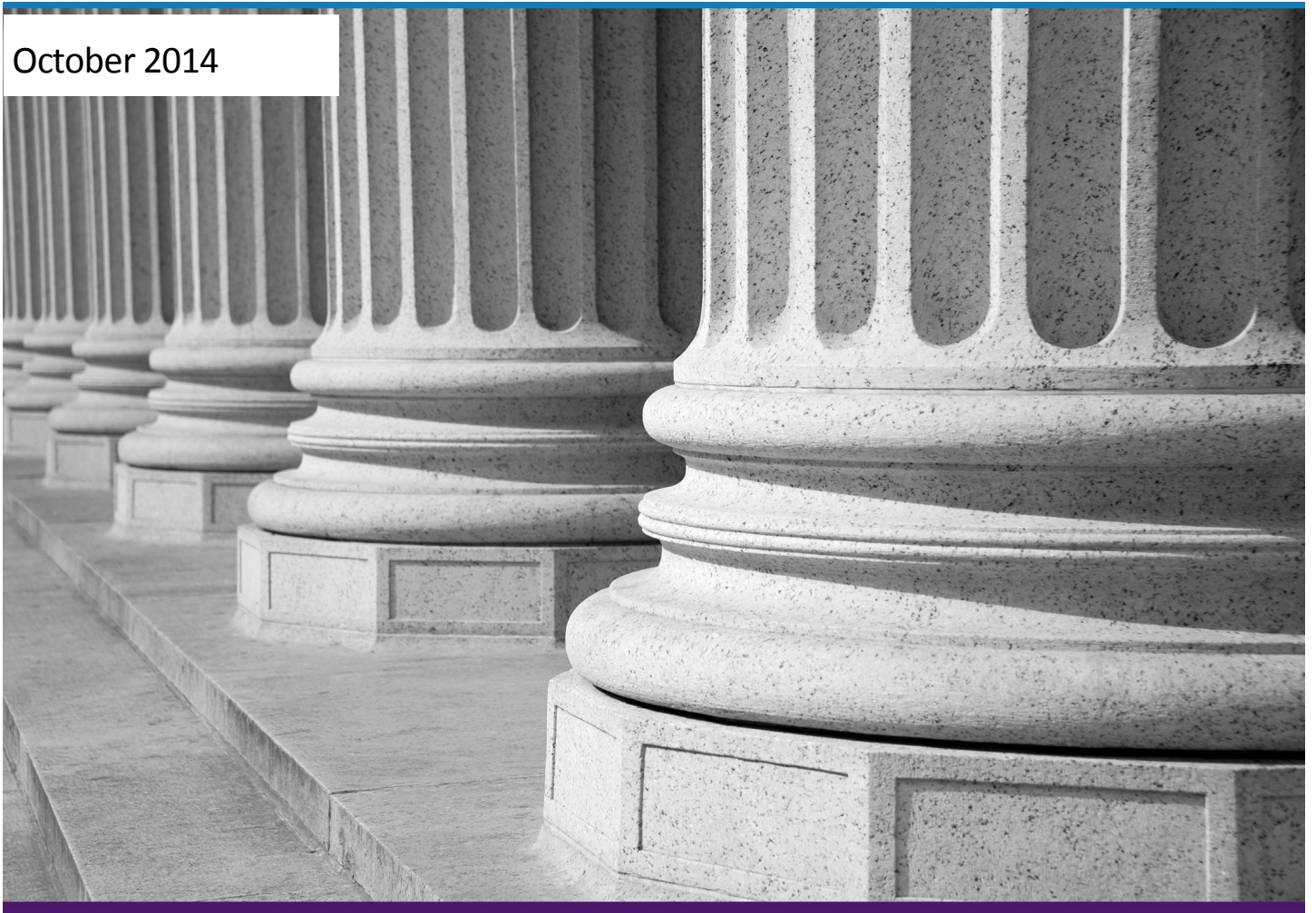


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## Lending to law firms

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**Since the relaxation of the restrictions on business structures for law firms in 2011 (with provisions coming into force permitting "Alternative Business Structures"), limited liability partnerships ("LLPs") have become the preferred business structure for law firms.**

**Broadly, the reasons for this are to ensure limited liability for their members while retaining the flexibility and tax advantages associated with an ordinary partnership.**

**Accordingly, whilst it is possible to structure a law firm in a manner other than as an LLP, this article will focus on exigencies associated with lending to law firms structured as LLPs.**

## **Features of an LLP**

An LLP is a business entity introduced by the Limited Liability Partnership Act 2000 ("LLPA"). LLPs have a number of characteristics which distinguish them from alternative business structures such as companies, limited partnerships or partnerships. These include:

- Unlike limited partnerships or partnerships, an LLP is a body corporate with a legal personality separate from that of its members (of which there must be at least two). This means that it has all the powers of a natural person (i.e. it can hold property, enter into contracts and sue or be sued).
- The liability of a member to contribute to the liabilities of the LLP in the event of it being wound up is, subject to certain exceptions, limited to the amount contributed by that member to the LLP, broadly speaking their capital contribution and any undrawn profits.
- The LLP does not pay tax but rather the members are liable for tax on their income and capital profits in the same way as in an ordinary partnership.
- Each member of an LLP is an agent for the LLP and has the power to bind the LLP to contracts. Members have duties applicable to them similar to director's duties, although their interest in the LLP is more akin to shareholders.

An LLP must be registered at the UK Companies House in order to be validly incorporated. An LLP may rely on the LLPA for its rights and duties in relation to the LLP. Normally, however, the rights and duties of members of an LLP are governed by a written partnership or members' agreement ("Partnership Agreement"), but such an agreement is not mandatory.

## **Lending to a law firm**

In addition to the usual considerations involved in considering whether to provide finance, lenders should also consider the following matters specific to lending to a law firm:

### ***Terms governing the law firm***

Whether or not the law firm is governed by a separate Partnership Agreement or whether it relies on the default provisions set out in the LLPA will be relevant. If a separate Partnership Agreement exists (which invariably will be the case), a lender will want to ensure that such document is satisfactory. Typically, a lender will want to ensure that:

- The Partnership Agreement is duly signed and the law firm is duly formed and registered.
- The Partnership Agreement does not contain any fetters on the power of the law firm to do all such things as are required of it in connection with the transaction.
- The authorisation requirements in the Partnership Agreement required to commit the law firm to the documents are duly completed, including authorisation by the law firm of the members who are intended to sign the finance documents on behalf of the law firm (which person must actually be a member of the law firm at the time of signing).

If a lender has engaged external lawyers, it may be that, the borrowing law firm does not wish for another law firm to review and be privy to the terms of its Partnership Agreement. In such case, the lender's internal legal counsel will need to be satisfied as to the matters set out above.

In any event (whether or not reviewed by external counsel), the lender should obtain a certified copy of the Partnership Agreement and any relevant authorisation documents as a condition precedent to lending.

### ***Covenants in finance documents***

In addition to a review of the Partnership Agreement, the loan agreement should contain covenants in relation to the composition, continuance and business of the law firm. Such covenants should cover the following matters:

- Terminating the law firm or taking steps to terminate the law firm should be prohibited.
- Changes to the composition of the law firm should be controlled. Typically an outgoing partner will wish for its capital contribution to be repaid at the time of leaving the partnership. Accordingly, the loan agreement may need to allow for an ability of the law firm to repay capital contributions for outgoing partners. However, a lender may

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wish to include some restrictions on the number of partners that may leave in a particular period to ensure that a large exit of partners from the law firm cannot occur without its consent.

- Changes to the Partnership Agreement should be restricted, in particular, the lender will want to ensure that the copy of the Partnership Agreement provided to it is the most up to date version.
- Financial covenants to monitor the health of the business, for example an interest cover test/ debt service cover test or a test measuring recoverable WIP and debtors as against the amount of indebtedness owing by the LLP to the lender.
- Usual warranties conformed to reflect the borrower being an LLP (eg. power and authority of the partnership, due formation and registration, compliance with laws, each partner validly appointed etc).

## Security

### *Guarantee and indemnity by members*

As the liability of members is limited under an LLP structure, a lender may wish to consider obtaining from the partners a guarantee and indemnity on account of the debts of the law firm. Any guarantee and indemnity should be considered carefully in light of any capital contribution loans of individual partners. It is likely that most law firms will resist this.

### *Debenture over LLP assets*

As an LLP is a legal person in its own right and has unlimited capacity, it is capable of granting security over its assets, including by debenture or instrument granting a floating charge, as security for monies lent to it.

Typically the most valuable asset of a law firm is its goodwill, WIP and debtors. A law firm will usually also own or lease its fit out (to the extent not owned by the landlord) and will have a lease of its office premises.

Whilst fixed charges are generally considered to be more desirable than floating charges, in the case of a charge over WIP and debtors, a lender may wish to consider whether, in the circumstances, a floating charge is more appropriate than a fixed charge if the law firm wishes to continue to control its WIP and debtors in the ordinary course of its business and to use the proceeds for working capital. In the context of a particular transaction, a lender may consider this to be acceptable, rather than to establish blocked accounts and monitor each payment in and out of such account.

One point that the law firm will have to consider in granting security over its assets, is that it does not breach the confidentiality of its clients through the granting of the security, or in the manner in which it is enforced.

Security granted by an LLP must be filed in respect of the LLP at Companies House (as is the same for a limited company incorporated in England and Wales).

### *Security over a member's interest in an LLP*

Under the LLPA, a member of an LLP is able to grant security over its interest in the LLP, provided that neither the member nor the assignee who receives the benefit of the charge can interfere with the management or administration of the business or affairs of the LLP (section 7 LLPA).

However, under the Solicitors Regulation Authority Handbook, a member of an LLP practising law is prohibited from granting security over its interest in the LLP.

There is no equivalent provision restricting the LLP itself from granting the security, just the members.

### *Loans to Partners*

In conjunction with lending to a law firm, a lender may also provide facilities to individual partners to fund their capital contributions to the law firm.

If this is the case, consideration needs to be given to the separation of the liabilities of each partner under its capital contribution loan and the liabilities of the partnership for the debts of the law firm under the primary loan agreement.

If a guarantee and indemnity is granted by the partners on account of the debts of the law firm, this and any other security should be careful to carve out the indebtedness of the individual partners under their capital contribution loans.

As part of agreeing to provide loans to individual partners to fund their capital contributions, normally a lender will require an undertaking from the law firm under which the law firm agrees to pay any capital payments due to any such borrowing partner direct to the lender.

### *Solicitors Regulation Authority*

In enforcing any security granted by a law firm, the lender, or a receiver appointed by the lender should consider the rules and regulations applicable to a law firm as issued by the Solicitors Regulation Authority.

It is likely that as a condition of granting security, a law firm will require that the lender agree to this.

## Summary

In summary, in addition to the usual considerations applicable to lending to a new customer, if the customer is a law firm structured as an LLP, the lender will also need to ensure:

- The terms governing the partnership are acceptable to the lender and all things required under the Partnership Agreement to authorise the entry by the partnership into the relevant documents.
- Relevant covenants are included in the finance documents to ensure that the partnership does not change in a manner which is unacceptable to the lender but also to allow movement of partners if appropriate.
- Security should be considered carefully as well as enforcement rights in light of ongoing obligations of law firms to comply with regulations and rules made by the Solicitors Regulation Authority.
- The lender may wish to also offer individual partners of the law firm loans to fund capital contributions.

This briefing is intended only as a guide and does not constitute legal advice. We would be pleased to provide more detailed advice if required.

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