Steering the course: Research into the characteristics and risks associated with law firms in financial difficulty

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This research explores the related issues of profile, prevalence and impact of financial difficulty in law firms by reviewing our experience of regulating firms in this situation. The research centred on file reviews of 76 firms that we have worked with in relation to financial difficulty.

This research also illustrates how financial difficulty can act as a good predictor of firms that present a high risk to the interests of clients and the public interest.

Executive summary

This research sets out to explore the SRA's experience of responding to financial difficulty in a range of law firms. The aim of the research was to understand:

- What are the key characteristics of financial difficulty in law firms?
- What are the combinations of factors that lead to firms entering financial difficulty?
- What are the good and bad practices followed by firms in relation to financial management?
- What can we learn from our experience of engaging with firms in financial difficulty?

In exploring these questions, the research also illustrates how financial difficulty can act as a good predictor of firms that present a high risk to the interests of clients and the public interest.

To answer these questions we undertook a review of 76 case files of firms where financial difficulty has been a key feature. These reviews were supplemented by interviews with Supervision staff that worked with these firms.

Law firms that are regulated by us have an obligation, under Principle 8 of the Handbook, to:

Run your business or carry out your role in the business effectively and in accordance with proper governance and sound financial and risk management principles.

This principle is included in the SRA Handbook as the result of an explicit acknowledgement that there is a clear link between law firms being financially stable and the likelihood they will operate in a way that presents lower levels of risk to the interests of clients and the public. It does not suggest that firms should act in a "risk averse" manner. Nor should it be seen as an attempt by the regulator to stifle the dynamics of a competitive market which drives the exit of poor firms.

The regulatory rationale for focusing on this issue stems from a need to engage with firms that present a high risk to clients and the public interest. A significant finding of this research was that:

- In over a quarter of cases, evidence of misuse or misappropriation of client money was found.

This is a significant risk to clients and a practice that is clearly not in the public interest.

Misuse of client money is more likely to occur when there is both the means and a motive. Financial difficulty undoubtedly creates a motive, and therefore higher incidence of this risk is to be expected amongst firms in this situation.

This approach has already helped us to identify and respond to the risk of misuse of client money. The chart below shows seasonally adjusted trends in "dishonest misuse of client money or assets" since 2009. It can be seen that from the summer of 2013 we have been dealing with a greater volume of these cases relative to previous time periods. Much of this increase has come from " internal reports", i.e. Supervisors finding evidence of this risk in law firms. Economic growth has been slow throughout the entire time period shown by this chart and so the recent increase in this risk is unlikely to have been caused by an external market event or impact. The main change that has influenced the increased incidence of this risk coming to our attention has been our active approach to engage with law firms in financial difficulty1 [#n1] .

A summary of our approach to managing this risk is set out in the "Navigating stormy seas" paper [/risk/risk-resources/financial-difficulty-law-firms/] .

Dishonest misuse of client money or assets

Further research may be required to explore the direction of causality between financial difficulty and other risks. However, understanding that a correlation exists is nonetheless valuable in assisting the targeting of regulatory resources.

The analysis of 76 case files, also found that:

- In over 80% of cases, failure to pay debts was a key feature. This generally acts as a key mechanism for us to identify firms in financial difficulty. The significance of failure to pay debts also emphasises the importance of our staff having strong links with institutions to allow this information to be reported. In most cases, failure to pay debts has the most significant detrimental impact on creditors. However, this can occasionally spill over and create a negative impact on clients. For example, if the debts are owed to service providers such as legal file storage this could lead to clients' data and information being put at risk. An example of this was found in the files reviewed as part of this study.
- In over 50% of cases, the effect of adverse economic conditions was identified as a key driver for the firm entering financial difficulty. This may not seem particularly surprising, but key features of the firms that were most vulnerable included a narrow focus on a single or very limited number of areas of legal practice. Many firms offer niche, specialist services and the findings of this review do not suggest any particular problem with this approach. However, firms taking a narrow approach may be at greater risk to market changes and so the importance of contingency planning is highlighted. The case reviews also included firms that had tried to diversify into new areas of work, but had not done so with sufficient preplanning. This points to the need for proper due diligence when embarking on a process of diversification.
- In nearly 40% of cases, poor financial and business management w ere identified as central to the firm being in this situation. Frequently identified issues included autocratic management, failure to implement standard financial management practices, excessive partner drawings and failure to control billing for work carried out. This finding also shows that financial difficulty is not always a result of poor financial management. In the non-random sample of firms this study looked at, it was a key factor in less than half.
- Although there is an obligation on regulated individuals to run their firm in adherence to good financial and risk management (Principle 8), these findings show that financial difficulty can occur for a range of reasons, and sometimes these are beyond the control of the firm. It is worth highlighting that this demonstrates that we will not always see financial difficulty as a

breach of Principle 8 of the Handbook.

- In over 20% of cases, a key partner leaving the practice was a significant contributory factor. A number of different scenarios were identified in the file reviews, from partners making a calculated decision to leave a practice knowing that its prospects were very poor, to a key fee earner departing and leaving the firm unable to maintain its previous levels of revenue. This finding further highlights the importance of contingency plans and the need for all partners to have oversight of a firm's financial position.
- In general, it is difficult to assert whether poor standards of service were the reason for firms starting to struggle, or the result of financial difficulty placing excessive strain on the wider operations of firms. Poor standard of service was found in a fifth of cases, although the exact nature of cause and effect will be specific to each individual firm. Nonetheless, where one of these issues is present, it also appears more likely than average that the other will be as well. Examples of poor service quality tended to involve delays in completion of house sales, failure to attend court proceedings and overcharging.
- Breaches of the SRA Account Rules were only present in a small proportion of cases. This illustrates that simply relying on identification of breaches of accounts rules will not allow a regulator to adequately identify law firms in financial difficulty.

These findings demonstrate some of the key characteristics of financial difficulty in law firms. It also illustrates why engaging with law firms in financial difficulty is a justifiable regulatory response to the risks presented to clients and the public interest. A focus on financial difficulty is a proactive step for a regulator, and one that can prevent harm from materialising.

A review of firms engagement with us, once in active supervision, shows a range of different reactions. Some firms take a proactive approach and seek to identify the factors that led to financial difficulty. In many cases this leads to firms taking steps towards longer term recovery. Unfortunately, this is not always possible, but when these firms do take the decision to stop trading, they are usually in a better position to do so in a way that reduces risks to clients.

There are also firms that continue with the practices that led to them entering financial difficulty in the first place. Unsurprisingly, the prospects for these firms to recover are diminished by these practices.

1. Introduction

This research explores the related issues of profile, prevalence and impact of financial difficulty in law firms by reviewing our experience of regulating firms in this situation. An effective approach to managing the risk of financial difficulty (and the associated risks it drives) is essential for consumers' ability to safely access legal services.

The research centred on file reviews of 76 firms that we have worked with in relation to financial difficulty.

These file reviews were supplemented by interviews with the "frontline" Supervision staff involved in these cases.

The research was carried out in parallel with our recent thematic work on this topic, the Financial Stability Programme2 [#n2] . This has meant that evidence and findings have informed a proactive response to the risks related to financial difficulty.

Through the Financial Stability Programme3 [#n3] , we have built more of an understanding of financial difficulty, what causes it, how it manifests itself and what approaches have bee n most effective at addressing it. The evidence base contained in this report has contributed to this by looking at the following research questions:

- What are the key characteristics of financial difficulty?
- What are the combinations of indicators and drivers that lead t o firms entering financial difficulty?
- What are the good and bad practices followed by firms in relation to financial management?
- What can we learn from our experience of engaging with firms in financial difficulty?

We have previously investigated the use of appropriate indicators of financial difficulty in law firms. These indicators have contributed to the analytical framework for this research, and provided the opportunity to test the effectiveness of these indicators by making a more detailed inspection of how financial difficulty manifests itself in practice.

The research went beyond simply looking at indicators in isolation, and explored the relevance of different combinations of indicators. The presence of one indicator is unlikely, in the majority of cases, to be the sole cause of financial instability. However, particular combinations may have a more significant impact.

1.1 Report structure

The remainder of this report is organised into the following sections:

- **Section 2 - Research approach**: Sets out a concise description of the research approach utilised in the collation of evidence.
- **Section 3 - Profile and prevalence of indicators and characteristics**: Highlights the profile of financial difficulty indicators, most notably what is covered by each indicator and associated examples. This section also outlines how frequently these indicators occurred and in what combinations.
- **Section 4 - Firm engagement practices**: Provides an overview of our engagement process and gives examples of both good and bad practices exhibited by firms during engagement.
- **Section 5 - Conclusions**: This section provides an overview of key findings.

2. Research approach

In designing a suitable research approach that ensures a structured and detailed evidence base, there were a number of important considerations:

- the need to identify relevant trends relating to indicators and practices,
- how best to use existing data and intelligence, whilst avoiding duplication of current and previous research,
- the need to establish a framework for data collation that facilitates consistent identification of patterns and trends.

These considerations led to the development of a four-stage research approach.

2.1 Stage one: Selection of historic and current firms

The most appropriate approach to obtaining information on indicators and practices was a structured desk-based review of firm case files relating to financial difficulty.

Changes in our approaches to identification of risk and firm engagement necessitated a review of both historic and current firms, which were selected in different ways. Using a selection of current and historic firms provides an opportunity to examine a cross section of issues related to financial difficulty rather than matters specific to recent market conditions.

2.1.1 Historic firms

A total of 35 firms that are not currently being engaged with by Supervisors or Regulatory Managers (RMs), were selected according to the following considerations:

- incidence of financial difficulty between 2009 and 2012,
- firms were selected to provide a range of different sizes and areas of legal work,
- examples were needed of firms that had closed and firms that had continued trading, following financial difficulty,
- firms were prioritised according to "primary" and "secondary" matches.4 [#n4]

2.1.2 Current firms

To select firms currently experiencing financial difficulty, we asked Supervisors to identify suitable firms from their wider firm portfolio. A total of 31 Supervisor and 10 RM firms were identified for subsequent analysis5 [#n5] .

Profile of sampled firms

Historic firms

Of the 35 historic firms reviewed, the closure of many firms meant profile data was limited for 29 (including 12 that had been the subject of an intervention). Available profile information was extracted from case files rather than our central databases.

- The main work areas encompassed professional regulation, personal injury, civil law, residential and conveyancing and immigration.
- 70% of historic firms were sole practitioners or firms with fewer than 10 partners.
- Typically, the larger firms employed between 11 and 30 fee earners, of which 10% were partners.

Current firms

41 current Supervision and RM firms were reviewed and profile data was derived from central SRA databases.

- 14 firms were limited companies, 8 were Limited Liability Partnerships and 9 were partnerships.
- 10 were RM firms, which are usually larger and whose failure poses the greatest risk to consumers and our regulatory objectives.
- The remainder were small, employing between one and 30 fee earners.
- Firms offered legal services in a range of work areas, the breakdown of which is detailed in the table below.

Work area	Number of firms
Conveyancing	10
Family Law	5
Personal Injury	7
Wills and Probate	4

Legal Aid	5
Immigration	7
Social Welfare	3
Criminal	5

2.2 Stage two: File reviews

The 76 firms selected for review each had a large number of case files cataloguing their engagement history6 [#n6] . Only the most recent file relating to financial difficulty was reviewed (however, these normally contained a summary history of previous issues recorded at the firm).

To structure and organise the data, an Excel matrix was developed covering the following categories: firm profile; matters; indicators and characteristics; background (story board); engagement and firm practices; and outcome.

2.3 Stage three: Supervision and RM interviews

Alongside the file reviews, interviews were conducted with the Supervisors and RMs responsible for those firms7 [#n] . The purpose of these interviews was to obtain an overview of the firm, the issues and the engagement that had already taken place, together with an assessment of the likely outcome, based on the knowledge and perceptions of the supervisor or RM. A short proforma was developed to ensure continuity and comparability of findings.

2.4 Stage four: Analysis and reporting

Information collated in the matrix needed to be distilled and t he most pertinent points extracted, organised and analysed. The starting point for analysis was to extract data pertaining to each research question. To illustrate different points, case studies have been included. These include some high profile cases, as well as some less well known examples.

Selection of indicators and characteristics

To structure our analysis of firm files, we used a set of indicators and characteristics. These were broken down into "lead indicators" and "lag characteristics" "Lead indicators" and "lag characteristics".

This classification made a distinction between two "types" of indicators and characteristics used to assess the probability and/or actual presence of financial difficulty within a firm. First, there are "lead indicators", which relate to the economic, market and cultural factors that influence the day-to-day operation of a business. Their presence is not directly correlated with incidence of financial difficulty but, their presence does make a firm more vulnerable and increases the level of risk that financial difficulty could occur. Such indicators include adverse economic circumstances, poor financial and business management, partner leaving, single work area and sing le funding source.

The second indicator type are "lag characteristics". These are often present in firms already experiencing financial difficulty. They could be viewed as the direct result of financial difficulty.

The distinction between the two can become blurred and is not always clear. For example, poor standard of service may be a cause of financial difficulty as well as being a consequence of it.

Lead indicators	Lag characteristics

Poor financial and business management (including mergers and acquisitions)	Failure to pay debts Misuse of client money
Partner leaving	Poor standard of service
Adverse economic circumstances	Personal Indemnity Insurance (PII) and Practising Certificate (PC) renewal
Firm carries out a single work area	
SRA Accounts Rules breaches	

3. Profile, prevalence and combinations of characteristics

This chapter sets out how each of these indicators and characteristics manifested themselves in practice and how they combined and overlapped with each other. The risks are ordered according to the number of times they were identified as the primary risk in the firm.

3.1 Failure to pay debts

Total occurrences: 62 out of 76 (82%)

Failure to pay debts was the most frequently identified indicator and occurred in 82% of all the firms reviewed.

Key features of this indicator are explained below:

Level and size of debt: As would be expected, the scale of debt largely correlates with the size of the firm and more specifically, the number of partners and fee earners. However, there were examples of sole practitioners and two-partner firms with debts of equal magnitude to larger firms, usually owing to HMRC or clients and pointing to financial difficulty over a period of many months or years.

Sustaining high levels of debt from borrowing is becoming more difficult, despite the Bank of England setting historically low interest rates of 0.5%8 [#n8] . We have observed a shift in the chasing of debt, with companies and organisations pursuing solicitor firms more vigorously for ever-decreasing sums of money9 [#n9] .

Type of debt: The debtors and types of debt identified in the file reviews were wide ranging and included the following:

- **Failure to pay service providers**: Firms often make use of a wide range of business services to operate effectively. From the point of view of client interests, the most concerning examples of this were failure to pay file storage costs, which could lead to confidential files being inappropriately secured. Other examples included failure to pay tradesmen who had completed work on firm property and even translators and expert witnesses.
- **Tax arrears**: The review found several examples of non-payment of tax, particularly Value Added Tax (VAT). This was often a result of funds that were ring-fenced for payment of tax being used to cover a financial shortage elsewhere in the firm. Debts to HMRC can run into hundreds of thousands of pounds.
- **Bank debt (overdrafts and loans)**: Firms in the sample had often used their overdraft facility, on a regular basis, to cover the costs of other financial losses and debts. This means they were rarely in a position to reduce the overdraft, with the level of debt some times spiralling out of control. We also identified instances of firms taking out finance from secondary lenders or facing very high levels of interest from payday loan companies in an attempt to obtain working capital.10 [#n10] 11 [#n11] 12 [#n12]
- **Failure to pay staff**: This was a rare occurrence among the firms reviewed, but one that

pointed to severe financial implications for those concerned. Firms will often wind down when they reach this position and, in the interests of clients, this process must be orderly and well managed.

The following table highlights the other key characteristics that were found in case files where failure to pay debts was also identified. The percentages refer to the number of cases that each of the risks in the table was found alongside "failure to pay debts".

Failure to pay debts - combined with ...			
Adverse economic circumstances	Poor financial and business management	Partner leaving	Unsustainable partner drawings
53%	**29%**	**19%**	**15%**
Other SRA Accounts Rules breaches	Misuse and misappropriation of client money	Failure to obtain PII/PC	Poor quality service (complaints)
-	**21%**	**11%**	**16%**

Unsurprisingly, failure to pay debts was often accompanied by poor financial and business management, highlighting the inability of partners and managers to address the issue or to admit the existence of a problem. In many examples, the partner or sole practitioner failed to ac knowledge the level of debt and sought to implement inappropriate solutions, including misuse of client money.

In many cases that had ended in a decision by us to intervene13 [#n13] , we found a combination of poor financial and business management, failure to pay debts and misuse of client money.

3.2 Adverse economic circumstances

Total occurrences: 39 out of 76 (51%)

The financial performance of law firms is correlated with trends in the wider economy. Demand for legal services is directly linked to levels of activity in other sect ors of the economy. During a recession, demand for certain types of legal services will reduce, although demand for other types of legal service may increase, for example insolvency and employment law.

The economic downturn has placed unparalleled pressures on the financial profiles of businesses and has served to highlight the frailties of financial management of certain firms. The firms included in this review worked across most major areas of law. Across these firms, macro-economic trends led to financial difficulty in the following principal ways:

Reduction in particular markets: A key feature of the recent economic downturn was the associated "crash" in the housing market. While this is currently recovering, transaction volumes are still below those seen in the early to mid-2000s14 [#n14] . This downturn led to reduced demand for conveyancing services. A large number of the firms reviewed had some proportion of their work in conveyancing and property law, which resulted in significant losses when the housing market crashed. Another notable change has been the reduction in revenue from Legal Aid, which has been driven by the government' s need to reduce the national budget deficit.

Reliance on a single work category of legal practice or a single funding source: Closely linked to the above point, an over-reliance on a single area of work or a single source of funding can make a firm or individual highly vulnerable should the market for such services diminish.

An over-reliance on just one or two areas of legal work was found within a significant proportion of the firms reviewed. Many of these derived significant proportions of their work from just one or two of the following areas: conveyancing/property, personal injury, immigration and family law.

A narrow range of revenue streams was not just limited to small firms. It was identified across the sample, including some RM firms.

Diversification into unfamiliar markets: Reductions in certain markets has led to firms diversifying into unfamiliar areas of work. If well managed, diversification is widely accepted as a positive move to secure the financial stability of a firm. However, legal services require specific skills and success is closely correlated with reputation and experience. Some firms have been very successful, and recruited specialists to grow the business in particular areas. Others have been less successful, moving into areas where they have no previous experience and where strong competition already exists. In the case of the latter, ill-conceived diversification has led to firms entering into financial difficulty.

Economic Circumstances - combined with ...			
Poor financial and business management	Partner leaving	Unsustainable partner drawings	Other SRA Accounts Rules breaches
49%	**18%**	**18%**	**-**
Failure to pay debts	Misuse and misappropriation of client money	Failure to obtain PII/PC	Poor quality service (complaints)
77%	**15%**	**13%**	**8%**

Economic circumstances have combined with all other indicators, but most commonly with failure to pay debts and poor financial and business management.

3.3 Poor financial and business management

Total occurrences: 30 out of 76 (39%)

Poor financial and business management can take many forms, ranging from autocratic management to an inability to adapt to market conditions. The following section highlights some of the key characteristics amongst the firms we reviewed.

Autocratic management: We found evidence in a number of case files of senior partners who failed to share the true financial position of the firm with other partners and those in other managerial positions. Too many partners were unaware of their firm's financial situation and the personal implications of the business failing. This meant that they were not armed with the right information to ensure the firm dealt with the financial challenges being faced.

Denial of difficulties: There were also several examples of senior managers and partners who were in denial as to the severity of the firm' s financial position, either because they appeared unable to recognise the situation or because they carried on regardless in the hope that a resolution would be found. This often led to partners continuing to draw money whilst the firm was in significant debt.

Although excessive partner drawings were identified as a key issue in the file review, there were also incidences highlighted of managing partners being unable or unwilling to draw a salary from their firm due a lack of available funds. This demonstrates a responsible approach, but one that is clearly unsustainable for those involved.

Lack of business acumen and financial management skills: Surveys in a number of different professional sectors have identified a lack of planning and financial management skills among senior staff15 [#n15] . Within law firms, partners may be highly adept at securing legal contracts and delivering a high quality service to clients, but lack the required business management skills.

The survival of a business in a difficult economic climate may require innovation, diversification and tight budgetary and financial management. However, many are unable to produce meaningful business or recovery plans and are ineffective at managing revenues and costs.

Failure to control cash flow associated with work in progress (WIP): This research has highlighted the inability of some firms to control billing and payments for their WIP. For firms attempting to manage financial difficulty this is often one of the key areas where attention is required. Some firms are poor at requesting and processing outstanding bills for work they have completed and in some instances, the sum of money in question can be many hundreds of thousands of pounds. This lack of working capital often results in the taking out of loans to cover shortfalls.

Personal performance: First, and most significant for sole practitioners, was the personal performance issues of practitioners within firms employing other legal and paralegal staff. There were examples where the performance and/or the practice of the partner were sub-standard, leading to insecurity for the firm as a whole. Sometimes this was related to competence issues and on other occasions other factors, such as health, played a part. Examples from the reviewed files related to inadequate and incomplete case documents and inaccurate recording of clients' personal circumstances. There were other examples where transactions on properties had not been finalised due to key documents being lost or not signed and where solicitors had failed to turn up to court to represent a client, the latter having serious repercussions for the client.

Due diligence in mergers and acquisitions: There are firms that have sought to diversify and expand their activities during the economic downturn, through recruitment of specialists and senior partners from other practices or via mergers and firm acquisitions. If managed well, these approaches can have a positive impact. However, we found examples where mergers and acquisitions had been undertaken without proper due diligence. This was a particular issue amongst some of the larger firms included in the sample of files reviewed.

There are two notable examples from the firms reviewed that illustrate this point. In one case, a firm had borrowed significant amounts to pay for several acquisitions. However, this rapid, debt-based expansion left the firm vulnerable to changes in some of its key markets - conveyancing and Legal Aid. The firm was not able to adjust to these changes in market conditions.

In another example, a merger took place to allow a firm to diversify into a new area of legal services. In doing so, the firm inherited a significant amount of debt, which it had not planned properly for dealing with. This example illustrates significant shortcomings in due diligence when executing a merger.

Poor financial and business management - combined with ...			
Adverse economic circumstances	Partner leaving	Unsustainable partner drawings	Other SRA Accounts Rules breaches
67%	**10%**	**23%**	**3%**
Failure to pay debts	Misuse and misappropriation of client money	Failure to obtain PII/PC	Poor quality service (complaints)

77%	**17%**	**23%**	**17%**

The most common indicators that combined with poor financial and business management were failure to pay debts, which occurred on 23 occasions, and economic circumstances, which was identified on 20 occasions.

3.4 Misuse and misappropriation of client money

Total occurrences: 20 out of 76 (26%)

Misuse of client money results in a significant detrimental impact for clients. In most cases where client money is misused, it is to pay outstanding debts or to cover the costs of overheads. It is characterised by the movement of client money into the office account. It may also involve mixed receipts, of client and office money, to the firm's bank account, followed by a failure to transfer the client money to the client account.

Misuse of client money can also take less obvious forms. A recently identified practice has been the creation of loan agreements between partners and clients. In these instances, partners may "take advantage" of a strong relationship with clients, usually those holding the most money in the account. The solicitor will make a written request to the client to use their monies for other costs and, in some cases, will draw up a more formal written agreement. This practice can lead to conflicts of interest and has also led to instances where the client has needed to access their funds and they have not been available.

One such example of the above involved a sole practitioner and a client living abroad. A recent transaction on the purchase of a holiday property had been finalised and the solicitor held the funds, totalling over £120,000 in the client account. This client had been a regular user of the solicitor and the relationship was a positive one. When the solicitor entered into financial difficulty, largely as a result of reductions in particular service types, he approached the client to request an initial loan for £30,000. Upon oral agreement, the solicitor drew up a contract detailing the amount borrowed and the intention to pay back the loan. Some six months later, the solicitor again approached the client, requesting a further £50,000. Again the client agreed and a contract was drawn up. However, when the client required their money for a personal matter, the solicitor informed them that the money was not available and had been used to cover the monetary shortfalls in the practice.

Misuse and misappropriation of client money - combined with ...			
Adverse economic circumstances	Poor financial and business management	Partner leaving	Unsustainable partner drawings
35%	**25%**	**5%**	**5%**
Other SRA Accounts Rules breaches	Failure to pay debts	Failure to obtain PII/PC	Poor quality service (complaints)
15%	**65%**	**5%**	**35%**

This indicator was most frequently identified alongside failure to pay debts. Client money was often used to pay debts, regularly to HMRC, associated service providers and ourselves16 [#n16] . There were further indicators that frequently occurred in conjunction with misuse of client money, including evidence of poor quality of service, which was often highlighted when clients wanted their money from a transaction returned and it was no longer available.

3.5 Partner leaving the practice

Total occurrences: 18 out of 76 (23%)

Whilst not exclusively an issue associated with smaller firms, the knock-on effects of a prominent partner leaving a firm with fewer than five partners are far more significant when compared with larger firms.

There were a number of reasons for a partner leaving a firm, the majority of which were unavoidable. These included sole practitioners and partners in two partner firms leaving due to retirement or illness, or because they had successfully obtained employment elsewhere. However, there were examples where the conduct of the solicitor could be called into question and where this conduct had left the firm on a precarious financial footing. Partners had left firms as a direct result of debt incurred under their management. Upon leaving, the partner hoped to relinquish their financial liability to the firm and leave the remaining partner and staff members responsible for the debt.

Partner leaving - combined with ...			
Adverse economic circumstances	Poor financial and business management	Unsustainable partner drawings	Other SRA Accounts Rules breaches
50%	**17%**	**-**	**11%**
Failure to pay debts	Misuse and misappropriation of client money	Failure to obtain PII/PC	Poor quality service (complaints)
61%	**11%**	**22%**	**17%**

A partner leaving a firm occurred most commonly alongside the "lag" indicators of failure to pay debts and poor service quality and the "lead indicator" of economic circumstances. However, a partner leaving a firm of fewer than five partners was significant enough to cause firm closure in the absence of other indicators, particularly when that individual was solely responsible for earning fees in a given area of law.

3.6 Failure to obtain Professional Indemnity Insurance or a Practising Certificate

Total occurrences: 17 out of 76 (22%)

Practicing solicitors require both Professional Indemnity Insurance (PII) and a Practising Certificate (PC). To provide legal services in the absence of either is a serious breach of the professional principles. In addition, practising without PII leaves the consumer vulnerable to financial loss.

The review highlighted a number of examples of individuals failing to maintain their PII or PC. This provided a key opportunity for us to engage with these firms on the matter of financial difficulty.

Failure to obtain PII/PC - combined with ...			
Adverse economic circumstances	Poor financial and business management	Partner leaving	Unsustainable partner drawings
35%	**41%**	**24%**	**6%**
Other SRA Accounts Rules breaches	Failure to pay debts	Misuse and misappropriation of client money	Poor quality service (complaints)
18%	**71%**	**12%**	**6%**

Failure to obtain PII and a valid PC correlated with failure to pay debts. Another combination involved poor financial and business management, specifically where senior partners had decided to take the risk of not renewing insurance and PCs.

3.7 Poor service quality

Total occurrences: 16 out of 76 (22%)

Poor service quality was highlighted as an issue in 16 of the 76 firms reviewed. It is difficult to understand whether the pressure of financial difficulty had led to deterioration in professional standards in these firms, or whether poor standards of service had led to a loss of clients and therefore been a cause of financial difficulty. Nonetheless, the two are likely to be linked and the exact nature of cause and effect will be specific to each individual firm.

Examples of poor service quality tended to involve delays in completion of house sales, failure to attend court proceedings, inaccurate and incomplete documentary evidence and overcharging for work. The most common of these were delays in completion of house sales and in one example, resulted in the client's house purchase falling through due to the solicitor failing to exchange the contract. In another example involving conveyancing, the solicitor held a significant amount of money for a client, money that was due to be used to purchase a new property. According to the complaint made by the client, the solicitor had reiterated on numerous occasions that the money remained in the client account and would be immediately available to finalise the purchase. However, it later transpired that the solicitor had moved the money and used it to cover tax and rental arrears, resulting in the purchase failing to go through. This example combines both poor quality of services with misuse of client money.

Poor quality service (complaints) - combined with ...			
Adverse economic circumstances	Poor financial and business management	Partner leaving	Unsustainable partner drawings
25%	**38%**	**19%**	**-**
Other SRA Accounts Rules breaches	Failure to pay debts	Misuse and misappropriation of client money	Failure to obtain PII/PC
13%	**75%**	**44%**	**25%**

Poor service quality most commonly combined with indicators of poor financial and business management and economic circumstances.

3.8 Other SRA Accounts Rules breaches

Total occurrences: 7 out of 76 (9%)

Failure to provide an accountants report results in a breach of the SRA Accounts Rules and associated sanctions. We can grant extensions to facilitate provision of an accountants report, however failure to supply a report is often the first sign that a firm may be attempting to hide the financial position of their firm. This issue was characterised by firms failing to provide reconciliation statements and accounting records following numerous verbal and written requests from us. Common excuses for failure to comply ranged from being out of the country with work or on holiday, illness or that accounts had not been finalised and remained with the accountants.

SRA Accounts Rules- combined with ...			
Adverse economic circumstances	Poor financial and business management	Partner leaving	Unsustainable partner drawing partner drawings
25%	**38%**	**19%**	**-**

Failure to pay debts	Misuse and misappropriation of client money	Failure to obtain PII/PC	Poor quality service (complaints)
-	**43%**	**43%**	**14%**

4. Firm engagement practices

This chapter reviews the practice of firms during engagement, highlighting good and poor approaches by firms which have served to improve or worsen their financial situation. A range of different practices have been identified, from positive, responsive and assistive practices, to what could be categorised as "evasive" behaviour.

4.1 Overview of the engagement process

The exact engagement process with firms in financial difficulty varies on a case by case basis. The shift to outcomes focussed regulation has seen an accompanying move away from a highly prescriptive, tick box approach, towards more flexible and responsive engagement with firms. That said, there is still a strong underlying framework that serves to structure the overall engagement process. This process is detailed below:

Engagement process overview - financial difficulty17 [#n17]

4.2 Good practices

The good practices exhibited by firms reviewed can be organised into the following categories:

4.2.1 Self-reporting

As a recent article in the "Solicitor's Journal" argues18 [#n18] :

"...many firms would be loathed to involve the regulator for fear of regulatory action or damage to their commercial standing if such a sensitive issue became public".

However, the early identification of financial difficulties by the firm, and notifying us of these difficulties, can lead to more positive outcomes for all parties. This highlights the importance of firms understanding the severity of their situation and seeking information and support as soon as possible.

One aim of the implementation of Compliance Officers for Legal Practice (COLPs) and Compliance Officers for Finance and Administration (COFAs) is to encourage self-reporting and early notification of issues.

Firms that identify financial difficulty the quickest are more likely to self-report and act swiftly to minimise its impact. Such identification can be aided via the sharing of company and financial information among partners and key decision makers.

4.2.2 Making a proactive response

Once a problem has been identified, inability or unwillingness to react can be very damaging. It is important that firms take immediate and decisive action to tackle financial problems before they escalate further. This could improve the chances of a firm recovering and significantly reduce the risk of enforcement action against responsible partners.

A good example of proactive behaviour was one firm's decision to attend leadership and management training, including a focus on financial management and business planning. Firm partners recognised the skills gaps and shortcomings of their managerial staff and sought to rectify this through external training.

Other examples of positive practices include:

- making improvements to accounts procedures and reconciliation of accounts,
- reducing office space to reduce rental costs,
- chasing outstanding payments for completed work and improved management of WIP, and
- recruitment of a fee earner to facilitate diversification into a new market area.

The key for many firms in achieving short-term recovery, and then long-term financial viability, is a recognition and acceptance of the internal structural, management and administrative process shortcomings that have resulted in financial difficulty.

There have been a number of good examples of Supervisors highlighting issues at firms that need to be resolved. When firms act on this, it can lead to positive outcomes. Examples of this include:

- effective business and debt planning,
- assessment of future performance,
- restructuring of debt re-payments and
- improving accounting procedures.

4.2.3 Continual updates and open dialogue

During the engagement process, Supervisors and RMs will request regular information updates from firms, the frequency of which is determined by the level of engagement required. When engaging with firms we will often set out a compliance plan. This is framed around regular weekly updates, providing information on totals in office and client accounts, live files, and any judgments or unexpected expenditure.

Case study 1: Positive changes as a result of SRA engagement

The COFA at a general practice law firm with two partners approached us to inform us that the firm was in financial difficulty. They were in a "time to pay" arrangement with HMRC and, alongside other issues, were regularly entering and extending their overdraft facility. The COFA was concerned about the firm's ability to pay staff salaries and continue trading.

While work in progress (WIP) and turnover were healthy, the firm was struggling to control its overheads. The firm had acquired two small practices, expanding its footprint to four offices. This had resulted in overcapacity, characterised by more support staff than fee earners. They were also slow at chasing unpaid fees, using quarterly rather then monthly billing and only requesting payment via written correspondence rather than phone calls or emails. As a consequence, the firm regularly had to find money to pay VAT on billing not yet received.

The SRA supervisor highlighted possible risks resulting from existing inadequacies in the firm's processes. The firm chose to implement a number of changes to address these risks, including improving billing and fee collection, office closures and possible redundancies. In particular, office closures using break clauses were considered effective with negligible impact on fees, as their office locations were close together, with one operating from a low profile location and competing with a better located rival firm.

The supervisor then returned at a later date to determine whether the firm had started to implement steps to manage risks and stabilise its financial position. She saw that the firm had made some progress, closing one office and using the building for storage, which reduced overheads. Redundancies were also planned, and there had been an overhaul of billing and collection policies.

Importantly, the firm had successfully reduced the risk of disorderly closure resulting from financial difficulty. The firm continues to trade and the supervisor is in regular contact to monitor continued performance.

4.2.4 Positive responses to information

Case study 2: Positive reaction to firm engagement

At the start of 2009, and following large-scale redundancies, a partner self-reported financial difficulties to us, including a request for an intervention. Two weeks later, the firm was placed into voluntary administration following a request from the firm's bankers.

It had become clear that there was insufficient numbers of staff to cope with the number of post-completion matters. Although attempts had been to minimise the impact of closure, the partners felt they were no longer in a position to protect the best interests of all current and former clients, a situation compounded by the imminent closure of the firm's main office.

Discussions with the administrator had clarified the firm's precarious position and their unwillingness to continue the employment of certain key staff following the vacation of the premises.

Rather than wait for us to identify the severe financial, resource and security problems present in the firm, the partners were proactive and contacted the SRA to request a pre-intervention meeting before key staff members left the firm. These same members of staff, all of whom faced imminent redundancy, cooperated with our staff and agreed to the organising of closed files and re-allocating open client files to appropriately skilled solicitors in alternative firms.

The proactive and positive engagement of the firm and the rapidity of response from us meant that a full scale and more costly intervention into the firm was avoided and the partners, together with other staff, were in a position, with assistance, to instigate an orderly wind down. This limited the detrimental impact to clients and led to much improved outcomes for the partners and employees of the firm.

4.3 Poor practices

The review of firms also highlighted poor practices. Key examples are outlined below.

4.3.1 Continuation of poor practices during engagement

Several firms simply failed to change practices from those that had led to them entering financial difficulty. We expect firms to manage their risks, and Principle 8 of the Handbook requires firms to:

"Run your business or carry out your role in the business effectively and in accordance with proper governance and sound financial and risk management principles"19 [#n19]

Despite this, there have been several firms that continued those poor practices throughout the engagement process. This included failure to keep to repayment plans, undertake contingency planning and consideration of more detailed business and financial plans. In some cases partners even made significant drawings while the firm was in financial difficulty.

4.3.2 Failure to respond to information requests

Once we have identified the need for engagement with the firm, a letter is sent requesting a range of information from the individual or entity, including the number of open cases and live files, the amount of money held in both the client and firm accounts, copies of bank signature mandates and certification from the bank of the accounts held by it.

In a large number of cases, there were significant delays in response to this initial information request. We have also encountered firms that have simply failed to respond to some or all correspondence. Reasons put forward by firms included non-receipt of request, illness, being out of the country or delays on receipt of information from banks and accountants. Whilst in many cases, such excuses may be justified, they occurred too often to be coincidental.

4.3.3 Deliberate deception

It may be difficult to distinguish between mismanagement, poor organisation, inadequate internal processes and procedures, and deliberate attempts to conceal information or activity. There were a number of examples where deliberate deception proved to be the case, and where poor management and organisation could not be put forward as a mitigating factor.

Where evidence is presented to individuals, there is often an attempt made to deflect blame onto other partners or staff in the firm. Whilst there are genuine examples of partners withholding information from other partners and firm staff, the use of the "blame game" is a common practice among two partner firms in particular. One such example of the latter involved the repossession of a firm's premises. An informant had previously informed us that the property had been repossessed to cover the debts accrued by the firm, however, the partner interviewed as part of the investigatory visit claimed ignorance only for it to emerge later that he had been aware.

In relation to deliberate dishonesty, the commencement of the investigatory process will involve a "no notice" engagement at the firm's premises.

Deception or techniques of avoidance also took the form of deliberate absence from the firm's offices on the date of an FI visit. Upon making contact with the solicitor, common excuses included being called away on urgent business, non-receipt of email (despite presence of "read receipts") or illness. On two occasions, our investigators have attended premises only to meet the partner on the doorstep about to leave for the day, claiming the arrangement of a prior appointment or simply refusing to see them.

In two extreme examples, our investigators have arrived at a firm's premises to find that offices and computer equipment have been abandoned and that the solicitor concerned had absconded in an attempt to avoid disciplinary proceedings.

There were also examples of solicitors continuing to practice following receipt of information stating the firm had closed, or partners with conditions on their PC continuing to undertake activities the condition prohibited, such as handling client money.

Case study 3: Excessive borrowing and failure to contingency plan

A south west based law firm provided legal services for both individuals and businesses across a variety of areas including corporate and commercial, clinical negligence, cohabitation disputes, family and criminal law.

When the economy was strong, partners and managers at the firm had borrowed a significant amount of money compared to their annual turnover, to expand their office and service portfolios. However, this high-risk approach to expansion had left the firm in a vulnerable position following the onset of the economic downturn and changes to Legal Aid, which represented 25% of total income. The firm was no longer in the position to pay back the loans taken out during the "boom period".

The first meeting between firm representatives and our staff did not lead to any significant financial issues being identified. However, shortly after, detailed analysis and scrutiny of financial information alerted us to a number of concerns. This led to a forensic investigation and an urgent financial stability visit. Over the next two months, we met with the firm a further four times and then moved engagement to weekly phone updates.

Within about six months, firm debt was still significant and a further loan of £250,000 had recently been taken out. The firm hoped that a successful application for an ABS would facilitate the likelihood of external investment. However, Authorisation stated that a successful application was in no way guaranteed and that the firm should start planning for an alternative solution. There was no sign of a "plan B" and the firm brought in an insolvency practitioner. Their assessment indicated that the situation may have been even worse than already understood. This led to a notice of intention to appoint administrators.

A professional advisor was brought in to oversee the sale of the business, which it had been hoped would be a whole practice sale, However, it ended up being a sale of parts. During the administration process, our staff were onsite ensuring that client interests and client monies were being protected. Regular meetings were also held with the administrator to confirm the presence of a plan for safeguarding ongoing client interests.

By the time the firm had formally entered into administration, much of the preparatory work to facilitate the "selling off" of various parts of the business had been completed, including client notifications, interests and confidentiality.

To minimise costs from archiving files, the administrator was informed of the likely intervention costs at an early stage, resulting in a plan for destruction, storage and re-distribution of files. A proportion of files were sent to the various firms that had acquired parts of the business, with the remainder being sent to Capita and the ourselves for safe storage.

4.3.4 "Phoenix" and "Ghost" Firms

This issue was identified in several firms reviewed in this study. There are no recognised or commonly applied definitions of either "Phoenix" or "Ghost" firms, but the common objectives in both these instances, is to avoid payment of debt, minimise liabilities and to continue operating as a partner following the closure of the previous firm. Where these structures are used firms may be in breach of Principle 8 which requires regulated individuals to run their business, or carry out their role in the business, effectively and in accordance with proper governance and sound financial and risk management principles.

- **Phoenix Firms**: In the case of a "Phoenix" firm, this is when a new firm with a different name, but a similar or identical management and partner structure, is established following the closure of the old firm. Solicitors and partners can continue to practice unhindered and can continue to provide services to the same clients as the old firm.
- **Ghost Firms**: Whilst eliciting the same effects as a "Phoenix" firm, "Ghost Firms" are slightly different as they involve the presence of a parent corporate structure. The partners of the wider corporate structure set up new business activities under the guise of the parent firm. They effectively own and run both the parent firm and the "ghost" firms.

5. Conclusions

The risk to clients of disorderly closure is one of the more dramatic impacts of financial difficulty. However, this review has shown that the related regulatory risks associated with financial difficulty go much further than this. Although the explicit aim of the research was not to map all of the regulatory risks identified with the firms sampled for this research, the case reviews nonetheless highlighted the public interest benefits of regulating the financial and structural stability of law firms.

In over a quarter of reviews undertaken, the case files highlighted evidence of misuse of client money or assets. This is not the result of a random sample, but nonetheless it highlights that there is far more than just a theoretical correlation between financial difficulty and serious regulatory risks to consumers and the public interest. Evidence of poor standards of service, although less easily identified via this research method, also featured relatively regularly in the files reviewed (evidence was found in over 20% of cases).

We have already published information on our approach to managing the risks associated with financial difficulty and the "key features" of these firms20 [#n20] . This research provides a more detailed review of the characteristics of firms in this position.

Engagement with firms has highlighted a wide range of poor practices. These have included a failure of firms to take notice of our warnings about the risks that need to be managed and deliberate deception, such as concealment of information.

Good engagement practices experienced in our engagement with firms have included a proactive approach being taken to managing risks, an open dialogue on the firm's financial position and efforts to reduce operating costs and secure payments for completed work.

Notes

1. A summary of our approach to managing this risk is set out in the "Navigating stormy seas" paper [/risk/risk-resources/financial-difficulty-law-firms/]
2. This report provides an overview of the work carried out through the SRA's Financial Stability Programme: Navigating stormy seas: financial difficulty in law firms, November 2013 [/risk/risk-resources/financial-difficulty-law-firms/]
3. Solicitors/handbook, Part3, Rule7 [/solicitors/handbook/code/part3/rule7/resources]
4. Data matching is a process that we use to categorise the events and issues that we deal with to risk categories. Primary matches referred to matter reasons that were closely correlated with financial difficulty. Secondary matches identified matter reasons that "could be", to a greater or lesser extent, associated with financial difficulty.
5. "Supervisor" firms refer to firms with a low or medium impact rating and "RM" firms to those with a high impact rating. Regulated firms are allocated an "impact score", which is calculated using a number of criteria. Larger impact scores indicate that if something went wrong at a firm, it has the potential to make a greater detrimental impact on the regulatory objectives. Impact scores are independent of "probability scores", which relate to the likelihood that a negative impact will occur. This means that, taken alone, a high impact score does not mean that a firm is viewed as presenting a higher overall level of risk.
6. Files may be opened up for different issues, or "matters", relating to a single firm. More recent files were reviewed as it was difficult to ascertain whether older recorded matters would have been related in any way to the engagement with firms on the basis of financial difficulty. Restricting the number of files to be reviewed may have limited the scope of the research to fully explore linkages between financial difficulty and other regulatory risks. This may mean that the actual incidence of other regulatory risks in these firms is higher than that identified by this review. However, this approach does mean that issues identified in these firms were present at the same time as financial difficulty.
7. Interviews regarding historic firms were only undertaken when the relevant supervisor still works at the SRA.
8. The Bank of England has set the Base Interest Rate at 0.5% since 2009.
9. CCR Magazine (August 2013) "Warning - creditors are seeking judgments for smaller debts" [http://www.ccrmagazine.com/index.php?option=com_content&task=view&id=9711&Itemid=33]
10. Owen White & Catlin LLP Solicitors "Many small businesses 'using pay

day loans to survive'"

11. Law Society Gazette (June 2013) "Law firms and bank finance"
12. Solicitors Journal (July 2013) "Desperate firms turn to 'non-mainstream' lenders"
13. When there SRA finds a severe risk to the public interest it has the power to intervene and/or close down that firm. This process is known as an intervention.
14. House price crash forum (October 2013) "Property transactions will never recover" [http://www.housepricecrash.co.uk/forum/index.php?/topic/193667-property-transactions-will-never-recover/]
15. Management Matters: Key Findings from the UKCES Surveys, UK Commission for Employment and Skills (July 2013) [http://www.ukces.org.uk/publications/management-and-leadership]
16. Debts to the SRA centred on outstanding payments for Practicing Certificates and Professional Indemnity Insurance (PII) cover.
17. In relation to the first box on "assessment and allocation", in the summer 2013 we took a proactive approach to target resources at firms where a high risk of financial difficulty existed. Prior to this financial difficulty was still identified using a range of data and intelligence, but this was not done as part of a systematic programme of engagement. To read more about the approach taken to managing the risks of financial difficulty in law firms, please see: http://www.sra.org.uk/riskresources/ [/risk/risk-resources/]
18. Solicitors Journal Risk & Compliance Digital Supplement 2013 "Setting off on a new compliance journey"
19. Solicitors handbook - SRA Principles 2011 [/solicitors/handbook/handbookprinciples/]
20. 20. Navigating stormy seas, financial difficulty in law firms, November 2013 [/risk/risk-resources/financial-difficulty-law-firms/]