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LSLA SJ Civil Conduct article

Here Be Dragons

Individual clients are often asset rich, but cash poor. The gap between legal fees and the ability to pay is increasing. Third party funding, CFAs, DBAs, ATE or any combination are not always available, appropriate, or affordable.

Solicitors have been finding increasingly creative approaches to funding from agreeing to payment over time or by instalments to more complex arrangements such as charging interest and/or providing some form of security. Probably best known is a Sears Tooth Agreement, secured by a charge over property, and widely used in matrimonial financial cases.

The precise application of financial services rules, including the consumer credit regime, to these types of arrangements has never been entirely clear. Following recent changes, including amendments to the SRA Financial Services (Scope) Rules 2001 ("Scope Rules"), the position has shifted again.

Regulations

On 1 April 2016 the Scope Rules were amended to clarify the types of consumer credit activities law firms can undertake without being FCA regulated.

Part 20 FSMA permits SRA-authorised firms to undertake certain regulated activities as an exempt professional firm ("EPF") provided they comply with the Scope Rules. The SRA's 'consumer credit toolkit' is intended to assist firms in understanding their obligations relating to consumer credit activities but it does not address the myriad (at times conflicting) provisions and obligations.

Credit arrangements

Law firms should consider three broad issues if undertaking credit arrangements with clients:

(i) Is it a 'regulated activity'?

To be engaged in a regulated activity for FSMA purposes (such as entering into regulated credit agreements), a firm must be carrying on a specified activity "*carried on by way of a business*" (s.22 FSMA). The definition is clarified by the Perimeter Guidance Material 2.3, with the general conclusion that:

"Whether or not an activity is carried on by way of business is ultimately a question of judgement that takes account of several factors.....These include the degree of continuity, the existence of a commercial element, the scale of the activity and the proportion which the activity bears to other activities carried on by the same person but which are not regulated."

(ii) Is the firm authorised for those credit purposes?

The core prohibition (s.19 FSMA) makes it an offence to carry on a regulated activity in the UK unless authorised or exempt.

An SRA-regulated law firm should be exempt under s.327 FSMA in relation to regulated consumer credit activities conditional upon compliance with:

(a) Part 20 FSMA (in particular s.327(4) and s.332(4)); and

(b) the SRA Financial Services (Scope) Rules 2001, and the SRA Financial Services (Conduct of Business) Rules 2001 (together the "SRA Rules").

The Scope Rules specifically prohibit:

(a) Rule 3.1(l) – entering into as lender, or administering, a 'regulated mortgage contract'.

(b) Rule 5.11(b) – entering into a 'regulated credit agreement' as lender (or otherwise exercising the lender's rights and duties under such an agreement), which is secured on land by a legal or equitable mortgage.

A law firm wishing to enter into regulated credit agreements, other than those permitted by the legislative and regulatory regime, must have separate FCA authorisation. This appears to include funding arrangements secured over land (whether a first or second, legal or equitable charge).

Any funding arrangement between law firm and client, which includes security over land, no longer appears to be available if the firm is only SRA-regulated. There are exemptions (such as for high net worth individuals), and a more limited application of the Consumer Credit Act ("CCA") for non-commercial agreements.

(iii) <u>Law firms' obligations on agreement content.</u>

A firm is bound by CCA obligations if it enters into a regulated credit arrangement that does not benefit from an exemption. Even if the credit arrangement does not include requirement for a legal charge it must still comply with CCA obligations. Failure to comply renders it potentially unenforceable.

Payment delays

Any form of "financial accommodation" (including giving a client time to pay) amounts to "credit".

Exemptions include where: (i) the number of repayments does not exceed 12; (ii) the payment term does not exceed 12 months; and (iii) no interest or charges are levied. Solicitors cannot rely on the exemption for payment by instalments where liability has already been incurred.

Law firms have an immediate problem (particularly with an ongoing retainer) if a client fails to pay an invoice, seeks extra time but cannot meet the provisions of the exemption. Are firms meant to immediately cease to act; issue proceedings; or simply write-off the liability?

Conclusion

Law firms seeking to be creative about funding options for individual clients including time to pay may face a significant regulatory risk.

Until SRA guidance is expanded and clarified, law firms should approach any form of funding arrangement for an individual client cautiously or risk falling foul of the regulatory dragons.

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