OFR and mergers: another hurdle to overcome?

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For many law firms, a merger could be the next logical step to consolidating and expanding their business. In the new regulatory regime, it is advisable to be wise before the event and tread carefully to avoid unseen pitfalls ahead

Consolidation between firms of solicitors is a trend which is bound to increase sharply given the highly fragmented state of a legal profession made up of nearly 11,000 law firms, the majority of which are too small to be viable in the long term. I question the viability of many small firms because the pressures on them have been growing for a number of years and are now taking their toll. The effects of a difficult economy and a changing marketplace, more competition from both new entrants to the market and existing firms, government cut-backs and an increasing compliance burden following the introduction of outcomes-focused regulation (OFR) are all forcing partners in many small practices, who are barely making a living, to consider throwing in their lot with other firms. At the same time, there are also pressures on much larger law firms as they seek to gain greater market share and become more competitive in increasingly cut-throat environments. Consolidation in these circumstances can only gather pace.

The trend to consolidate law firms into larger economic units will inevitably mean that firms will have to become increasingly knowledgeable about the regulatory requirements in respect of the process of merger – 'merger' being used here to refer to the process whereby two law firms (whether partnerships, limited liability partnerships (LLPs) or corporates) are brought together

and integrated, whether by one acquiring the other or there being a genuine fusion of two firms which are more or less equal. This article does not, however, consider any issues relating to alternative business structures and their establishment, or their acquisition of a 'traditional' law firm.

OFR is likely to be both a driver of consolidation, in that smaller firms may be finding it difficult to become compliant, and an additional hurdle to overcome when firms come to deal with the process of merger. I say an 'additional hurdle' because, before OFR came into effect, regulatory matters (other than, say, in the case of multi-jurisdictional firms) often tended not to be at the top of either merger party's agenda. Culture, business fit and a strong financial case have tended to be the areas upon which parties to mergers have in the past sensibly focused. Prospective merger partners will now need to place Solicitors Regulation Authority (SRA) compliance issues high on that list.

This article looks at some of the SRA compliance issues with which firms are likely to be confronted when they begin their merger journey and, in particular, how they should approach compliance issues arising on merger, such as:

- aspects of due diligence and documentation;
- notification and approval requirements; and
- merger implementation.

Due diligence and documentation

On revisiting some law firm mergers from even the quite recent past, it is surprising to find that compliance with regulatory issues often did not feature prominently, other than in relation to the former Solicitors' Accounts Rules 1998 (now replaced by the SRA Accounts Rules 2011), and issues around, for example, the successor practice rules, given that mergers are regarded as a 'risk' issue by professional indemnity insurers. Due diligence checklists and warranties asked for, and mutually given, have tended to focus on the business, client base, employment, and financial, audit and tax affairs of both firms and their partners.

OFR is likely to be an additional hurdle to overcome

Sometimes in merger agreements there appear warranties that the parties have, for example, '*not received notice* of any breach by them of Law Society or SRA rules or regulations or of any investigation, enquiry, report or order by or by reference to any such regulatory authority under any such rule or regulation'. There might also have been reference to necessary licences to continue in practice, with a warranty that '*the parties know of no reason* why any such licences should be suspended, cancelled or revoked'.

However, such regulatory warranties often tended to be limited in scope, which was understandable in relation to a rules-based regulatory system. OFR has given regulatory compliance a much-heightened profile and as a result is likely to change the way law firms will need to approach due diligence and documentation.

Under OFR it is not sufficient just to be compliant. Firms must be able to demonstrate their compliance to the SRA. Likewise, a prudent law firm contemplating merger is therefore likely to wish, for example, to be satisfied that at the very least (tracking the wording of outcomes 7.2 and 10.1 from the SRA Code of Conduct 2011), the prospective merger partner:

'has effective systems and controls in place to achieve and comply with all the principles, rules and outcomes and other requirements of the Handbook [and] *has complied with all the reporting and notification requirements in the Handbook'.*

In addition, a party to merger discussions is likely to require the compliance officers of the other firm (compliance officers for legal practice (COLP) and for finance and administration (COFA)) to confirm that they have fully complied with all their responsibilities under the SRA Authorisation Rules 2011 (including reporting all breaches).

In the same way that many firms are likely to find it difficult to demonstrate to the SRA their achievement of such outcomes if challenged, equally they will have difficulty demonstrating such compliance to a prospective merger partner. How can a firm involved in merger discussions deal with SRA compliance issues in a practical way, finding a balance between realistic due diligence to protect itself (and to protect the new firm to be created by the merger) and not taking undue risks?

A prudent firm is quite likely, at the outset of detailed merger discussions, to consider the outcomes in the SRA Code of Conduct, together with other requirements in the SRA Handbook and to prepare a detailed due diligence checklist and a set of detailed warranties based around them. As corporate lawyers will tell you, the purpose of warranties is not just about providing protection for a purchaser but also to ensure that the purchaser makes full disclosure of any problems that may exist. Knowing about a problem and being able to take decisions in the light of that knowledge is often seen as preferable to just taking and enforcing warranties against the partners of a legacy firm who may be 'men of straw' and by which time in any event, the damage will have been done.

However, in a merger between two law firms it is likely that mutual warranties will be requested of each party. Given the difficulty of demonstrating SRA compliance, it is likely that the partners of one of the firms involved in merger negotiations may well say that, in addition to the other firm and its partners providing warranties, they wish to carry out their own 'compliance audit' to satisfy themselves as to the compliance position. The other firm, in response, is likely to say the same.

So, are compliance audits a way through this minefield? It is essentially an issue of who takes the risks and on what basis? It can be envisaged that some firms involved in merger discussions are now likely to take the view that it is preferable for each firm to carry out a compliance audit on the other firm in place of, or as well as, taking detailed warranties. While an audit is likely to take time and possibly add to cost, it is likely to have some advantages. For example:

- An audit should enable both firms to gain an in-depth knowledge of the operations of the other, which is likely to be invaluable in terms of bringing together the two firms.
- If compliance failures are brought to light, that will enable the firms to consider, as part of their merger discussions, how to deal with such issues. Of course, it could also mean that a compliance failure is so serious that one party calls off the discussions at that point. That may be a better outcome than concluding the merger in ignorance of the problem which then makes life very difficult for the merged firm.

- Effectively, carrying out an audit is what every law firm should be doing currently in relation to its existing businesses with a view to putting in place a compliance plan. The results of a compliance audit carried out prior to merger will enable the merged firm to know where the 'compliance gaps' may lie and so lay the foundations for compliance by the new firm.

Whether or not two firms negotiating a merger take warranties and/or carry our compliance audits, there will be some matters that will need to be looked at particularly carefully. For example, both firms are likely to want to know the position regarding any complaints made against the other, or circumstances which might lead to complaints, particularly in the light of the proposals by the Legal Ombudsman for the publication of tables listing a firm's name, the number of complaints investigated, the number of times action had to be taken and what area of law the complaint covered. As Socrates wrote over two thousand years ago, 'regard your good name as the richest jewel you can possibly be possessed of': many firms may baulk at the notion of merging with another firm which has had or might have its name published in this way. And will there be any way for parties to a merger (and their professional indemnity insurers) to find out how both firms are 'risk-rated' by the SRA?

Before finalising their approach to issues such as compliance due diligence, the parties to a merger are also likely to consider whether and to what extent they can ask for and expect guidance from the SRA in relation to particular regulatory aspects of their merger. For example, one of the questions which often arises on law firm mergers is how to structure the merger arrangements with a view to arriving at the optimum position for the parties and the new firm. Discussions will often revolve around issues relating to the impact of potential risk areas, taxation and accounting matters and successor practice rules, as well as regulatory matters (particularly where foreign jurisdictions are involved).

However, even in a wholly domestic (i.e. England and Wales) merger situation, achieving the right structure is likely to be crucial for a number of reasons and it is in this context that the parties may wish to discuss matters with the SRA before 'tying the knot'. It would be helpful to know whether and to what extent the SRA will be prepared to discuss such issues with the parties to a merger and proffer guidance, as it will be preferable for the parties to know that their proposed course of action will be approved by the regulator rather than to make a costly mistake.

Notification and approval requirements

A reading of various elements of the SRA Handbook will reveal extensive requirements of firms to notify the SRA in relation to merger arrangements and, since April 2012, to obtain certain approvals which are likely to have timing consequences for completion of the merger and about which the parties should be talking to the SRA at an early stage. The following are just a few examples.

The most recent change which has just come into effect requires recognised bodies (i.e. traditional law firms) to seek the SRA's approval for new managers and owners in advance of them joining the firm, rather than just notifying the SRA (the position prior to 31 March 2012). The term 'manager' refers to a partner, a member of an LLP and a director of a company. The approval process must be completed in advance and cannot be done retrospectively.

In relation to the approval process, under Part 4 of the SRA Authorisation Rules 2011, the SRA will deem a solicitor with a current practising certificate as suitable to be a manager or owner if the criteria set out in rule 13.2 of the SRA Authorisation Rules are met. Application must be made on form NM1 and the SRA says that it expects 95 per cent of decisions in NM1 applications to be made within 30 days of receipt of the completed form. Merger agreements will now need to take account of this approval requirement. The effect on the lateral hire of partners (as opposed to mergers) will also need to be thought through.

So, are compliance audits a way through this minefield?

Rule 8.7 of the SRA Authorisation Rules 2011 requires a firm to notify the SRA:

'as soon as it becomes aware of any changes to relevant information about itself, its employees, managers or interest holders, including any non-compliance with these rules and the conditions of the body's authorisation'.

If such changes involve, for example, having a new COLP or COFA for the merged firm, then approval for a replacement will be required.

Guidance note (xv) to rule 8 says that firms must update the SRA by giving details of general changes that occur in respect of a firm and lists reporting and information requirements that apply to individuals or firms to include:

- rules 3, 8.7, 8.8, 8.9, 8.10, 18, 23, 24 and 25 of the SRA Authorisation Rules 2011;
- rule 18 of the SRA Practice Framework Rules 2011;
- rule 32 of the SRA Accounts Rules 2011;
- regs 4.3, 4.5 and 15 of the SRA Practising Regulations 2011;
- chapter 10 of the SRA Code of Conduct; and
- s.84 of the Solicitors Act 1974 (notification of a solicitor's place of business).

Rule 8.3 of the SRA Authorisation Rules also needs to be considered carefully, requiring as it does the giving of a notice of succession in certain circumstances (which include a merger) in relation to the calculation and payment of fees to the SRA. And if a merger results in a partnership split (as sometimes happens), rule 24 will need to be carefully considered to ascertain which of the groups of former partners will continue to be covered by an existing authorisation.

Accordingly, if two firms are considering merger then they will need at an early stage to research every notification and approval requirement in the SRA Handbook which could apply to them arising from their merger and draw up a list of what will need to be notified or what approval obtained and by when. These requirements may affect both the potential merger structures to be adopted and the date of completion of the merger arrangements, leading to a timing gap between signing and completion to enable such matters to be dealt with.

Consideration will, however, also need to be given to the continuing requirement to meet all the outcomes set out in the

SRA Code of Conduct, and in particular those set out in chapter 10, which include the following:

- **outcome 10.1** – 'you ensure that you comply with all the reporting and notification requirements in the Handbook that apply to you';
- **outcome 10.2** – 'you provide the SRA with information to enable the SRA to decide upon any application you make';
- **outcome 10.3** – 'you notify the SRA promptly of any material changes to relevant information about you'.

And reporting to the SRA details of a merger and key personnel joining or leaving the firm are specifically mentioned by indicative behaviour 10.8 as behaviour which may tend to show achievement of outcomes.

Putting effort into the implementation of a merger is the key to the ultimate success

One particular issue which can arise on a merger is when one party discovers something about the other firm which, notwithstanding a confidentiality agreement between the parties, may require disclosure to the SRA. Outcome 10.4 requires you to report to the SRA promptly serious misconduct by any person or firm authorised by the SRA. No doubt in such circumstances that party will also walk away from the merger talks.

Other chapters in the SRA Code of Conduct which will need to be carefully considered include:

- **chapter 1** (client care), particularly in relation to informing clients about the merger and how they may wish their matters to be dealt with in the future;
- **chapter 3** (conflict of interests), where the effect of the merger might be to place the merged firm in a conflict situation;
- **chapter 4** (confidentiality and disclosure), particularly in relation to information exchange and due diligence;
- **chapter 8** (publicity), in relation to, for example, how the merger is announced and the merged firm's continuing operations.

As can be seen from the above examples, the notification and reporting requirements arising from a merger are complex and extensive and, as already mentioned, if two firms are contemplating merger then they really need to be clear as to every notification requirement they must meet. This will be an important and necessary task to be completed on any merger, and will require resources.

Implementation: merger is the beginning, not the end!

Putting effort into the implementation of a merger on every level is usually the key to the ultimate success of the merger. This will be as important in relation to SRA compliance as any other aspect of merger implementation and a few pointers to helping to achieve this are mentioned below.

If the two legacy firms have carried out their due diligence and, in particular, a compliance audit, then between them they should have a very good picture of the extent to which each is compliant and any compliance gaps which the new merged firm will need to fill. In particular, they will need to go through the same processes they followed in their legacy firms in relation to putting in place a 'compliance plan'.

However, it will be sensible for a newly merged firm *to think bigger and adapt to the enlarged size of the new firm by growing with it.*

Accordingly, when considering how to achieve particular outcomes in the SRA Code of Conduct, the new firm should take into consideration the enlarged size and complexity of the business and understand that compliance procedures which might have worked well in each legacy firm may not be appropriate to the new firm. Particular note should therefore be made of the mandatory outcomes in chapter 7 of the SRA Code of Conduct, including:

- **outcome 7.1** – 'you have a clear and effective governance structure and reporting lines'; and
- **outcome 7.2** – 'you have effective systems and controls in place to achieve and comply with all the Principles, rules and outcomes and other requirements of the Handbook'.

Thus, if you are a managing partner, rethink how you operate personally and, in particular, delegate more – you cannot in a larger organisation do it all yourself. Quickly enhance the quality of the management capability if necessary by upgrading systems and people and do not avoid taking tough decisions. This may involve, for example, recruiting professional compliance people with a view to building a stronger team around the COLP and COFA. The need for greater resources is likely to have been part of the rationale for merger and something which the new firm should be better able to afford.

Merger should also be seen to be not just the opportunity to build a more competitive firm, but also to take compliance management to a higher level than either of the two legacy firms could have achieved.

A brainstorming exercise should be carried out in relation to the outcomes in each chapter of the SRA Code of Conduct to see whether the new firm will be able to achieve every outcome, to ascertain where any gaps may lie, and then take whatever steps are needed to ensure compliance on an ongoing basis.

At the same time the merged firm should carry out a cost-benefit analysis to ascertain the most resource-effective method of managing compliance in the new firm – for example, whether to use part-time partners or compliance professionals or internal resources to carry out all aspects of compliance management or whether to buy in some aspects. These are, however, matters which should not be left for consideration and decision until after the merger is concluded – they should be agreed as part of the merger agreement and ideally implemented between signing and the merger taking effect so that the new firm hits the ground running.

Mergers between law firms have always been fairly complicated matters requiring a great deal of expertise and thought. It is likely that, with the advent of OFR, the merger process will now require even more thought, but hopefully the new regulatory regime will not be a stumbling block to further consolidation within the profession that is now so urgently needed to secure the future competitiveness of its members.

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