Musical chairs: solicitors' liabilities under the Successor Practice Rules

There is nothing new in solicitors' firms merging or one firm absorbing and "incorporating" another, and there seem to have been a striking number of high profile mergers and take-overs (and some de-mergers) in recent years.

The dramatic reduction in fees from property and commercial work and the squeezing of profit margins caused by the current economic downturn might well lead many firms to consider mergers or taking on teams of lawyers from other practices to help by providing economies of scale and strength in numbers. But as well as these obvious commercial considerations, there are very important implications relating to the liabilities arising from the practices concerned which should not be overlooked – and cannot be avoided.

In the days of the Solicitors' Indemnity Fund (SIF), the monopoly indemnity provider for all firms, it mattered far less precisely how liabilities transferred when firms split or merged, since, in the event of a third party negligence claim, all claims were funded and paid by the great monolith, SIF. But since professional indemnity (PI) insurance was thrown open to the commercial market in September 2000 the question of who carries the liabilities for matters conducted by a previous, but now defunct, firm – and which insurer must provide indemnity – is of real importance, not only to claimants seeking to make a recovery but to the partners of any firm that has merged with another or taken in principals from a firm which has ceased practice.

The Law Society and Solicitors Regulation Authority have sought to provide clear answers to this question, which may arise in a myriad of situations: see the relevant provisions of the Solicitors Indemnity Insurance Rules and the Minimum Terms and Conditions, collectively referred to loosely as the successor practice rules. This scheme is not always simple and can produce seemingly unfair results. It seeks to fix a firm (the "Successor Practice") with a requirement to maintain PI cover for new claims arising from a "Prior Practice", regardless of the legal transfer of the Prior Practice's third party liabilities in contract and tort. When trying to track which firm, if any, is subject to the obligation to maintain insurance for a claim relating to a defunct firm, a careful reading of these provisions is required.

The starting point is that a Successor Practice (referred to here as 'B') is required to maintain insurance cover in respect

of matters arising from a Prior Practice ('A'). The change which triggers the successor practice provisions is referred to as the "transition", and this is (tautologically) defined as meaning any *"merger, acquisition, absorption or other transition which results in A no longer being carried on as a discrete legal Practice"*.

There are various ways in which a firm can be deemed a Successor Practice, including the following most common examples. In each case the Prior Practice is referred to as 'A' and the Successor Practice as 'B'.

1. B holds itself out as A's successor or as incorporating A
The holding out can be express or implied, and can be seen on the firm's notepaper, business cards, e-mails, publications, promotional material or otherwise. Imagine a sole practitioner firm, Old & Co, being wound up because Mr Old retires to tend his geraniums. The large local firm of Up & Coming buys his assets and client base and styles itself as 'Up & Coming (incorporating Old & Co)'. The transaction expressly excludes the taking on of any liabilities of Old & Co. Five years later a claim is made by one of Mr Old's former clients for negligence perpetrated in the last year of his practice. In these circumstances, Up & Coming is deemed the Successor Practice and its insurer is required to cover the third party claim – the exclusion of legal liabilities in the sale agreement is ineffective to preclude this, which could come as a shock to the partners of Up & Coming. The only way they might have some security is if they took an indemnity from Mr Old at the time of the transfer (and assuming he is able to satisfy it).

2. A was a sole practitioner and moves to B as principal or assistant
In this scenario Mr Old closes down his firm and is employed by Up & Coming (with no change of name) without becoming a partner in it – either as an assistant or more likely as a consultant. Again, Up & Coming is liable to Mr Old's former client. Note the potential unfairness to that firm if, because of the size of its practice, it has a large excess (say, £50,000) while Old & Co had a small excess of £3,000 – the partners of Up & Coming (but not Mr Old) may end up paying the whole of the claim themselves for Mr Old's historic negligence of which they previously knew nothing.

3. The majority of the principals in A become principals in B
Imagine Hungry & Co, an 8-partner firm splitting up, with 5 partners going to Up & Coming, 2 partners going to Messrs Small & Co and the senior partner, Mr Hungry, retires from practice. Again, Up & Coming is the Successor Practice and must deal with a claim arising from the previous firm's practice.

4. No majority of principals ends up in another firm, but one or more principals move to B as principals, and one or more of the following apply:

a) B is carried on under the same name as A or a name which substantially incorporates A's name (or a substantial part of A's name)
b) B is carried on from the same premises as A
c) B acquired the goodwill and/or assets of A
d) B assumed the liabilities of A
e) The majority of A's staff became employed by B

This shows how widely drawn the provisions are. But note that the 'holding out' provision in point 1 above trumps the others. Imagine the 7 remaining partners of Hungry & Co all joining Small & Co on the retirement of their esteemed senior partner, but the client base and goodwill of the firm is sold to Up & Coming, which now styles itself as "Hungry, Up & Coming". When Mr Hungry's negligence of 5 years earlier comes to light it is Hungry Up & Coming that will be liable, even though the 7 solicitors who were partners of the errant Mr Hungry (and hence would have been jointly liable with him in law) all practice together elsewhere.

So the decision, for example, to take on part of another firm's name, or to employ a sole practitioner as a consultant for a year before he retires, while it may have great commercial attractions, can have serious consequences if any old claims subsequently emerge. The consequences could be magnified if a whole series of claims (perhaps by the same lender against different files) were later made.

Successor Practice liabilities should be seen as a risk factor to be taken into account whenever such a merger or take-over or purchase of another practice is being considered, and this is likely to be especially relevant where the levels of the excess in the prior and successor practices are very different. Practitioners should bear in mind that any exclusion of liabilities in the agreement governing the transfer is likely to be ineffective, although there is nothing to stop the partners in the firm, when taking on someone else's practice liabilities, requiring an indemnity to be granted against those liabilities.

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