers may contend that even LLP members are personally liable to pay it if the LLP is insolvent. The recent case of **Zeckler v Assigned Risk Pool Manager Capita Commercial Services Ltd**[1] is not the last word on this point; it is an issue on which the writer has defended LLP members in the face of fiercely contested litigation by a number of insurers.

Readers with longer memories will recall the writer's article, 'Pass the Bomb', in Issue 12 of A Propos Partnership (November 2004). Others can download it from the APP website.[2] It gave the example of a firm taking over part of another practice, with the remaining partners setting up a new firm. Depending on the detail, either, neither or both could end up as successor practice. The transaction has to be structured as far as possible to achieve the desired result rather than leave it to chance.

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Since that article was written, there have been changes to the rules making it possible, subject to certain conditions, to make an election as to the outcome, but in practice that is not always practicable and in any event may not assist in achieving the commercial objectives.

Successor practice liability is not invariably to be avoided, but a business risk to be considered carefully. Like tax planning, it can often be engineered to achieve the desired result if addressed in advance, but not after the event. The writer has seen even experienced practitioners fall into traps, such as making provision in the acquisition documents to the effect that 'X shall be the successor practice of Y', which will not work.

Top up (or excess layer) insurance

Most firms, other than the smallest, will buy more than the compulsory primary layer of minimum insurance (£3 million for LLPs and compa-

nies, £2 million for sole practitioners and partnerships). This is not subject to the same statutory regime as the compulsory layer. Insurers have more opportunity to avoid cover. Cover in some cases may not be on an 'each and every claim' basis. There may be multiple layers of insurance, and it is important that the wording in certain key areas is consistent. A failure to achieve this was reported to have exposed one City firm to massive uninsured liabilities on a £50 million claim which, fortunately, was defended successfully.

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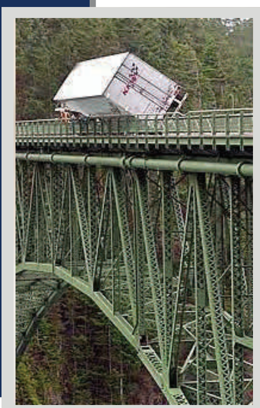
The other issue in practice is that if the firm is closing or being taken over without any successor practice (see above), run-off cover may be expensive or even unobtainable, and may not be available for as long as six years. (Note that even six years may not be enough: the writer has seen a claim where the alleged act occurred in 1932!)



On the brink

Acquiring part of a practice

This point follows on from the previous two. Commercially they can present problems, and are causing difficulty in a matter in which the writer is involved at present. To take a simple example, a ten partner target firm has five partners doing low risk employment work and five doing higher risk non-contentious pensions advice. The target firm is set to close. The acquiring firm is only taking the employment team and their clients, while the pensions partners are going to another firm.

The firm taking the employment team will not want to take on the burden of insuring the whole of the firm's prior risk, including high risk pensions work. Yet the statutory effect of the successor practice rules means that it is no easy matter to split the risk so that the employment team would take the prior risk on employment work to their acquiring firm, and the pensions team would take their prior risk to their new firm. Partial, if imperfect, solutions may be attainable but require complex engineering.

Over the brink

This in turn is a development from the three previous points. A firm may, by stealth, target a team at another practice. When the partners in the team give their notice, it can trigger the dissolution of the whole practice, either automatically by operation of a 'Turner Kenneth Brown clause',[3] or simply as a matter of commercial reality. This lack of control over the situation may make it very difficult to engineer the preferred solution in relation to run-off cover and successor practice issues.

Lloyd's Building, London

Coverage issues

Professional indemnity insurance has been relatively cheap in recent years. Those who talk of a 'hard market' in years such as 2003 (when the profession paid £272 million for its compulsory primary cover) have forgotten, or were not in practice, in the 1980s when the cost and availability of cover, and the scope of available cover, gave rise to significant concerns. Indeed these were the drivers for setting up the Solicitors Indemnity Fund.

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Coverage issues may relate to the scope of cover, or points on 'aggregation', under which insurers contend that multiple claims are subject to one policy limit with one self-insured excess.

Many revolve around dishonesty issues, which the better firms will hope do not concern them, but there have unfortunately been many recent examples showing that even the firms with the finest reputations can have rogue partners and staff. Several have attracted high profile in the press, but the writer's firm is representing firms in several more cases which have thankfully escaped attention, and the firm has also seen a significant increase in the number of instructions on other coverage points being taken by primary and excess layer insurers in recent years.

In rogue partner and employee cases, insurers frequently seek to widen the net to uninvolved partners, on the basis that they allegedly turned a Nelsonian blind eye to the rogue's lifestyle, which would have been unsupportable from legitimate income alone. Insurers may seek to have the uninvolved partners interviewed by their chosen leading counsel in a taped interview – if rather questionably in terms of entitlement.

On mergers and acquisitions, these may be issues to check when doing due diligence.

Executors and trustees

Personal appointments may give rise to personal liabilities. Provided they are in the course of practice, albeit an important proviso, they will generally be covered by insurance. However, problems can arise where the liability arises from a solicitor's previous firm which has been dissolved and may not have adequate run-off insurance in place. The compulsory primary cover may be inadequate. This may not be capable of resolution, particularly if a claim has arisen, or knowledge of circumstances which may give rise to a claim, but is a risk solicitors should consider when taking personal appointments as it may be avoidable in more ways than one.

From an acquiring firm's perspective, whether on merger, acquisition or lateral hiring, it may be unattractive to take on a partner who faces personal liability.

Insurer solvency

The recent collapse of Lemma, the Gibraltarian subsidiary of a Ukrainian insurer, which covered hundreds of UK law firms – with the collapse of Independent Insurance in 2001 – is a reminder that insurance does not provide protection against everything which may go wrong in professional life. The writer has encountered a number of firms facing substantial, seven-figure claims with little prospect of indemnity following the demise of their insurers, giving rise to a real and credible risk of personal insolvency.

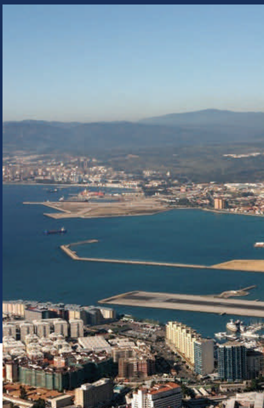
Many law firms have had to pay calls from top-up mutual insurer SIMIA, and while it is not insolvent, this has still been an unexpected financial exposure for firms and their partners.

Again, when acquiring another practice or part of one, firms need to be cautious about the risk of taking on partners who may face bankruptcy. There may also be a practical issue, if there is an outstanding claim by a key client, which may not be met by insolvent insurers, but payment may be critical to keeping the client.

Law firm insolvency

The collapse of numerous US law firms with London offices shows that this is not just a small firm/high street issue. The global insurance arrangements used by most US firms have given rise to significant personal liability issues in several cases to the writer's knowledge, and doubtless many more. When a US firm folds, the insurance usually comes to an end and the firm's bankruptcy trustee is most unlikely to sanction the purchase of run-off cover.

Worse still, the compulsory primary cover required in England & Wales may not in practice provide much protection for the partners. This is because the compulsory cover will



Gibraltar

often have been arranged to cover the layer above the global cover of perhaps a few hundred million dollars (which has fallen away), leaving the partners to fund the gap from their own resources. The compulsory insurance under the Minimum Terms and Conditions will 'drop down', but the insurers can seek reimbursement from the firm and possibly also the partners (potentially including LLP members).

Transatlantic mergers

We have already identified one issue in relation to US firms in the previous section.

All policies contain exclusions, but US policies more than in the UK. It is unlikely that a US firm will have cover on an each and every claim basis. The self-insured excess will probably be far larger. The scope of cover for claims in the US and Canada under UK policies is also less than for claims in the UK, with even compulsory cover under the SRA's Minimum Terms and Conditions excluding the 'award of punitive, exemplary or like damages under the law of the United States of America or Canada, other than in respect of defamation'.

Partners joining US firms need to do so with their eyes open. If things do turn sour, for other firms taking on the London office, or part of it, there are a number of additional considerations.

Death row

The writer is probably one of a select band of professional indemnity lawyers to have defended a claim arising from the imposition of the death penalty. In an unrelated matter, a leading global firm missed the time limit for a death row appeal. One can but imagine the client's disappointment, which would not have been softened greatly by the knowledge that the work was done pro bono.

Although the death row appeal was reinstated (but only by a majority of three to two), presumably mitigating the risk of a claim, the case does highlight that a law firm's risks may not be confined to their core practice areas. The biggest claims often arise in areas where firms are least adept – including partners in major City or multinational firms conducting personal injury or conveyancing for their friends, when they should be sending the client elsewhere for specialist expertise, instead exposing the firm to avoidable claims. (It has happened.)

So, when considering merger due diligence, do not confine your assessment of risk to the practice areas which make the firm attractive.

By Frank Maher, a partner in Legal Risk LLP*, solicitors, specialising in professional regulation and professional indemnity for law firms. He can be contacted on 0845 330 6791 or frank.maher@legalrisk.co.*uk

1 Lawtel, 13 September 2012

2 http://www.app.org.uk/download/3/154/%0D%0A%09%09%09%09issue12.pdf#view=FitH&scrollbar=1&search=bomb&toolbar=1&statusbar=0&messages=0&navpanes=1

3 A clause under which the departure of a specified number of partners over a particular period of time triggers an automatic dissolution, following the inclusion of such a clause in the partnership agreement of the City firm of that name which became financially distressed and was taken over in 1995.