I was recently informed by a lawyer from South Texas, whom I have had the pleasure of working with for the past two years, that there are three things the end consumer should never see: politicians making statutes, lawyers practising law, and butchers making sausages.

The butchers’ secret remain mercifully obscure to most, but for better or for worse in the UK there are few mysteries left in either politicking or lawyering. By the two-pronged attack of the Legal Services Act and the new Code of Conduct, the provision of legal services in this country is set to become subject to a degree of transparency that must surely leave even the most inquisitive of consumers satisfied.

With increased transparency will certainly come greater risk for those firms who are unprepared. However, with a little risk management spring cleaning, there is a great deal which can be done to prepare for greater scrutiny, in particular by observing the close connection that exists between risk management and effective financial management.

Is risk management a good place to look to cut costs?

In recent months this magazine has tracked as closely as any the effect of the economic downturn on law firm revenues. This reduction in revenues has forced an unprecedented search for areas in which costs can be reduced so as to maintain the degree of profitability necessary to attract and keep talented lawyers. Reports suggest redundancies of over 3,000 lawyers and nearly 5,000 non-legal staff across the world’s largest firms since the beginning of the downturn.

Law firm management must ask themselves whether Risk and Compliance are necessarily the right centres to be looking to for cost reduction in the present climate. The conventional wisdom is that whilst the Legal Services Board has now been fully constituted, and will become fully operational during the course of 2009 and 2010, the extent to which the LSB is required to descend into the arena and micro-manage the professions will depend on the perceived effectiveness of the SRA and other Approved (or Frontline) Regulators to achieve the statutory Regulatory Objectives independently of the LSB.

This pressure on the SRA will almost certainly manifest itself in a greater workload for the Risk and Compliance functions with law firms, including the workload of firms’ dedicated, full-time resource as well as the non-chargeable time of partners charged with Risk Management roles. This is perhaps particularly the case now that the tantalising prospect has been raised of an elite band of larger firms who might qualify for more specialised SRA regulation and a greater degree of self-regulation.
MARK CASSADY, a Solicitors’ Professional Indemnity Underwriter with Insurer QBE, comments: “We take an increasingly close interest in the risk management function of proposed insured firms, and while it is not for us to take our insured’s management decisions for them, we might well raise an eyebrow at firms scaling back on their investment in risk management at this stage of the economic cycle.”

The costs of claims against law firms are very significant

The Minimum Terms & Conditions under which UK Solicitors’ Professional Indemnity Policies are written are amongst the most insured-friendly terms in the commercial insurance market. Nonetheless, it would be wrong for any law firm to rely on its insurance policy to meet all of the costs of professional negligence claims. The direct costs to the affected firm can be very significant indeed, and may include any of the following:

- The firm’s policy excess/deductible
- Fee earner (witness) time
- Management time
- Increased future professional indemnity premiums
- Mitigation costs: reproducing/completing work
- Uninsured liabilities: for example fee disgorgement claims

From my own practice in defending claims against transactional solicitors, I can vouch directly for the time taken by the principal witness for the defence in any claim which advances beyond an initial exchange of correspondence. If a claim goes to trial the solicitor involved can comfortably spend over 100 hours in the company of his former file and the solicitors appointed by his firm’s insurer to defend the claim, followed by an altogether less delightful period of hours in the company of cross-examining Counsel and a Judge.

Of course, aside from more direct and measurable costs, professional negligence claims can have significant intangible effects, which, whilst immeasurable may also have an immediate and direct effect on a firm’s future revenues. These may include:

- Impact on the affected client relationship
- Impact on firm reputation
- Disciplinary sanctions

In its 2005 Professional Liability Risk Management Handbook, law firm insurer Chubb advanced an estimate of 1:4 for the ratio of insured v. uninsured costs to law firms of claims – without trying to take into account reputational harm.

Is new business being properly policed?

In the current climate many law firms are, quite properly, re-tooling talented lawyers whose primary business area has contracted to meet demand in areas where demand has grown. Surely an experienced transactional real estate lawyer has the skill-set to advise on a technical real estate dispute, and a transactional finance lawyer the capability to take on restructuring advice? Good and loyal clients whose trust the firm has acquired will no doubt take your word for it that the lawyers you assign to their work have the expertise to take on their new matters.

However, the law reports do not lack examples of very high calibre law firms whose entrepreneurial instincts temporarily prevailed over sound risk management practices, with disastrous consequences.3 There must therefore be a Risk function within the firm which is properly empowered to intervene in the firm’s business intake processes in order to counter-balance the natural enthusiasm of those charged with generating revenue in a challenging and competitive market. If appropriate, a litigator must be put alongside the former transactional real estate lawyer, and an insolvency specialist alongside the fledgling restructuring expert.
LINKING FINANCIAL MANAGEMENT WITH RISK MANAGEMENT

In a diversified firm, effective Risk Management in the current climate must also entail setting realistic financial targets for all practice areas: both those business groups whose practice area has shrunk with the market, and those who are fortunate to be in a counter-cyclical practice area and who may therefore be expected to make good the shortfall. For this to be achieved, appropriate Risk Management representation must be present in firm senior financial management.

Insurers regard partner compensation for Risk Management time as a strong indicator of a firm’s attitude to risk. As well as budget and strategy setting, this will include time spent on:

- Solicitor training
- Supervision
- Internal peer review/audit
- Conflict management
- Lateral partner/new business scrutiny

Perhaps law firms would be wise to learn from the recent and much-publicised failings in the Risk Management functions of some of the world’s largest financial institutions, where it is reported both that the simple failure of the Risk and Compliance departments to understand the complex transactions being undertaken by certain business units was a contributing factor in substantial losses, and that those same departments were not sufficiently empowered to second-guess powerful revenue generating business units. Does your Risk Management function have the expertise to analyse new business areas? Is your firm’s Business Intake function empowered to reject work on the basis of its risk profile?

Accounts and risk management departments singing from the same hymn-sheet

It could be said that Risk Management enters into each key stage of the financial lifetime of a matter:

- Business development and budgeting
- Client intake/Matter opening
- Work in Progress – invoicing. The best time to present a client with a bill is concurrently with the delivery of your work product.
- Accounts receivable – debts

Although lawyers are getting better at financial risk management, it is an area where the accounting profession is streets ahead. Any accountant will tell us to bill smaller and more regularly. None of us has yet discovered the client who enjoys surprises. And in addition to avoiding leakage, regular billing can avoid claims. Build-up of WIP can be a warning sign of another problem on the file, and should not be ignored. The option of terminating the retainer in appropriate circumstances is one which should not be overlooked.

Where appropriate the relevant fee earner may have to be separated, at least partially, from the process of pursuing unpaid fees. The fee earner may be overly concerned about the relationship to the detriment of the firm’s position (and in addition, her time may be more profitably spent.) At the same time, the value of the fee earner’s relationship in the recovery process should not be lost. The answer is usually for the relevant fee earner to work with alongside an independent individual from the firm who speaks purely for the firm’s interests.

Does your firm have adequate systems for escalating significant outstandings to senior management level?

Fee estimates

Consistent with the number of recently reported cases on the subject, our experience in defending claims against law firms confirms that fee estimates are a particular area for Risk Managers to be alive to.

As with every discussion of Risk Management, one’s attention is drawn to the firm’s retainer letters. It is useful to remind ourselves of
paragraph 2.03 of the Code of Conduct, which reverses the burden of proof requiring us all to justify our departures from the Code’s detailed requirements. Sub-paragraph (5) requires that information we provide about costs must be clear, and must be confirmed in writing. The client must be told:

- the basis and terms of the firm’s charges
- if charging rates are to be increased
- of likely payments which the firm or the client may need to make to others
- that there are circumstances where the firm may be entitled to exercise a lien for unpaid costs.

This advice must be revisited with the client if circumstances change, and firms must discuss with clients how they will pay, including whether they might be eligible for public funding, whether the clients’ own costs are covered by insurance or might be paid by someone else such as an employer or trade union. Clients must also be advised of their potential liability for any other party’s costs and whether their liability for another party’s costs might be covered by existing insurance or insurance to be obtained after the event.

I am aware that some law firms require that all substantial fee estimates are peer reviewed for compliance with the Code - and to give a measure of objectivity. Is this something your firm might wish to consider?

**Suing clients: do it at your peril**

“...probably the most axiomatic risk management precept for law firms, allowing for only a very few exceptions, is never sue a client for fees...”

It would be fair to say that approximately half of the claims we defend for lawyers begin with a claim by the lawyer for unpaid fees. Some might contest the “never” in the rather dogmatic quotation above: many firms will point to a good track record of successful claims against clients who have “tried it on”, and no firm can afford to acquire a reputation as a soft touch. However, there can be no doubt that the decision as to whether and when to push the button on proceedings against a client is one which calls for a cool head, experience, and judgment.

It is rather depressing but true that in general, a well motivated and well advised client will be able to develop an argument that a portion of the services they received fell below an expected standard of care in some respect or another. In the current climate, motivation is not lacking for many commercial and private clients. Can your firm afford to throw good money (not to mention management time) after bad? Would that money be better re-invested in addressing gaps in the firm’s financial risk management as referred to above, rather than on this ambulance at the bottom of the cliff? At the very least, would it be worth your firm taking an advice from Counsel on the merits of the threatened counterclaim before the fee claim is initiated? Finally, in some situations, it might also be worth consulting with your firm’s insurer specifically on the question of bringing the fee proceedings before doing so: speak to your insurance broker about this possibility, because insurers’ approaches do vary.

Mark Casady, QBE, explains: “The frequency of negligence claims which follow hot on the heels of firms suing for their fees is a depressing reality of our insuring lawyers. Our claims professionals will always be happy to discuss with our Insured firms whether issuing proceedings against one of their clients is necessarily the best way to proceed.”

I’m sure making sausages must be easier.
LINKING FINANCIAL MANAGEMENT WITH RISK MANAGEMENT

Endnotes

1. See the Initial Response to Evidence published by the Rt Hon Lord Hunt of Wirral this month in his independent review of the regulation of law firms commissioned by the Law Society.


3. Saab v. Jones Day (2002) EWHC 2616 (Ch)) is at least arguably just such a case.