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Law firm demergers: issues to consider

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A practice note outlining the high-level practicalities and issues that a law firm should consider when demerging or divesting itself of a non-core part of its business, either by sale to an acquiring firm or by spin out into an independent entity.

Scope of this note

UK legal services firms have increasingly diversified by seeking new opportunities to serve existing clients and attracting new business by offering more services at greater scale.

Diversification provides opportunities for growth and the cross-referral of business within a firm. However, shifting markets, regulatory issues and difficult economic conditions can often reduce its benefits.

Following the COVID-19 pandemic and Brexit-related and other challenges facing the UK economy, many firms will undoubtedly recalibrate their strategy and business plans to bolster business resilience while maintaining growth and profitability. Some firms may focus on and invest in their core and profitable business lines, and scale back and divest non-core and unprofitable business areas. This is usually achieved by selling the non-core business to another firm or demerging the relevant business into an independent spin-off.

This note highlights the high-level issues and practicalities that a law firm regulated by the Solicitors Regulation Authority (SRA) in England and Wales should consider when demerging or divesting itself of part of its business. These include how to plan the demerger, with a particular focus on setting up the new entity, and obtaining partner and regulatory approval.

The note does not cover acquiring a demerged business. For further information from the acquirer's perspective, see Practice note, Legal business M&A and reorganisations: overview.

Typical demergers

Typically, a demerger of a firm that is organised as a partnership or a limited liability partnership (LLP) involves a transfer by the divesting firm of the demerging business and associated assets and people (the demerging business) to a newly formed partnership, LLP or company (the new entity).

Some of the first issues that a divesting firm should consider include:

- Precisely what portions of the business are being transferred out of the divesting firm.
- Whether the demerging business is being sold to a third party or setting up as a new independent entity.
- Which partners or members, if any, are transferring with the demerging business.
- Whether the existing constitutional document or partnership agreement contains any terms that apply to a demerger.

Planning for the demerger

A demerger can often be a complex and sensitive process. It requires careful handling and preparation to ensure successful implementation, and to avoid disruption to the business and clients and the potential destabilisation of the partnership (or membership) and workforce if the demerger ultimately does not succeed. The more planning the divesting firm and the acquiring firm or proposed leadership of the new entity do before the process begins, the better the prospects of the demerger proving successful in the long term. For information about change management techniques which may assist the process, see Practice note, Change management: an introduction.

Identify the objectives of the demerger

A successful demerger is largely dependent on the wide support of the partnership and the partners of the demerging business (the demerging partners). It is therefore important for the senior management team in the divesting firm to identify and articulate to the partnership (or members and so on) the strategic

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objectives that the demerger aims to achieve for both the divesting firm and the demerging business.

Common objective drivers of a partnership demerger include the following:

- **Streamline business and expenditure and improve profitability.** A firm that has rapidly expanded into a range of practice areas may find that some business lines have consistently underperformed, no longer align with the firm's future strategy or both. Refocusing on its core competencies and divesting non-core and less profitable parts of the business are likely to reduce the firm's overheads and improve its profitability.
- **Autonomy.** For the demerging business, financial and management autonomy and the freedom to pursue a strategy that is specifically tailored to the demerging business and its clientele can unlock untapped value. This can be a compelling incentive for partners and employees in the demerging business to spin out as an independent firm. Where the demerging business is being acquired by an established firm, the demerger offers the demerging business the opportunity to develop its practice with the support of an acquiring firm which may be more aligned to its objectives.
- **Navigate regulatory issues.** Certain professional services and activities, such as audit, reserved legal services, insurance and financial services, are highly regulated. Compliance with a regulatory regime may involve significant costs and management time, and even restrict certain business activities. For example, the regulatory duties of independence and confidentiality that apply to solicitors and auditors can often cause intractable conflict issues in multi-disciplinary legal and audit practices. Brexit has also complicated the regulatory landscape for many regulated professions. For example, UK law firms with offices in the EU may no longer be permitted to practise in certain EU jurisdictions through their existing legal structures. A reorganisation of the firm's operations in those jurisdictions may be unfeasible or unattractive. The divestment of parts of the firm's business or certain non-core offices may therefore be necessary to avoid these conflicts and regulatory issues.

Plan and prepare for the demerger process

The following substantial legal steps to undertake a demerger require careful planning and preparation:

- **Establishing the new entity.** Unless an established firm is acquiring the demerging business, a demerger will involve the establishment of a new legal entity that is directly or indirectly owned by some or all of the demerging partners. This may be a partnership, LLP or limited company.

  For further information, see the following resources:

  - Article, Law firm structures: optimising opportunity;
  - A toolkit for general partnerships: Choosing the form of partnership;
  - A toolkit for limited liability partnerships: Creating a limited liability partnership;
  - Checklist, Setting up a limited liability partnership; and
  - A toolkit for forming a limited company: Forming a private limited company.
- **Defining ownership and control.** The partners of the new entity must agree their ownership and control rights and their duties, liabilities and financial entitlements, and set these out in a new constitutional agreement (whether articles of association or a partnership agreement) for the new entity. This usually involves significant consultation and negotiations. Where the demerging business is being acquired by an established firm, the demerging partners will want to negotiate their position within the acquiring firm. For information about some of the issues that may require negotiations, see Seller warranties and limitations on liability: commonly negotiated issues: business purchases.
- **Employees of the demerging business.** The employees of the demerging business may be transferred to the new entity or acquiring firm under the Transfer of Undertakings (Protection of Employment) Regulations 2006 (SI 2006/246) (TUPE). A transfer under TUPE requires employees to be given information and to be consulted within specified timescales, and they are also protected from changes to their terms and conditions of employment. The leadership of the divesting firm must carefully consider any issues in relation to compliance with TUPE and the consultation process, and factor these into the timetable for the transaction. For further information about the transfer of employees under TUPE, see Transfer of undertakings (TUPE) toolkit.

Legal and operational separation of the businesses

If the demerger and future arrangements are approved by the relevant partners, the demerging business needs to be transferred from the divesting firm to the new entity or acquiring firm in accordance with (respectively) a demerger or sale agreement. This includes the transfer of the demerging business's assets, employees and liabilities such as office lease, equipment, loans and client contracts.

The divesting firm may have entered into contracts (including with clients and suppliers) which relate to,

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benefit or are required by the new entity or acquiring firm. These contracts may need to be assigned to the new entity or acquiring firm. If that is not possible, or if the divesting firm needs to retain certain contracts, new contracts may need to be replicated or negotiated with the relevant counterparty and entered into by the new entity or acquiring firm.

Any transfer of client engagements need to be managed carefully to ensure that applicable professional duties to clients are complied with. Both entities need to agree a managed approach to notifying affected clients and obtaining consent to transfer files and confidential information and assign, or renegotiate, any terms of engagement.

Setting up a new entity: practicalities

The practical aspects of a demerger should not be forgotten or left to the last minute. If the demerging business is spinning out into an independent new entity, the new entity is likely to need:

- Regulatory authorisation (see Regulatory approval).
- New bank accounts.
- Its own insurance policies, including professional indemnity insurance (PII). For information about PII and successor practice issues, see Practice note, Law firm closure: professional indemnity run-off insurance and successor practices: Successor practices.
- Notifications to HM Revenue & Customs.
- Its own internal policies and procedures, tailored to the new practice. For guidance, information and template resources for designing a full suite of policies and processes for a law firm, see Practice Compliance & Management: Design policies and processes.
- Branding, website, email accounts and headed paper.
- File management, accounting and IT systems.
- To secure its own office space in advance of the completion of the demerger. All physical equipment and assets need to be transferred to any new premises.
- To recruit additional staff, or engage outsourced providers, if the new entity will not have continued access to the centralised support services of the divesting firm, such as the finance team, IT support, compliance and HR teams. For template outsourcing policies which may be adapted for use by law firms, see Standard documents, Outsourcing agreement: long form and Outsourcing agreement: shorter form.

Transitional services agreements

Most separation practicalities are often governed by the demerger or sale agreement, or by a transitional services agreement. Such an agreement allows for a temporary period of co-operation between the divesting firm and the new entity or acquiring firm to smooth the separation process.

For further information and templates that may be adapted for use by law firms, see the following resources:

- Checklist, Transitional services agreements.
- Standard document, Transitional services agreement.
- Standard document, Transitional services agreement: intra-group reorganisations.
- Standard document, Computer services agreement.

Potential issues

There are several issues which could complicate a demerger.

Obtaining partner approval

The divesting firm's partnership agreement may set out a specific voting threshold and procedure to approve a divestiture of part of its business. Voting thresholds for these types of decision in a partnership agreement for a professional services firm typically range between a simple majority and unanimous partner approval. If no threshold is specified, then unanimous approval may be required by default.

The divesting firm's senior management team should consider from the outset whether the requisite approval threshold is realistically achievable. A requirement for 90% or unanimous partner approval can be very difficult to attain, particularly in large, dispersed partnerships. In these cases, management may need to consider potential workarounds, such as an amendment of its partnership agreement, before embarking on a demerger.

Once the demerger process is initiated, it is vital for the divesting firm to engage in advance planning and consultation with the demerging partners and the wider partnership to ensure that the requisite partner approval can be achieved.

Dissenting partners

Even if the requisite partner approval is secured, it may transpire that not all of the demerging partners agree with the demerger, whether for professional or personal reasons. In these circumstances, the divesting firm needs to consider how to treat these partners in the future.

If the demerger goes ahead without the dissenting partners, the partners who are left behind may need

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to be redeployed to other parts of the divesting firm's business. If that is not possible, the divesting firm may need to agree exit terms with those partners.

Financial terms

Most demergers of professional services firms do not involve the payment of consideration for the goodwill of the demerging business, although there are exceptions. Typically, the new demerged entity pays the net asset value of the demerging business to the divesting firm. Both firms will wish to ensure that a fair and balanced approach is taken to determining and valuing the assets and liabilities being transferred, such as the work in progress and book debts, and agreeing how these are collected and dealt with in the future.

Other financial terms to consider are the repayment of capital and the payment of undistributed profits and other reserves that are due to the demerging partners. The payment of these amounts may be accelerated, compared with the usual timescales set out in the divesting firm's partnership agreement, to facilitate the demerger.

Regulatory approval

Regulatory authorisation or notification may be required for both the divesting firm and any new entity before the demerger takes effect. Prior regulatory authorisation may involve a lengthy process and should be initiated at an early stage to avoid delays in the transaction timetable.

For information about obtaining SRA authorisation for a new legal services business, see Checklist, SRA firm authorisation and Flowchart, SRA firm authorisation process.

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