Credit arrangements with clients: Here be dragons

Firms seeking to be creative about funding options for individual clients, including time to pay, may face a significant regulatory risk, warn **Francesca Kaye** and **Elliot Elsey**

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Individual clients are often asset rich, but cash poor. The gap between legal fees and the ability to pay is increasing. Third-party funding, conditional fee agreements, damages-based agreements, after-the-event insurance, 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 or providing some form of security. Probably best known is a Sears Tooth agreement, which is secured by a charge over property and is 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, the position has shifted again.

On 1 April 2016 the Solicitors Regulation Authority (SRA) Financial Services (Scope) Rules 2001 were amended to clarify the types of consumer credit activities law firms can undertake without being regulated by the Financial Conduct Authority (FCA).

Part 20 of the Financial Services and Markets Act 2000 (FSMA) permits SRA-authorised firms to undertake certain regulated activities as an exempt professional firm, 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

Firms should consider three broad issues if undertaking credit arrangements with clients.

First, 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'. The definition is clarified by part 2.3 of the Perimeter Guidance manual in the FCA handbook, 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.'

Second, is the firm authorised for those credit purposes? The core prohibition (section 19 of FSMA) makes it an offence to carry on a regulated activity in the UK unless authorised or exempt.

An SRA-regulated firm should be exempt under section 327 of FSMA in relation to regulated consumer credit activities conditional upon compliance with part 20 of FSMA, and the Scope Rules 2001 and the SRA Financial Services (Conduct of Business) Rules 2001.

The Scope Rules specifically prohibit entering into as lender, or administering, a 'regulated mortgage contract' and 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 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).

Funding arrangements between a firm and client that include security over land no longer appear 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.

Finally, firms must consider their obligations on agreement content. 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. 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 the number of repayments does not exceed 12; the payment term does not exceed 12 months; and no interest or charges are levied. Solicitors cannot rely on the exemption for payment by instalments where liability has already been incurred.

Firms have an immediate problem (particularly with an ongoing retainer) if a client fails to pay an invoice and 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?

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, firms should approach any form of funding arrangement for an individual client cautiously or risk falling foul of the regulatory dragons. SJ