



Emergency exit

With firms feeling increasingly squeezed from all sides, it may seem tempting to divest yourself of underperforming practice areas. But getting it wrong could just make things worse. Grania Langdon-Down looks at the dos and don'ts



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The market and the economy may be recovering, but not across the board. Firms are seeing turnover in crime down by 9%, landlord and tenant by 12%, and social welfare by 35%, according to a recent risk report.

Meanwhile, legislative changes have affected personal injury (PI) and legal aid in particular, with further pressures from the new MedCo portal for whiplash medical assessment and the new contract process for criminal legal aid, which will hit the providers hard.

Exiting unprofitable areas of work may seem like the answer; when done well, it can free up the firm to concentrate on its remaining specialisms, and potentially diversify into new ones. But the risks are legion, warn legal sector experts, and making the wrong decision can be costly both financially and reputationally. The Solicitors Regulation Authority (SRA) highlighted in its 2015/16 Risk Outlook the wide range of poor practices it is seeing, from firms failing to react to a decline in revenue from their key markets, to poorly planned mergers and acquisitions which can make a firm's situation even worse. So what are the options and how can you avoid the pitfalls?

The PI market provides a salient example of the issues around both disposal and taking on new practice areas.

It is becoming increasingly difficult to sell existing books of PI work. David Bott is past president of the Association of Personal Injury Lawyers and senior partner of Cheshire-based PI specialists Bott & Co. Two years ago, he explains, buyers were keen to purchase the work in progress (WIP) from PI files commenced before the Legal Aid, Sentencing and Punishment of Offenders Act 2012 came into force, because success fees were still recoverable on those cases. 'But, as those cases conclude, people looking to sell are less interesting, because there is less money in the WIP,' he notes. 'Firms should have invested the old-style WIP in preparing for the new world, because just pulling in your belt and being a better lawyer isn't enough.'

And even if a firm can dispose of its PI work, some of the obvious areas to take on to replace it carry their own significant risks. Managing director of Manchester-based Citadel Law Lesley Graves, who specialises in valuing WIP, highlights one example: occupational disease.

'Firms bought a load of cases at high prices without the correct systems or expertise in place,' she says. 'Over the last year, we have had an unprecedented number of instructions to help them get out of the mess they are in. But if they try to sell the book of business, it is like toxic waste. To me, it is a big accident waiting to happen.'

Case study



The writing was on the wall. Mike Clary (pictured), partner at 23 fee-earner, London-based Grant Saw Solicitors, explains: 'About 18 months ago, it became clear that PI and employment were not making a profit, and we

couldn't see how that would change.' Faced with the choice of 'farming the files out ourselves or bringing someone in to help', the firm chose David Johnstone of

PI-Solutions to act as the conduit.

'The process was relatively painless,' recalls Clary. 'Colemans agreed to take on about 30-40 live files as our agents. What was critical was to make sure the files went to a good firm with the capacity to take over the caseload so our clients were well looked after.'

All the files were on a conditional fee agreement basis, so could be transferred without delay, and the two firms will 'divvy up' at the end who gets paid what. There are also some ongoing issues over billing of costs. 'Some of the medical reporting agencies we used are still sending invoices, which we have to pay even though we haven't received payment yet, as the cases

are still live.'

On the employment front, the firm stopped taking on new work, and transferred about five to 10 open files to another firm. All were privately paying, so there are no outstanding fees.

'It is sad to see these areas go, because the need is still there,' he says, 'but you have to be either very big and take on volume work, or very selective and just take on high-end cases. We could have soldiered on and continued making a loss, but we wanted to consolidate our other practice areas.'

His advice is: 'Don't let it drag on. Act decisively or it risks damaging the rest of the firm.'

BABY STEPS

So how can you make a disposal work for you? The key is 'preparation, preparation, preparation', says Nigel Wallis, a partner in Liverpool- and London-based O'Connors LLP, which advises law firms on acquisitions and disposals. He recommends having a small internal team managing the project, with input from finance, HR, IT and marketing, and supported by independent experts with relevant legal sector experience. 'Otherwise, there is a real danger that you will take your eye off the ball with the rest of the firm, and when you look up, it will have gone off the boil,' he says.

David Johnstone, who created the business PI-Solutions to help firms restructure or exit from claimant PI, also emphasises the importance of independent advice. 'Don't go on until you hit the buffers and the SRA intervenes or the practice is insolvent, because it can end up with people suffering huge amounts of stress.'

You also need to decide what kind of disposal will work for you. Johnstone outlines the various options.

- **Internal run-off**

This produces cash, as the WIP asset is liquidated, but 'managing a graveyard' can be a significant distraction.

- **Sale of WIP** (either on a net present value or on a deferred basis as the value in the files liquidate). Expect heavy discounts on balance-sheet WIP values if you are selling for cash. But if you defer, you will need a clearly worded agreement on how that value is to be apportioned on conclusion of the case, and you must invest resources in recovering it.

- **Aggregated run-off**

The discount in value can be mitigated further by placing your book into aggregated run-off with outsourced monitoring and accounting of value as realised, dealt with by an independent accountancy service provider.

- **Trade sale of the whole department**

This deals with the exit swiftly, but is not necessarily a quick fix, because it can take a long time to identify an appropriate buyer.

Next, you need an independent valuation of your WIP. 'Most managing partners have been sold a good line by the practice team that everything is hunky-dory, but when due diligence is undertaken, things may not look so rosy,' cautions Wallis. 'So make sure you understand the value of your own book, because the buyer is likely to be canny and will make sure the valuation is at the bottom end.'

Once you've found a potential buyer, do your own due diligence.

'Make sure you are selling to a good firm,' Graves cautions, 'because if it doesn't have the necessary operational efficiency and expertise, you will ultimately be between a rock and hard place trying to get your money as cases come to an end. Two of my clients are having to go to litigation.'

COMPLETE COMPLIANCE

Once you have agreed a deal, you need to make sure the transfer of the work is conducted with risk and compliance in mind. SRA guidance stresses confidentiality is fundamental to client relationships.

'Firms are generally bound contractually and in conduct to complete matters on which they are instructed,' says Frank Maher, partner at Legal Risk LLP, which specialises in advising law firms, insurers and regulators on professional indemnity and compliance.

'We have seen insolvency practitioners thinking they can sell a book of business in the same way they sell a newsagents' shop, without regard to solicitor-client relationships, the duty of confidentiality, data protection, and the fact that the most of the file belongs to the clients, not the solicitors.'

Dealing with clients often gets left to the last minute, agrees Michelle Garlick, who is responsible for national law firm Weightmans' Compli service, which advises law firms on all aspects of regulation, compliance, and claims- and complaints-handling.

'It can be a vicious circle,' she says. 'The buying firm needs to know it is getting a good deal. But the selling firm doesn't want to approach clients to ask for consent to allow the buyer to look at their files before it is confident the deal is going ahead, because that will create uncertainty, which could affect the value.'

'But if files are properly managed and the WIP realistically assessed, the buyer doesn't need to delve into personal data such as medical records.'

Once a deal is struck, firms must write to clients explaining that their files are being taken over by X, but making it clear that the client can choose to go to another firm. 'Talk it through with the SRA's professional ethics team if you haven't done it before,' says compliance consultant Denise Butler, director of Peacock Risk Management. 'Too often, people try to skate over it.'

Professional indemnity insurance is another compliance issue to address head on; consult your professional indemnity insurance broker and insurer at an early stage.

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indemnity director with brokers Howden. 'But the key is to do it in a controlled manner. The temptation once a decision is made is to take resources away from the area.'

One of the thorniest areas is around successor practice issues. 'Buyers are very, very nervous of acquiring liability – it's a can of worms,' he says.

Most firms are aware of this risk and seek advice on managing it, says Maher. 'But we have also seen firms which have not addressed it and it has ended up costing them six- or seven-figure sums and, in some cases, it has put the acquiring firm out of business.'

The Legal Ombudsman Scheme Rules also have provision on successor practices, which is not identical to the insurance provisions, he adds, so acquiring firms can be exposed to complaints liability even though they are not a successor practice for insurance purposes. 'Firms disposing of files need to remember that they may still be liable for complaints, and could be exposed to them if they don't manage the ending of the client relationship carefully.'

PEOPLE MATTERS

Another area to consider is staffing. Issues to address include TUPE if a whole team is going; retraining staff into new practice areas; making redundancies; or buying out partners.

Band aid

Leaving legal aid work involves an entirely separate process – and for crime, a whole different set of challenges.

Legal aid consultant Vicky Ling, an editor of the *Legal Aid Handbook* (Legal Action Group), explains: 'Unlike non-legal aid practice areas, there is nothing to sell. You are bound by your contract, which is personal to your firm, so it has no value. Once you give notice, the Legal Aid Agency (LAA) will carry out a final reconciliation to see if the firm owes or is owed any money, which can be critical if the firm is in a weak financial position.'

'But my impression is quite a lot of firms are keeping their contracts and doing the odd case, but they aren't taking on new legal aid clients, so the work is just withering away.'

Before 2013, a firm couldn't stop doing the work while retaining its contract, because it would have been in breach for failing to deliver volume. But under most current contracts, there are no volume requirements. 'If I were thinking of getting out of legal aid, I would just let it run down

naturally and not bid for the next contract in 2016, rather than create a big job for myself,' she says.

'However, if you do pull out of a contract, there is a provision that allows you to continue working on cases until they close, as long as you run them to the same standard as if you had a contract. This ensures clients get continuity of representation.'

If a firm decides to get out of legal aid and clients transfer to new advisers, it can claim payments on account up to the point of transfer of the certificate. 'The problem is that you only get 75% of profit costs, so there is going to be an outstanding amount to be claimed at the end of the case,' she explains. 'You must ask the new firm to give you an undertaking to include your costs with theirs in the final bill, and then account to you for the money. It sounds straightforward, but it is a chore chasing old certificates.'

It's even more complicated for crime. Under the current crime contracts, firms

'Don't let your heart rule: any decisions must be based on sound business reasons,' says Johnstone. 'But remember, your staff aren't stupid. It is extremely stressful working when you know a cloud is hanging over your department, so be decisive.'

BUYER'S MARKET

But what if you're looking to buy a book of business rather than sell one? This should also be handled with care, Johnstone cautions. He suggests five key questions to ask to ensure for effective due diligence.

1. What are your criteria are for acquisition, including mix of matter types?
2. Do you have existing resources within the firm to deal with specialised matter types?
3. Do you fully understand the working capital cycle if the new work is of higher value or a new area?
4. Be aware of regulatory requirements when performing due diligence and project managing the change process – remember, you are shouldering all the risk.
5. Remember that even if the new team is a good fit, it will require significant change management if the two cultures are to merge successfully.

HANDLE WITH CARE

If there is a moral in the tale, it is to address the decision with care – whether you are the buyer or the seller. Wallis recounts the experience of one firm planning to sell a book of business. 'They called in an independent expert who said "You are pricing this work all wrong. You are undervaluing what you are doing and under-settling some of the cases, and if you restructure, you can make money" – and that is what they did.'

can give three months' notice. 'But under the new crime duty contracts, there is no provision to give notice, so if you accept one – and you have to accept all you bid for, you can't pick and choose areas if you are successful in more than one – you are in for a minimum of four years.'

Firms are taking a long hard look at their crime departments. 'If they decide it isn't viable, they will get rid of it, usually by floating it off, sometimes into another firm. The question then is whether the LAA will agree to novate the contract to the new entity. It will usually agree with a crime contract, but not if you want to float off housing and keep family, because that would split the civil contract.'

And your ties with the LAA don't end there. You remain liable to the agency for at least six years. 'Generally, if you give up your contract, they come in and do a wash-up audit and hopefully that will identify any issues and you make a final payment and they go away,' she says. 'What is worrying is they will never say we won't come back.'