



Protecting partner assets

While more firms may be looking more seriously than ever at their risk-management strategies, the potential threat of a major claim against your firm is still very real, especially as firms grow and find themselves practising across international jurisdictions.

By Frank Maher, Legal Risk

Imagine the scenario: you have received a major new instruction for a foreign client worth several times the amount for which you are insured (if you are insured at all). Equally, it might be an instruction for a domestic client.

How can you maximise the protection for partner assets in the event that it goes wrong and there is a major claim against the firm?

The problem

There is an increasing number of claims above or around firms' limits of indemnity. A survey by the American Bar Association shows that the number of big-ticket suits – those with claims of \$2/€1.5/£1m or more – against firms has risen dramatically since 1996. That figure is low, however, and does not paint the true picture.

Accountants in particular are exposed to high-value claims, mainly audit related,

following large corporate failures. The Securities and Exchange Commission in the US is reported to be making contingency plans in the event that a 'Big 4' accountancy practice collapses.

There were press reports of one claim against a leading international law firm for £600/€880/\$1,200m (albeit said to have been settled for €14.7/\$19.9/£10m). Two large claims against law firms have gone to trial in the UK in recent times. Both were defended successfully.

*Football League v edge Ellison*¹, which was the largest ever claim against a law firm to go to trial in the UK courts, was defended successfully.

The case arose from the solicitors' alleged failure to advise on bidder solvency, or the desirability of seeking parent company guarantees for the League's contract with ONdigital for television rights, with claimed losses of

£142/€210/\$280m. ONdigital crashed spectacularly when its two major parent companies, Granada and Carlton, withdrew support in a manner that few could have foreseen. The court held that the solicitors' duty did not extend to advising a commercial client on commercial aspects.

In 2007, a £100/€147/\$19.9m claim went to trial against a small firm in *Earl of Malmesbury v Wilsons*². This claim arose from the lease of a regional airport car park, which increased substantially in value after it was let, because of the development of the airport.

Although this too was successfully defended, large claims have a cost – increased insurance premiums, adverse publicity and the threat hanging over the firm, particularly if the firm does not have enough insurance cover.

Large claims reported in the press include the settlement of the

WorldCom claim against Andersen for \$60/€44/£30m; \$20/€14.7/£10m punitive damages against Gibson Dunn & Crutcher; Baker Botts (\$33/€25/£17m – conflict of interest during 45-minute meeting); Seyfarth Shaw (\$35/€26/£18m, including \$15/€11/£8m punitive damages). The collapse of major multinationals (Enron, WorldCom, Parmalat) has increased awareness of large-scale risk among professionals, caused in part by the increase in global business. A recent trend in the US is claims for deepening insolvency.

A UK firm with no overseas offices is currently being sued in the US for fraud and racketeering in relation to corporate work, which it appears was done solely in the UK.

There is only limited statistical data available, but figures provided by St Paul Travelers, who have a large part of the market in England and Wales, particularly among larger firms, shows that claims over £1/€1.5/\$2m have reached the same level as the previous peak in 2002, and the American Bar Association survey covering 2000 to 2003, shows an increase in claims over that level (though neither set of figures may represent the full picture across the professions).

Liability on paid claims exceeding cover is rare – an accountant's claim, *ADT v Binder Hamlin*³, was a notable example, but even that was reputedly negotiated down pending appeal.

Remember too, that the potential claim is not limited to the value of the transaction. There may be interest and substantial costs and, in some jurisdictions, notably the US, there may also be punitive or exemplary damages. The writer has defended an environmental claim worth over 100 times the value of the transaction. In addition, similar claims may be added together for insurance purposes under the 'aggregation rule', meaning that quite small transactions can give rise to

issues on indemnity limits; this might arise where there is a defect in standard documentation, which is used in multiple transactions.

Note that the indemnity limit under an insurance policy (except in Germany) is the one at the time of the claim or when circumstances are notified to insurers, not the time of alleged act – firms may find they have less cover in future when the claim comes in.

Incorporation

In some jurisdictions firms may incorporate as limited liability partnerships (LLPs) or as limited companies, or similar. The extent to which this provides protection to individuals may vary according to the jurisdiction.

The conversion rate to LLP in the UK (about half the top 100) suggests that fear of the rare but possible cataclysmic claim is an issue. Legal Risk has compiled a survey of professional indemnity and risk management in the top-100 UK law firms over the past four years. The most recent survey attracted 59 responses from a wide cross-section of the sector⁴. This showed that 52 per cent of respondents had already converted, 19 per cent were planning to do so in the next 12 months and only 29 per cent had no plans to do so; of these, many may have had accounting or tax reasons preventing them from doing so, rather than a desire not to convert.

Lawyers will often have professional duties to supervise staff and may owe personal obligations to clients and others; for example, where they hold personal appointments as trustees or by court appointment, so incorporation may not offer sufficient protection though it is doubtless better to have such protection as it is better than none. There may in any event be personal liability on the individual lawyer dealing with the matter.

In any event, collapse of the LLP is still a problem in terms of earning

a living – and there may be guarantees or other personal liabilities to banks or landlords of office premises.

Limiting liability by contract

In some jurisdictions (but not the US) lawyers are permitted to limit liability to clients by contract, though there may be restrictions and it may be subject to limitations such as a reasonableness test⁵. In the UK there has long been a prohibition on limiting liability in litigation work in certain situations⁶ (though perhaps not as broad a prohibition as many think⁷), but there is a proposal to relax this in part in the near future⁸.

Legal Risk's top-100 law-firm survey of 2007 showed that 34 per cent of respondents were routinely limiting liability, 61 per cent sometimes and only five per cent not at all.

In practice, the banks in particular may be resistant to firms limiting liability in this way. However, gradual progress is being made in the UK.

The Lawyer carried reports⁹ in April 2007: "Clifford Chance has implemented a formal policy of liability caps in all of its corporate due diligence deals despite strong resistance from certain banks, a move that will be watched closely by other City firms experimenting in this field.

The magic circle firm has managed to cap its liability at €40m [£27/\$44m]... on vendor due diligence work and, more controversially, has managed to extend this policy to buy-side due diligence to €70m [\$95/£48m]. This applies to reports relied on by both its clients and also by third parties and the banks."

A further report¹⁰ stated: "... Freshfields Bruckhaus Deringer will reassess its approach to managing risk by looking at introducing liability caps in the UK beyond sell-side due diligence to the buy-side."

It has already managed to introduce buy-side liability caps in Germany and the Netherlands on several occasions, as

such measures are not controversial to clients there.

But Freshfields is thinking of extending a policy beyond the corporate arena, to finance and tax as well.

The writer is aware of other large firms routinely limiting liability to between €14.7/\$19.9/£10m and €22/\$30/£15m, and, in many cases, lower sums.

Accountants routinely limit liability in non-audit work (and the EU has recently conducted a consultation on this). From a lawyer's perspective, the risk increases if the client cannot recover damages in full from accountants who may be liable, as well as the lawyer.

Financial limits on liability are not the only type. Others may include:

- Consequential loss (or loss of profit);
- Time limits for making claims or bringing proceedings;
- So-called 'net contribution clauses', which exclude any obligation to pay the proportion of damages that may fairly be attributable to another adviser or other party.

There is surprisingly little authority in the English courts on the validity of terms limiting liability, but in one recent case¹¹ a court held that a €29.4/\$29.9/£20m limit would have been effective, though in fact the lawyers defended the claim successfully on liability.

The need for a strategy

It will be apparent that the answer to the problem of protecting partner assets cannot simply be found by incorporating a practice or by agreeing limits on liability with clients. There has to be a strategy, though these may form part of the strategy.

Ingredients in the strategy may include the following:

- Reduce the risk of error – the causes of most claims against lawyers worldwide are generally

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administrative failures, not lack of knowledge of the law – issues to address here include know-how, training and supervision;

- Identify the high risk areas of work and the mistakes that are made, and introduce systems and quality control;
- Strengthen client due-diligence processes, including conflict checking (throughout the life of the relationship, not just on inception);
- Reduce the risk of claims by addressing client communication, client care and complaints;
- Share the liability with the client – for example, by contractual exclusions and limiting liability;
- Share the liability with another party – for example, external counsel and other professionals.

Avoid:

- Gratuitous assumption of risk to third parties;
- Advice beyond the scope of the firm's retainer;
- Advice that is not charged to the client. Examples include LLP members signing advice letters in their own name. Note how property valuers' reports, in accordance with insurers' requirements, include statements such as: 'This report is for the use of the named client only and no responsibility is accepted to any third party for the whole or any part of its content';

- Decide what to insure (extent of cover, aggregate limits, and any special or extra risks). This is the penultimate resort;
- Keep partners' personal assets out of sight.

We will look at these further. First we need to understand more about the types of work giving rise to large claims.

Large claims experience

Figures provided by St Paul Travelers, primary insurers of many of the largest UK firms showed the work types for claims over €1.5/\$2/£1m in 2005 were as shown in figure one.

Work type	Percentage of claims		
	All firms	Top 30 firms	Firms outside top 30
Commercial contract terms	22	29	13
Commercial Mergers and Acquisitions	22	36	
Property	18	14	25
Litigation	14	14	37
Tax	9	7	0
Fraud	10	0	25
Probate	5	0	0

Figure one: Work type to percentage of claims

Other jurisdictions will show different figures depending on local conditions. The same insurers' figures in 2006 revealed that claims over €1.5/\$2/£1m have reached the same level as the previous peak in 2002.

Linking associate performance against targets to bonus payments is a challenge. Obviously it is necessary to reward success, but should 'success' be measured at the individual level, or team or firm level?

While many of these figures may not surprise greatly, the figures for fraud claims are notable and we look at these further below.

Globalisation is giving insurers cause for concern: overseas offices of London firm used to be regarded as low risk, but there is a growing trend of claims from overseas offices, including two substantial claims from investment in eastern European countries.

The larger claims frequently arise from pension funds, financial services, and mergers and acquisitions. Corporate work is an issue; a number of our overseas clients have expressed concern, too, about the extent of their potential exposure to claims from non-clients for reliance on due diligence.

Conflicts of interest are an area of increasing focus. In fact, it is rarely the underlying cause of a claim in practice, but it makes the defence of a claim far more difficult and, in certain circumstances, can increase damages.

E-mails have been a major problem for businesses outside the legal sector and there have been a few claims so far in the legal sector – not the much-vaunted risk of security but inadvertently breaching confidentiality – for example, forwarding a client's e-mail to the other side, and 'metadata' risk (the risk of e-mailing a document that contains hidden data, perhaps showing earlier versions of the document, particularly embarrassing if another client's document has been used as a draft). Data security and data protection are also key issues.

Even though lawyers may not be involved in fraud themselves, they risk

being involved as accessories. The US experience is worthy of note, and will be commented on further.

A further development on the US scene is the case of *Stoneridge Investments v Scientific Atlanta*, which was due to be heard by the Supreme Court starting October 2007. Charter Communications bought set-top cable boxes from Scientific Atlanta. In return Scientific Atlanta bought some advertising. Charter Communications' management recorded the expenditure as capital, with the intention that this should be depreciated over several years. The receipts were recorded as revenue in the first year. This had the effect of falsely inflating cash flow.

Three Charter Communications executives were convicted and jailed. Investors brought claims against Charter and those executives, but they also sued the sellers of the equipment. The sellers deny liability on the ground they had no say in how Charter Communications accounted for its transactions. If the claimants succeed, the potential for claims against professional firms as accessories to frauds will increase.

There has been an increase in major commercial property fraud in the UK. The UK Financial Services Authority issued an unprecedented warning to lenders on 2 April 2006. There are also fears that any collapse in the property market, which might spread from the issues affecting sub-prime lenders in the US, could cause a significant increase in fraud claims.

We will look at the risk of staff fraud later.

Sources of risk

These are not confined to clients. They may include third parties, for example:

- Investors – for example, vendor due diligence and the possibility of *Stoneridge Investments v Scientific Atlanta* type claims as above;
- Lenders;
- Others using your precedent documents;
- Beneficiaries under wills.

At a seminar in New York in 2006 one representative of a major insurance broker commented that out of 41 large claims over \$20/€14.4/£10m, only two involved error by the law firm, 29 were dishonest clients and ten conflicts. The inference drawn was that to avoid claims you should focus effort on conflicts and client intake. Insurers in the UK and Australia have also noticed an increase in claims by non-clients. We will look at client-engagement issues later.

The risks to partners are not confined to professional risks, however, as there are also the risks that attach to any business – lenders, landlords and other creditors. In the UK, there are also potential liabilities to the firm's insurers if the firm becomes insolvent.

Client due diligence

Client due diligence and take-on procedures are probably the most significant contribution to a risk-management strategy. In this we include, for example:

- Client risks (see below);
- Geography;
- Work type – corporate work will be higher risk than litigation for anti-money-laundering purposes, for instance;
- The ability and capacity of the firm and the individuals to do the work.

Client due diligence has increased significantly in the UK since the

introduction of anti-money-laundering legislation in 2003. Although it was largely seen as an unwelcome intrusion into professional life, claims overall have gone down since then, even if there has been an increase in the larger claims as reported above, and it may be that better understanding of clients and their instructions, which has developed as a result of better client due diligence, has played a part in this.

PricewaterhouseCoopers' law-firm survey of 2006, on the top-100 UK law firms, reported that only 45 per cent of respondent firms did credit checks as part of their client-acceptance procedure (down from 51 per cent the previous year) and only 67 per cent included an assessment of risk (down from 76 per cent the previous year).

Consider who has authority to take on a new client or a new matter for an existing client. Do you require a second partner or a committee to decide? There may be an inherent conflict for the partner concerned to accept when s/he has financial targets to meet. Client risks may include the following:

- Those whose structure or nature of the entity or relationship makes it difficult to identify the true owner or controlling interests;
- Cash-intensive businesses;
- Clients who conduct their business in unusual circumstances;
- Frequent and unexplained movement of funds between institutions, perhaps in different geographic locations;
- Clients who have no geographic connection with where you practise;
- Politically exposed persons.

See the Financial Action Task Force (FATF) 'Guidance On The Risk-Based Approach To Combating Money Laundering And Terrorist Financing'¹².

Country risk is also an important consideration. Consider, for example:

- FATF mutual evaluations - www.fatf-gafi.org;
- The Transparency International Corruption Perceptions Index. The score relates to perceptions of the degree of corruption as seen by business people and country analysts;
- The Joint Money Laundering Steering Group (JMLSG) Appendix D – current FATF and EU members, dates of most recent evaluations, NCCTs (Nairu) and former NCCTs;
- Mutual evaluations by other regional organisations – Asia Pacific Group on Money Laundering, Caribbean Action Task Force, Offshore Group of Banking Supervisors, MONEYVAL;
- See also the Economist Intelligence Unit report 'Regulatory risk: Trends and strategies for the CRO'¹³.

The implementation of the Third EU Money Laundering Directive is being seen by many firms as a reason to review their client-engagement process across all their offices. The requirement to implement risk-sensitive systems, building on the risk-based approach, which has been adopted in the UK since the implementation of the Second Directive in 2003, will further enhance the protection that partners in law firms provide for themselves. In particular, the requirement for ongoing monitoring will be important – clients such as Enron, Worldcom and Parmalat, whose much-publicised financial problems triggered massive potential liabilities for professional advisers, were no doubt good clients when they were taken on initially (and in some cases may be again).

For international firms that have not aligned their worldwide client-acceptance procedures, this gives them the opportunity to address the issue, at least across Europe. Doubtless there are challenges to meet, such as the issues surrounding beneficial ownership and

data-protection concerns, but overall, the more resilient the client due-diligence process, the better protected will be the partners' assets.

Client engagement

Engagement letters and written terms are very much a creature of the US and UK firms, with considerable reluctance to use them elsewhere in Europe. But it would be fair to say that their acceptance took many years in the UK, despite client-care information being all but compulsory as a matter of professional conduct since 1992. Resistance to the use of them was probably more lawyer than client driven, despite the lawyers thinking 'the client would not like it'. In fact, the clients are used to receiving them from their accountants and may, if anything, be surprised by their lawyers' failure to use them.

A new Code of Conduct for solicitors in England and Wales requires extensive client-care and costs information to be provided at the outset of an engagement¹⁴.

PricewaterhouseCoopers reported that engagement letters were standard practice on all engagements in 99 per cent of firms responding to their survey, but it then added: "Our experience working with firms, however, indicates that actual adherence to this stated policy is less impressive."

Engagement letters provide the lawyer with the opportunity to protect themselves in several respects:

- Most importantly, defining the scope of the engagement – what work the lawyer will do, and what s/he will not (see below);
- Determining the jurisdiction in the event of a claim;
- Setting out details of cost – many claims arise because the client objects to the bill, which is more than they say they expected;
- Limiting liability where this is permitted – not just by financial caps.

Even if the firm has adequate cover and the claim is within the policy, a large claim, or frequent small claims, may add significantly to insurance costs in future years and even result in insurance being unavailable.

Defining the scope of the lawyer's duty is one of the most important risk-management tools. To take a simple example, a US client thinking of opening in Europe might instruct a London firm to advise, thinking the London firm will deal with all aspects of its proposed European operation. Will the London firm only advise on UK law? If so, has it made this clear? Will it co-ordinate the project with other European lawyers? Is the client to instruct the other European lawyers direct, or is the London firm to do so? These aspects need to be clarified, and it is important to guard against the arrangement becoming more fluid and less certain as to who is responsible for each aspect of the transaction.

It may also be appropriate to identify matters on which the firm is not advising. These might include:

- Aspects on which other advisers will deal, such as tax and accounting;
- Business/commercial issues;
- The client's own involvement and perhaps that of its in-house legal team.

If you are not intending to advise on commercial aspects – what does your website and marketing material say about this?

Defining the scope of an engagement can also be an important tool in managing conflicts of interest, by excluding particular aspects on which the firm cannot advise due to conflicts.

It may also be appropriate at a later stage to identify specific issues as being the client's responsibility rather than the lawyers – for example, exercising options under contracts.

With the scope of the engagement properly mapped out, it should be possible to identify who is responsible for each aspect of a matter. Where this has not been defined in writing, lawyers are at the hostage of the courts to decide what was and what was not part of their task to advise.

A note of caution: be wary of agreeing to do half the job for half the price. Clients may still expect you to shoulder the full responsibility if it goes wrong.

People risk

Having decided to take on the instruction, who will do the work?

Remember that the best people may be the most overloaded and least able to protect the firm's interests as well as the client's. Will they (even if they are partners) be effectively supervised? Do you have procedures requiring second signatures on opinions or high-risk matters.

Be wary of overdependence on one client – either for the firm or the individuals: independence may be compromised.

Is the work to be done by a new lateral-hire partner? One US broker commented on the problem of a lateral in a branch office who is the only person doing that type of work carrying a 100 per cent chance of a claim. What checks do you do when recruiting lateral-hire partners? Legal Risk's top-100 surveys have revealed that even many top firms do not undertake checks, which could easily be done – such as CVs (including checks for accuracy), references, claims and disciplinary records.

Problems posed by lateral-hire partners are increased where inadequate due diligence has been done prior to recruitment. This is an area where firms

are showing signs of improved controls, as shown in the case of UK firms by Legal Risk's surveys. Several firms that failed to make these checks have found mortgage fraudsters in their midst, with alarming results on their ability to obtain insurance, payment of excesses under their insurance policies and, in one case, loss of a major, high-profile client due to reputational damage.

It is important therefore to consider what controls are in place for monitoring partners and staff.

Branch offices and overseas offices are in any event a frequent cause of problems – the risk-management procedures may not be enforced there in the same way as in the principal office. Do you audit your other offices? Some firms do, some intend to but do not find the time and others simply hope for the best.

Work done in multiple offices can be a problem – using people who do not know each other. Consider too, with which part of the practice is the client contracting?

Insurance

Many lawyers have thought of insurance as the first resort for risk management, whereas it should in fact be close to the last resort. Even if the firm has adequate cover and the claim is within the policy, a large claim, or frequent small claims, may add significantly to insurance costs in future years and even result in insurance being unavailable.

Insurance limits and the breadth of cover vary significantly around the world. UK firms generally have the highest limits and the broadest cover. Issues to consider include:

- Aggregate limit on cover, or any one claim if available;
- Aggregation risk, where similar claims may be treated as one for indemnity purposes;
- Exclusions from cover;
- Jurisdictions that may not be covered.

It is generally not possible to obtain a significant increase in cover for one particular instruction, because insurers want to take a basket of risks. Nor would it be economic to do so because claims made policies (which are the norm except in Germany) mean that you would need to maintain the additional cover for many years.

It is important to ensure that claims and circumstances giving rise to possible claims are notified promptly to insurers, otherwise the cost of the premium may have been largely wasted if insurers can then decline to cover a claim. Do you regularly ask all staff – not just partners or fee earners – whether they are aware of anything that should be disclosed?

Ensure too, that if you have a complex multinational structure, the umbrella cover for the whole practice is effective.

Other types of insurance to consider are 'lifeboat' policies, which may help protect members of incorporated practices in the event of personal liability, and management-liability policies, which may protect the management of the practice against claims in that capacity, like directors and officers cover for a corporate body.

Disposing of assets

Professional people have over the years transferred assets to their spouses or partners to obtain a degree of asset protection. There are, however, risks:

- They may be set aside under bankruptcy legislation in some jurisdictions;
- The spouse/partner may be sued – s/he may even be a lawyer or other professional person too;
- Tax considerations;
- Divorce or separation;

Asset protection through offshore trusts is also used and is particularly popular with US doctors. Putting assets out of the reach of creditors in the UK may in some circumstances involve criminal offences under the Insolvency Act.

This is an area where specialist advice should be sought.

Audit

The best systems and controls will only work if you check they are being applied. Consider the following points:

- Do you have internal file audit?
- Do you have external file audit (with client consent)?
- Do you have an audit of the firm's money as well as client money (incorporated practices may be required to do so)?
- Do you have partner-to-partner peer-review processes?
- Do you audit across offices to ensure consistency?

The PricewaterhouseCoopers' law firm survey 2006 reported that only one third of top-25 UK firms have an internal audit function. Effective file review is something that has long eluded the majority of law firms.

Issues that might be covered in file audits include:

- File opening – anti-money laundering, credit checks, conflicts, engagement letters;
- Fee estimates – regularity and interim billing;
- Time limits – recording, back-up systems and provision of information to clients – and who is responsible?
- Claims – notification and advising clients where mistakes have occurred;
- Client comfort – commerciality, response times, telephone calls returned, clarity of language.

Audit of offices is a large topic in itself, beyond the scope of this article.

Conclusion

More firms are addressing the issue of partner-asset protection. Where permitted, more are also considering limiting their liability.

There is no guarantee that all or any of the elements will be effective, but it may at least be possible to gain a bargaining position if the firm faces a substantial claim with inadequate insurance.

Any efforts need to form part of a strategy and need to flow through everything the firm does: risk management is a culture, not an event. ■

References:

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2. [2007] EWHC 999 (QB)
3. [1966] BCC 808
4. Full report available on www.legalrisk.co.uk News and Events page.
5. In England and Wales, the Unfair Contract Terms Act 1977 and the Unfair Contract Terms in Consumer Contracts Regulations 1999
6. Section 60 (5), Solicitors Act 1974
7. The prohibition relates to work under a 'contentious business agreement', but by no means all litigation is conducted under a contentious business agreement as defined.
8. Legal Services Bill, Schedule 16, paragraph 51
9. <http://www.thelawyer.com/cgi-bin/item.cgi?id=125322&d=11&h=24&f=23>
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