WELCOME BACK (AGAIN)

Twelve months ago, Frank Maher provided some 'back to school' planning tips for the regulatory year that lay ahead. One year on, the credit crunch has not gone away, property values have fallen, and recession looms. **Francis Dingwall** and **Frank Maher** report.

It is said that the bleak economic outlook led many business owners to forgo their summer holidays. Hopefully, law firm finance directors and CEOs did manage to get away, because it pays to gaze from afar – whether from a sun-drenched piazza in Perugia or from a leaky tent in the Lake District – at the business year which has gone, and return refreshed to the fray.

This article 'gazes from afar' at regulatory and other financial developments in the 12 months since last July when the Solicitors' Code of Conduct 2007 came into force. We look ahead at the financial risks presented to law firms by the oncoming fray, and what you can usefully do to manage them.

The Solicitors Regulation Authority: you ain't seen nothing yet

Many lawyers still find it hard to understand that the Solicitors Regulation Authority (SRA) is not there to represent their interests as the Law Society was. Those of you with backgrounds where the Financial Services Authority (FSA) was the regulator will find it less difficult. Indeed, the risk manager at a top-ten firm recently said: "If you don't like the SRA, try the FSA. You ain't seen nothing yet!"

Over the past 12 months, the SRA has made it clear by its actions that it is serious about protecting the public interest and we can expect it to step up those efforts in the coming

year because its credibility as a regulator still hangs in the balance. Is it independent, or a puppet of the Law Society? We can expect it to demonstrate its independence with vigour.

Regulator's focus on business management

The question of whether or not a law firm is a business is relatively new. Historically lawyers, however competent at advising others, have not been famous for running their own practices in a business-like manner. The advent of professional managers revolutionised the management of firms as businesses. But for a long time, the regulation of the profession has lagged behind. The Law Society focused on the misconduct of individual members of the profession, at times seeming obsessed with sexual peccadilloes and hands in the till.

The Regulatory Review Working Party stressed that "... business management is as central to the proper delivery of services to clients as professional competence...", and this is reflected both in rule 5.01 of the Code of Conduct and in the SRA's focus over the past 12 months.

Rule 5.01 places the onus on the partners of a firm to fulfil supervision and management responsibilities. We have seen several cases now where an employee has done something wrong – stolen money from client account, or become involved in mortgage fraud – and the SRA has taken disciplinary action against the partners for failing to supervise their employee (breach of subparagraph (a)) or for failing to provide for the safekeeping of assets entrusted to the firm (subparagraph (g)).

We are not reliant on clues from recent cases for insights into the SRA's thinking; they have published their thoughts on their website under the heading 'Risk-based regulation'. They state that they "...are concerned by failures to comply with basic regulatory requirements, to implement effective money-laundering procedures and to identify conflicts of interest...".

Anti-money laundering

The Money Laundering Regulations 2007 came into force on 15 December 2007 and already some firms have been inspected for compliance by the SRA.

Well-run firms will have complied with their obligations to obtain training and to record policies and procedure in line with the legislation. Those who have done so cannot, however, rest on their laurels. Regulation 20 requires firms to maintain certain specified policies and procedures "in order to prevent activities related to money laundering and terrorist financing". As the anniversary of the implementation of the regulations approaches, a number of the larger firms have appreciated the need for external audit of their compliance. Certainly all firms must conduct a review as otherwise it is difficult to see how they will be able to demonstrate compliance.

Conflicts of interest and confidentiality

It is not just the SRA who may be knocking at the door of solicitors firms. The FSA recently published a set of 'Principles of Good Practice' for the handling of inside information aimed at the unregulated sector. The Principles are not binding, but the SRA has welcomed them and reminded solicitors of their obligation to put in place "…robust procedures and management systems for maintaining the confidentiality of client affairs and for managing risk, in accordance with rules 4 and 5 of the Solicitors' Code of Conduct...". As the FSA tightens up on its own regulated sector in the coming months, with several arrests already, we can expect the SRA to follow suit. In any event, firms should be reviewing the adequacy of the information barriers which they use.

Risk management

The final item of management listed in rule 5.01, for which partners are required to provide, is risk management. Most firms have in place a sound framework for financial management, with well-established procedures that are rigorously enforced. Have you put in place a similar framework for risk management? Have you established procedures for identifying the risks the firm faces, assessing them, responding to them and monitoring them? The biggest firms have, but it is difficult for smaller firms to assemble the necessary resources in-house. Just as important as implementation of these procedures, can you demonstrate compliance if the SRA ask for it? The British Standards Institute is about to publish BS31100, its guidance on risk management, which provides a starting point for anyone setting up a framework for risk management.

Now is the time to tighten up the management of the firm.

Regulation of the organisation and the biggest firms

Law firms are complex organisations. With the introduction of entity-based regulation, the SRA has made it clear that it plans to move away from purely regulating the individual and towards regulation of the firm, turning its focus away from the individual's misconduct and towards scrutiny of the business management.

The SRA's Practice Standards Unit and Forensic Investigations Unit are gradually working their way through the profession in their inspections of firms. Perceptions that

they have a combative attitude towards the firms they visit have been reported and countered in the legal press.

The SRA's programme of visits has not yet touched the large City firms. Last month, however, Clifford Chance volunteered itself as a guinea-pig to undergo a trial inspection to enable the SRA to develop protocols to deal with this size of organisation, very different from what the Practice Standards Unit team are used to. In time, the biggest firms may be subject to the same level of scrutiny that financial institutions (in some cases belatedly) receive at the hands of the FSA.

Key compliance areas

During the Practice Standards Unit's visits to mid-size and larger provincial practices, two particular areas of focus have been how firms acquire their clients and 'secret profits'.

Where does your work come from?

Most large law firms will be used to accountants, bankers and other professionals introducing business to them. Yet how many of these firms can say they have complied with the requirements in the Code of Conduct? Rule 9 provides that you must draw the attention of potential introducers of work to the provisions of that rule and to rule 7, which deals with publicity. This applies regardless of whether you have financial arrangements with the introducer. It is not just a provision relating to high-street firms doing volume conveyancing or personal injury: it applies to all firms. Far more extensive requirements apply where referral fees are paid and where the introducer pays the solicitor's fees: these have been a hot topic for enforcement action.

Secret profits

The SRA has sought out firms making charges dressed up as disbursements that are not true expenses incurred by the firm. The SRA has targeted CHAPS fees, where many firms have billed as disbursements say £20 for a transaction fee which cost them £12. We have seen firms punished with reprimands and fines, and firms have faced the expense and humiliation of having to repay their clients the sums wrongly charged, with the administrative burden of writing to clients over a number of years inviting them to claim. The Law Society issued a Practice Note on the point on 30 July 2008. The issue arises with a variety of other elements of costs which are billed as disbursements, for example internal photocopying charges. The only basis on which you can legitimately charge the clients is by making provision in your terms of business and by including the items as part of your profit costs, not as part of your disbursements.

Helping clients to keep costs down

Still on fees, but moving away from the SRA, with the threat of recession comes pressure from clients on costs. An article in the Financial Times on 19 May 2008 headlined 'Time to stop the lawyers' clock' was published four weeks after the lambasting a magic circle firm received from The Hon. Mr Justice Floyd in *Research in Motion UK Ltd v. Visto Corporation* [2008] EWHC 335 (Pat). The judge observed that two senior associates had between them recorded over 4,500 hours in 15 months on the case, for which he observed "one would be entitled to expect each of them to be able to recite all the documents in the case by heart". The costs were estimated at nearly £6 million, against the opponent's costs claimed at £1.6 million.

Since then Microsoft has launched a plan to slash their legal spend over the next 12 months, requiring firms to propose (according to senior vice-president and general counsel, Brad Smith) "creative alternative billing solutions...value based in place of hourly-rate billing". For ideas, a place to start would be 'Pricing and Profitability for Law Firms', a report just published by Ark Group in association with *Managing Partner* magazine.

Fee estimates

Lord Justice Ward opened his judgment in *Burkhard Hedrich v. Standard Bank & Zimmers* with the following comment: "A cigarette packet carries the warning that smoking can kill you. Solicitors' standard terms of business should carry a warning that litigation can cost you."

One positive step firms can and must take is to manage clients' expectations on fees by providing accurate estimates. Required by rule 2.03 of the Code of Conduct (information about the cost), a string of cases in the High Court during the year showed the risks solicitors run. In *Mastercigars Direct Ltd v. Withers LLP,* the judgment of the costs judge left the solicitors facing a jaw-dropping loss of £600,000. They fared better on appeal before Mr Justice Morgan, but a key feature was that Withers' standard terms made it clear that the estimate they gave was not intended to be a fixed quotation. You should double-check your firm's terms of business and develop tools to enable fee-earners to give – and update – accurate fee-estimates.

Fee disputes and limiting liability

However good your estimates are, cash-strapped clients can become challenging clients. A client who makes money from a transaction is unlikely to sue, but with asset values falling your client may be cutting his losses and he may begrudge your fees. Tight billing and collection is vital. Many professional negligence claims start as counter-claims in fee disputes, and it is therefore perilous to sue for fees. So long as the firm bills its clients before the WIP builds up, and is then disciplined about not incurring further WIP until each bill is paid, the loss suffered by non-payment of any one invoice will not materially damage the firm and you will be able to avoid fee disputes altogether.

If you do, nonetheless, face a claim from a disgruntled client, you will reach for the firm's terms of business to check what the potential exposure is. As you will know, auditors have finally got the power to impose limits on their

liability under provisions of the Companies Act 2006 which were brought into force in April, and accountants have been limiting their liability in other areas for many years. Solicitors have historically been behind the game. This year the Legal Risk's Top 100 Professional Indemnity and Risk Management Survey[1] (to which 64 firms replied) established, for the first time, that all limit their liability at least some of the time.

Tenders – the questions clients ask

You may have concerns about your clients' viability, and prospective clients may also show an interest in yours. During the year, we conducted a worldwide poll into the questions typically asked on tendering exercises carried out by prospective clients. The top issues were:

- Archiving;
- Business continuity;
- Claims record;
- Complaints handling;
- Confidentiality;
- Conflicts;
- Corporate social responsibility;
- Diversity;
- File auditing;
- Information barriers;
- Insurance cover;
- Knowledge management;
- Quality systems;
- Risk management systems.

The most sophisticated clients also asked questions about the firm's viability, demanding:

- The past three years accounts;
- Gross fees for relevant work type;
- Gross fees earned from the client;
- Staff turnover;
- Overview of business strategy;
- Mission statement for the firm and team;
- Substantial changes over the past two years;
- Proposed changes in the next two years.

As clients become more discriminating, we can expect them to scrutinise the business management of firms they are looking at ever more closely. Client-focused fee-earners who glaze over when you warn of pressure from the Regulator may be more attentive to the pressures from this direction.

Mortgage fraud and insurance premiums

No gaze into the oncoming fray would be complete without a mention of mortgage fraud. Solicitors are in the business of managing the legal risks their clients entrust to them, and one of the principal risks their lender clients expect them to keep an eye out for is mortgage fraud. The badges of mortgage fraud are many, and generally only the case-handler is privy to them. There are some, however, which may be caught by the central management of the firm:

- The agreed charging rate or fixed fee is higher than usual;
- The client purchasing the property works for your firm, or is related to an employee or partner in the firm; and,
- At the conclusion of the transaction, a substantial sum is paid back to the client purchaser, or to another party other than the seller.

It is entirely possible that, if the property market continues its slide, the profession will face a deluge of claims arising out of mortgage frauds in the next couple of years repeating the experience of the early 1990s. That in turn may cause the market for professional indemnity insurance to harden, after many years of low rates. It has yet to be seen whether rates will go up for the current year, or whether firms with exposure to mortgage fraud claims will be able to find cover. Even if rates do remain low this year, they may well increase next year. In a hard market, insurers will look for evidence that firms are well-run, and that they have in place good systems for managing risk. Remember too, that it is not simply premium levels which are in issue. Where insurers perceive a firm has a high risk of mortgage-related claims (or any others for that matter), they may impose higher excesses, perhaps with no aggregate limit. We know of several firms that have found this ended up causing massive uninsured exposure.

In summary

Add together the pressure from the Regulator, from clients and from professional indemnity insurers, and you have an overwhelming case to present to the partners and fee-earners that now is the time to tighten up the management of the firm. And as it is the function of the firm's risk management system to tell you where to focus, that may be the item to start on... after you download the over-exposed snaps from Umbria, or the under-exposed blurs from Ullswater. FD*Legal*

1. www.legalrisk.co.uk

Francis Dingwall

Frank Maher

Francis Dingwall and Frank Maher are partners in Legal Risk, practising solicitors specialising in advising law firms in the UK and overseas on risk management, professional indemnity, anti-money laundering and compliance. They can be contacted at francis.dingwall@legalrisk.co.uk and frank.maher@legalrisk.co.uk