

Like tax, the law of risk management for law firms permeates everything you do, affecting anything that happens in the practice from top to bottom. Yet how many partners and senior managers give the subject more than a cursory thought – perhaps once a year when the professional-indemnity renewal comes around?

How many law-firm partners have a risk-management project on their ‘to do list’, but one which they never actually find the time to tackle? Perhaps they know there are concerns about a partner’s work, or about a client whose business ethics seem to be increasingly dubious. They intend to review client-engagement procedures in the light of the recent case of *Jasmine Trustees v Wells & Hind*.¹ They mean to start on the substantial preparation required for the new Money Laundering Regulations 2007 in time for the 15 December 2007 deadline. They want to consider whether a costs case, *Wilson v The Specter Partnership*,² might impact on their ability to limit liability in litigation.

And whatever happened to insurance mediation that caused a brief moment of concern but then sank to the bottom of the pile? And how many defendant insurance firms are complying with the Rules 16D and 16E on conflicts and confidentiality? Rather fewer than should be is my estimate of the position. These – or other similar tasks – will inevitably be pushed to one side when more pressing matters on client files come to the fore. The legal, regulatory and compliance world in which we practise is constantly changing, and is becoming a priority for many of the larger law firms: new issues are also constantly emerging, a recent example being business continuity.

Guarding the guard

Everyone is responsible for risk management, but at the core of it all is the supervision and management of the practice. Responsibility for this



Compliance

Partner monitoring in practice

Under increasing pressure to perform and produce high fees, a few partners may be inclined to push the boundaries of acceptable behaviour. The risks in a partnership are many, but how can lawyers realistically supervise their peers?

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rests with the principals, but who will guard the guards themselves? I have addressed the topic of ‘rogue partners’ in a previous article in this magazine³ – one that largely focused on the threat

posed by the dishonest partner. This article addresses the issue of partners who are not dishonest, but may push the boundaries too far and expose the firm to avoidable and unnecessary risk. It will explore ways of controlling this risk – the supervision and monitoring of partners.

Headline-grabbing tales of rogue partners making off with client accounts are an obvious cause of risk,

albeit rare in practice, but partners can also expose firms to unacceptable margins of risk in other ways if left unchecked by others. This is not just confined to large claims for negligence or breaches of other duties, such as undertakings. Other examples include employment claims, such as harassment or discrimination, and bad debts caused by overextending credit to a client.

The current Law Society Practice Rule 13 requires solicitors to ensure that their practice is supervised and managed so as to provide for compliance with solicitors' duties in law and conduct and to ensure adequate supervision of client matters and effective management of the practice generally.

Guidance notes explain what is meant by supervision and management. In particular, it explains: "Supervision' refers to the professional overseeing of staff and the professional overseeing of clients' matters. 'Management' is a wider concept, which encompasses the overall direction and development of the practice and its day-to-day control and administration. Management functions include business efficiency as well as professional competence." These requirements now have statutory effect as the Code of Conduct has received the appropriate consent.

Systems supervision

Firms need to take note: what was described recently by a judge in a devastatingly critical judgment involving a major firm as "an astounding degree of ineptitude" by a fee-earner who then repeatedly misled her client as to the true position, would clearly fall a long way short of compliance. It would invite disciplinary action.

It is also clear from investigations of partner dishonesty in larger firms undertaken by The Law Society (a responsibility now transferred to the Solicitors Regulation Authority) that that the obligation to supervise is not confined to supervision of junior staff. Questions may also be asked about what was done to supervise partners.

In the larger firms this may impose obligations on heads of department or office managing partners.

range of personal liabilities. Few LLP members realise the extent of the personal liabilities that may remain,

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Those larger firms will all doubtless have many systems in place, including for: recruitment; client engagement; matter inception; case management; objective setting; and possibly internal audit. It is my view that firms which are not doing so already will have to implement internal audit to ensure compliance with the Money Laundering Regulations 2007, currently issued in draft for consultation. Properly executed, an audit process will not only assist compliance with the regulations but will be a valuable additional tool in the armoury for guarding against rogue partners.

But the larger issue that arises is whether that plethora of documented systems reflects the reality of what happens in practice. Problems arise when some people do not comply, but firms are unable to address the non-compliance because those concerned appear to be successful, high billers whom no one dare challenge. All these people need to understand that the firm is bigger than any one of them.

Left to their own devices, partners tend to be the worst culprits and some will be tempted to circumvent systems. The firm may have developed a multi-layered strategy for protecting partner assets, for example. Part of that strategy will have included conversion to Limited Liability Partnership (LLP). At that point, however, many partners switch off, thinking they have now completed their strategy on risk management. But nobody wants to turn up to work to find the LLP has folded and they are faced with a whole

including annuities relating back to the old partnership; named partners on office leases; and, potentially substantial liabilities to the firm's professional indemnity insurers, of which most remain blissfully unaware.

In the past, many partners thought their professional-indemnity policy was their risk management, and that no further action was required. Although major UK firms are in the main increasing their indemnity limits far above those of overseas firms, most are also undertaking deals for substantially more than their insurance cover, and there are still one or two with significantly lower cover than their competitors.

The second part of the strategy for protection of partner assets (and there should be several more links in the chain), may be limiting liability contractually. But the partner most likely to put partner assets at risk will be the one least likely to agree a limitation of liability with the client, and probably one doing higher-risk work, even though it may not be the highest-value work. An example of this might be repeat work which, although well within the firm's indemnity limit, carries the risk of aggregation under the indemnity policy wording. This could mean that a systemic failure resulting in multiple claims would be subject to one limit of indemnity. A defective rent review clause used in many leases might cause such a problem.

Partners like this may not appreciate the risks inherent in the work they do, or they may have convinced themselves

that it will not happen to them. They are also the partners who do not complete the conflicts-checking and anti-money

highly-specialist partner cannot explain the file to another partner, how will he/she explain it to a judge (or even worse,

Code of Ethics 2006 states⁵ in essence that accountancy practices should consider whether over-dependence on a client or client group by either the firm or an individual partner may create a self-interest threat. Suggested safeguards include monitoring and involving another accountant who is not a member of the same team. Guideline proportions on fees are a maximum of 15 per cent, or 10 per cent for a listed company. A review should be undertaken in the case of a listed company from which five per cent of fees are earned.

Another risk issue for which controls should be in place is that of partners holding outside appointments. Directorships of football clubs seem to be particularly fraught, and not only in the UK.

Limiting lateral risk

Lateral-hire partners present a myriad of additional issues. A cynic might say that the main difference between laterals and existing partners is that their faults have not been discovered. Many firms surrender the integration process in favour of the marketing department trumpeting the success of poaching from a competitor. Many a firm has also made a slip-up in the process. An extreme example was the partner who

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laundering checks before starting work. Remember that in the recent Marks & Spencer case⁴ the events unfolded in less than three weeks.

Partner monitoring methods

Client engagement is a particular risk, because the partner who is taking on the client has an inherent conflict caused by the need to generate fees and satisfy targets. A client-engagement process involving other partners as well as the client partner can introduce additional protection, although it may need modifying to cater for firms with high volumes of new matters. Controls are therefore needed, coupled with a willingness to enforce them. The general counsel for one leading global firm recently said that the majority of partners they had forced to leave were all very profitable. Unfortunately they were also unwilling to comply with the rules.

Partner-objective setting is part of the process, but it is important that there is buy-in within the firm as a whole. Partner-to-partner peer review is another valuable tool. Even large law firms tend to be far behind the large accountancy practices in this regard. Where a partner or small group of partners are engaged in highly specialised work, it is much harder to undertake effective peer review, although that is not a reason for not even trying. Good lawyers will know a good file when they see one – and risk management is not about eliminating risk; it is about managing it. If the

a jury), and how can the other partners be confident that all is well?

Management of key-performance indicators is also important. These will often contain hidden, or in some cases not-so-hidden, clues, such as excessive write-offs or poor cash collection. Important too is watching for over-dependence on one income stream, whether from one client or a referral source. There is precious little guidance from the Law Society or the SRA on this point, save that the Solicitors' Introduction and Referral Code recommends solicitors review the position if more than 20 per cent of referrals come from one source. However, there is much to commend the guidance to accountants issued by the Institute of Chartered Accountants

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in England and Wales (ICAEW), following the International Federation of Accountants' Code of Ethics for Professional Accountants. The ICAEW

faced a High Court action for what was alleged to be an extremely severe breach of fiduciary duty, resulting in a multi-million pound claim against the

firm and major reservations about the level of indemnity cover. Years later he became a partner in a prestigious firm, where he caused a massive loss to the firm and its insurers through a serious act of dishonesty.

Even the largest firms still have gaps in their recruitment processes. Although the position has improved considerably since the surveys started, there is still less than total compliance when it comes to basic recruitment checks, such as practising certificates, CVs and references. Claims and disciplinary records are checked even less, yet the example above is ample reason for checking claims (and other litigation) in particular.

Lateral-hire partners in overseas and branch offices who are the only ones doing their type of work in that office pose a particularly high risk and additional controls and monitoring are essential. A key question is whether the lateral understands and accepts the firm's systems of control, including supervision, internal audit and review, and subscribes to them before the terms are finalised. It may already be too late when they have arrived.

Lateral hiring is too often done without proper planning. A checklist should be prepared; and although time-consuming, the effort should prove worthwhile. The clients that lateral hires bring with them also require due diligence – no less than would be applied to any other client engagement. Full checks need to be done for both anti-money laundering and counter-terrorist finance, as one large firm found to its cost when

it inherited not only a dishonest partner but also dishonest clients, leading to involvement in serious mortgage fraud.

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Counting the costs

Benchmarking with your peer group is also invaluable. The comment "If you think risk management is expensive – try an accident" is attributed to Stelios Haji-Ioannou, founder of easyJet, but it applies equally to professional risk and the losses that flow from failure to manage professional risk. Examples of such failures are by no means limited to claims and complaints, but the hidden costs of a claim – time co-operating with insurers; written-off fees; insurance excesses; and increased premiums increase exponentially in rogue-partner situations.

A number of firms have sought external advice to tackle such problems. People often communicate valuable information to an outsider in confidence – information they may be unwilling to share directly with management. A third reason is that firms are likely to have limited data identifying key risks in their market sectors, perhaps having avoided problems more through luck than good management. External advisers may have access to more data, as well as tools to test for high-risk partners.

Cultural complacency

Many firms are over-reliant on a belief in their open culture as a means of risk control. They tell us

they have 'an open door policy'. Although this is to be encouraged, its efficacy as a means of risk control has limitations, primarily because it is dependent on the person with a problem recognising they have a problem. That person must then be willing to go through the open door and admit the problem, but all too often, it has been found to fail. Active supervision is essential at all levels.⁶

References

- [2007] EWHC 38 (Ch);
- [2007] EWHC 133 (Ch);
- Managing Partner*, July/August 2003;
- Marks & Spencer PLC v Freshfields Bruckhaus Deringer [2004] EWHC 1337 (Ch), which was upheld by the Court of Appeal [2004] EWCA Civ 741;
- Paragraph 290.206-207;
- The Law Society's new Lexcel 2008 standard is expected to specify this for accredited firms. ■

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