Staying Firm (or Not): the various business models available to solicitors

INTRODUCTION

For a long time, the options for solicitors' practices were limited to being a sole trader or partnership, which are together described in this note as traditional firms. More recently, they have been able to incorporate limited companies or limited liability partnerships, together described in this note as corporate bodies. Different considerations apply, depending on which model is chosen.

This note references some of the key differences between the various models and some of the implications of one being selected over the others.

The Law Society Gazette reported last week that Oliver & Co Solicitors of Chester is to become employee-owned with its shares held on trust and every employee of over six-months' standing receiving an equal share of the profits. It is not the first practice to adopt this model, but the move remains vanishingly rare within the profession. The move does, however, highlight the wider shift away from the traditional law firm structure.

Statistics posted online by the SRA date back to July 2010, when 70% of regulated practices were sole traders or partnerships and only 28% were limited liability partnerships ('LLP's) or companies. A further 1% were mysteriously described as 'other' and the remainder were unaccounted for. Five years later, a narrow majority of practices had opted for one or other of the limited liability models, at 51% against the 49% which remained as traditional firms.

Scrolling up to September 2022 at the top of the table, the percentages are almost exactly reversed from those at the bottom with companies and LLPs accounting for 68% of regulated practices and sole traders and partnerships making up just 31%. The final one percent was once again curiously unaccounted for.

Many, including the SRA, use 'solicitors' firm' as an umbrella term regardless of the model adopted. This is convenient and, for some purposes, it may not make much difference whether a traditional or limited liability structure has been adopted. But it risks overlooking the significant differences between the various models and the implications flowing from them.

LEGAL ENTITY

In the case of a sole trader, the firm is really just a brand name under which the individual concerned does business. It will very often be or include the individual's name, perhaps with the suffix '& Co' or 'Solicitors'. A partnership is a more complex arrangement but remains an arrangement between individuals. The partnership may rank in all the directories, have a presence in numerous countries and thank the staff every Christmas for all their hard work. But it is not a legal entity in and of itself. It can, however, sue and be sued as if it were.

By contrast, it has been understood since the seminal case of *Salomon v Salomon* [1897] AC 22 that a limited company has a legal personality of its own, distinct from its members and directors. The Limited Liability Partnership Act 2000 extends the same principle to LLPs.

It is worth noting, however, that LLPs are something of a hybrid. They share many of the characteristics of a limited company but some of a traditional partnership. There are no shareholdings or articles of association. The members are free to agree their internal arrangements and they are taxed as in the same way as partners.

LIABILITY

A number of advantages accrue from a corporate body having a separate legal personality, but perhaps the most important is that (as the name suggests) it limits the liability of its members or shareholders. Subject to personal guarantees and the like, if the practice does not have the assets to meet a liability, the members or shareholders are not obliged to contribute funds of their own. In traditional firms, by contrast, the principal(s') liability is unlimited. Partners are jointly liable.

TRANSPARENCY

Practices contemplating incorporation as a company or LLP need to be mindful of the information which this will put into the public domain. Officers no longer have to make their home addresses publicly available, but the practice will need to file annual accounts which will be freely accessible online to employees, competitors, and anyone sufficiently curious. Some practices will be perfectly happy with the transparency involved, but others might be less enthusiastic.

DUTIES

Given that company law developed from the existing law of partnership, it is no surprise to find significant overlaps between the duties owed by company directors and partners. That is not to say that they are coterminous. It is outside the scope of this note to catalogue the differences but one fundamental one is that partners owe duties to each other while directors and members of an LLP owe their duties to the corporate body.

As the Supreme Court has recently affirmed in *BTI2014 v Sequana* [2022] UKSC 25, the interests of a company can be treated as the interests of the shareholders of a whole while it remains solvent but extends to the interests of creditors if it suffers a reverse in its fortunes. In the employee-owned model adopted by Oliver & Co, directors will also owe the duties of trustees.

SHAM ARRANGEMENTS

Partnerships:

The fact that two or more people draw up and execute a partnership deed and hold themselves out to the world as partners does not necessarily mean that a genuine partnership exists. Conversely, a partnership may exist where the persons concerned have solemnly disclaimed any intention to form a partnership. The test is whether they are carrying on a business in common with a view to profit. If, on analysis, they are not, the courts may be prepared to find that the partnership is a sham.

But the point is not straightforward. It is, as always, an uphill struggle to persuade a court to make a finding of what amounts to dishonesty. The courts have indicated that there is a strong and natural presumption against a finding of sham.[1] They have rejected allegations that partnerships were shams in circumstances where they were formed to exclude security of tenure provisions in agricultural holdings legislation and to avoid tax.

---

[1] *NatWest Bank v* Jones [2000] BPIR 1092 per Neuberger J (as he then was)

In the solicitors' context, sham partnerships might be entered into for a number of reasons. These include providing a front to allow a solicitor who has been struck off to stay in business, introducing an ostensible supervisor for a solicitor too junior to run a firm, giving sole traders access to panels which require two or more principals or simply making the firm appear more substantial than it actually is. If an apparent partnership is in fact a sham, this may well have regulatory and coverage implications for those involved. To outsiders dealing with the firm, however, 'sham' partners will be liable as if they were real partners.

LLPs:

An LLP is in an altogether different position. As *Blackett-Ord and Haren on Partnership Law* put it:

> *"an incorporated, registered LLP can hardly be a sham in itself, unless it is arguable that its members intend that their relationship should be different from those in a real LLP, for instance that some should be employees rather than members. Even this argument is difficult because the law does not require any particular role of a member as it does of an ordinary partner who is to 'carry on business in common' with the other partners, and because an LLP member is so created by simply agreement with the LLP an, and his status is registered".*

Similarly, in *Eaton v Caulfield* [2011] EWHC 173 (Ch), Proudman J concluded that, "*There is no concept of a member in name only. Members are creatures of statute with statutory rights and obligations".*

Companies:

The same reasoning must extend to limited companies and their directors. Indeed, the notion that the court might declare a validly constituted limited company a myth and a fiction is where the Court of Appeal went wrong in *Salomon* way back in the late nineteenth century. Some confusion which may once have existed on this front has now been cleared up.

Generations of law students were taught that there were various categories of case in which the court might 'pierce the corporate veil' and disregard the separate legal personality of a company. One of these was said to be where the company was a façade or sham. As Lord Cooke observed in his 1997 Hamlyn Lecture, the fact that the courts who used the language of 'sham' ordered remedies against the companies concerned demonstrates that they were not shams.

In fact, it does not appear to have been suggested in any of the corporate veil cases that the relevant company did not really exist or existed as something other than a company. If this were the case, it would not have had a separate legal personality to disregard.

References in the older cases to façade or sham must now be seen as the "*incautious dicta and inadequate reasoning*" which Lord Hoffmann lamented in *Prest v Petrodel* [2013] UKSC 34 before dismissing those labels as unhelpful.

In *Prest*, the Supreme Court narrowed almost to the point of extinction the power to pierce the corporate veil. Indeed, Lord Neuberger, who could not identify a single English case in which the doctrine had been invoked properly and successfully, inclined to the view that it should be killed off. Lord Walker doubted whether it was a doctrine at all, "*in the sense of a coherent principle or rule of law*".

In the event, the court stopped short of plunging in the dagger, but the editors of *Gower's Principles of Modern Company Law* are surely right that it is hard to see much future for the doctrine. However that may be, it cannot now be suggested that jurisprudence on piercing the corporate veil supports the proposition that a properly registered company might not be a real company.

Directors, like members of an LLP, are creatures of statute. A director who leaves the management of the company entirely to others is not a 'sham' director but a negligent director. In *Dorchester Finance*

v Stebbing [1989] BCLC 498, a chartered accountant sued in his capacity as director of a lender maintained that he was but a non-executive director and left the running of the company to Mr Stebbing. The court found this argument *"quite alarming"* and concluded that the accountant's conduct could only be described as gross negligence.

This finds an echo in the learning on *de facto* directors, *i.e.* those who exercise the functions of directors and may be held out as such but are not registered as directors at Companies House. In *Secretary of State v Tiolle* [1998] 1 BCLC 333, Jacob J (as he then was) noted that *de jure* (properly registered) directors:

> *"have both common law and statutory powers and duties. In particular they are **entitled** to be at the heart of the company, and to have proper details of its financial position. They cannot be heard to say: 'I had no way of knowing what the position was'.[emphasis added]."*

By contrast, with reference to the defendant who held the title of director but was neither registered as such at Companies House nor had access to financial information about the company:

> *"someone who has no, or only peripheral knowledge of matters of vital company concern (eg financial state) **and has no right, legal or de facto, to access to such matters** is not to be regarded by the law as in substance a director [emphasis added]."*

Similar considerations apply to directors who are appointed as the nominee of others who want a say in the running of the company but cannot or do not wish to become directors themselves. Nominees are not 'sham' directors either. They have the same standing as any other director and owe the same duties. Lord Denning said of them in *Boulting v ACTAT* [1963] 2 QB 606:

> *"There is nothing wrong in it. It is done every day. Nothing wrong that is, so long as the director is left free to exercise his best judgment in the interests of the company which he serves. But if he is put upon terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful.*

It is precisely because nominees are real directors that the unlawfulness arises. Acting as a sock puppet for others is incompatible with the fiduciary duties which a director owes to the company. The appointing party in such an arrangement would potentially be liable as a shadow director, *i.e. "a person in accordance with whose directions or instructions the directors of the company are accustomed to act".*

Disqualified *directors* who act as shadows potentially commit a criminal offence and risk a custodial sentence. Yet it seems that they are free to join traditional partnerships[2]. There are two important qualifications in the present context. Solicitors who engage in the sort of conduct which might lead to them being disqualified from acting as company directors would seem very likely to face a regulatory prosecution. Non-solicitors who seek to become managers in legal practices must obtain prior approval from the SRA. The form asks whether the candidate has ever been disqualified as a director or committed an offence under the Companies Act.

SRA MINIMUM TERMS

The Minimum Terms automatically exclude civil liability arising from breach of a partnership, shareholder or equivalent agreement from the scope of solicitors' PI cover. They also provide that Insurers <u>may</u> exclude liability of a director or member arising otherwise from their legal work. By default, therefore, breaches of directors' or members' statutory, fiduciary and common law duties would fall to be covered.

Claims arising from fraud or dishonesty by an Insured may also be excluded, but the insurance must cover every other Insured. This might have straightforward application in the case of the dishonesty of

2 Blackett-Ord and Haren (6TH Ed) at 3.28, retreating from the contrary view expressed in earlier editions

a sole practitioner, but the difficulties which Insurers face with other models is illustrated by the case of *Bishop of Leeds v Dixon Coles & Gill* [2022] 2 All ER 1032. There, the dishonest senior partner helped herself to several million pounds of client monies over the course of many years, covering her tracks as she went. The other partners were innocent, so Insurers were liable to indemnify them. The Judge and the Court of Appeal, moreover, dismissed their argument that a single aggregate limit should apply to all of the partner's fraudulent acts.

Under the Minimum Terms, Insurers are disabled from imputing dishonesty to a company or LLP unless it was committed or condoned by all of the directors or members, as the case may be. In the case of a company, this plainly includes all of the *de jure* directors. Whether it might, in the appropriate case, extend to *de facto* or shadow directors could be an interesting debate but is outside the scope of this note.

CONCLUSIONS

The solicitors' profession has increasingly moved away from the traditional law firm model in favour of limited liability. This dichotomy is simplistic in that there are significant differences between, on the one hand, sole traders and partnerships and, on the other, limited companies and LLPs. But generalisations can be made.

Corporate bodies have a legal personality of their own which traditional firms do not. An important incidence of this is that the shareholders or members, as the case may be, of a corporate body have limited liability while the liability of partners and sole traders is unlimited. The duties owed by a director or member are analogous to those owed by a partner but are not identical. Importantly, a director or member owes their duties to the corporate body whereas partners owe duties to each other. An apparent partnership might, on analysis, be a sham. The doctrine of sham, by contrast, has no application to a company or LLP, despite older caselaw which used the language of sham but must now be regarded as wrong.

The SRA Minimum Terms automatically exclude liability arising from partnership disputes and permit the exclusion of claims arising from breaches of directors' or members' duties otherwise than in connection with legal work and for claims arising from dishonesty, provided that it was committed or condoned by all principals.

Further Information

Given the generality of the note it should not be treated as specific advice in relation to a matter as other considerations may apply.

Therefore, no liability is accepted for reliance on this note. If specific advice is required, please contact one of the Partners at Caytons who will be happy to help.

caytonslaw.com

Caytons
Changing Perceptions

Richard Senior
Partner
E: senior@caytonslaw.com

John Cayton
Senior Partner
E: cayton@caytonslaw.com