

Winds of change in the legal profession: the Chicago Legal Malpractice and Risk Management Conference 2006

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LEGAL RISK SOLICITORS

In March, Chicago, the 'Windy City', was the venue for 420 delegates attending the Legal Malpractice and Risk Management Conference 2006. Delegates came from law firms large and small, and insurers. The huge turnout would be hard to replicate in any other jurisdiction, no doubt reflecting both the number of lawyers per head of population and the incidence of professional liability litigation in the US.

The conference raised a variety of issues affecting regulation, claims, insurance coverage and risk management, and this article identifies some topics in relation to each from an outsider's perspective.

It would be invidious to identify speakers, given the number of eminent representatives of the legal and insurance sectors who participated, but an exception has to be made for Michele Hirshman, First Deputy to New York State Attorney-General Eliot Spitzer, New York State Department of Law, who gave a fascinating account of the regulatory process in high profile cases, such as the recent investigation into premium service agreements in the insurance industry. Notably, she also drew attention to the dangers of action by regulators eliminating a major player, as happened with accounting giant Andersen after the collapse of Enron, resulting in reduced choice for consumers.

Regulatory environment

Increasingly, lawyers the world over operate in a regulated environment. Lawyers in the UK are probably on the verge of the most significant change in this respect, with the government's White Paper *The Future of Legal Services: Putting Consumers First* (October 2005),¹ which goes further than the recommendations of Sir David Clementi, a leading businessman who was commissioned to produce a *Review of the Regulatory Framework for Legal Services in England and Wales*,² particularly with its proposals for 'alternative business structures', which may permit multidisciplinary partnerships and external funding of law firms. There are indications that the proposals will be followed in Ireland and Denmark, possibly leading to Europe-wide change in due course.

Proposals for change in the UK include a regulator modelled on the Financial Services Authority charging regulatory fees, coupled with an Office for Legal Complaints financed on the 'polluter pays' principle, which may cost the law firm £800 per complaint, regardless of outcome.

The power to award compensation for 'inadequate professional services' may see an increased limit from £15,000 to £20,000, or even more, and may include negligence claims. So-called 'front line regulators' — such as the Law Society, Bar Council and Council for Licensed Conveyancers — will be answerable to the principal regulator.

On a less formidable scale, there were several examples of increased regulation in the US. First and most obviously is the post-Enron Sarbanes-Oxley corporate governance legislation.

I attended a law firm risk management conference in New York in 2002, the day after the draft rules under the *Sarbanes-Oxley Act of 2002* were published; the rules contained reporting obligations going beyond state ethical standards which were seen as too restrictive and, most significantly, supervising obligations on firms which fail to supervise a violation of securities rules. Concerns expressed then were that although they were specifically not establishing rights of action, they would doubtless set the standard for civil claims.

To the relief of insurers, it was felt that Sarbanes-Oxley had had less impact than feared, and if anything they had noticed a downturn in errors and omissions claims.

Chicago delegates were enlightened by a résumé of other areas of regulation. There are new routes to professional liability through bankruptcy proceedings. The *Bankruptcy Abuse Prevention and Consumer Protection Act 2005* applies to bankruptcy cases filed on or after 17 October 2005 and imposes specific limits on what lawyers can and cannot say to clients.

An attorney must certify that the bankruptcy filing is not an 'abuse' as defined by the new 'means test' and good faith requirements. This provision arguably creates liability for an attorney who merely loses a 'means test' challenge, which was said to be a hugely complicated section of the Act.

The signature of an attorney on petitions and other court documents is deemed to certify that he or she has performed a reasonable investigation into the document; that it is well grounded in fact; and that it is

warranted by existing law or a good faith argument for the extension, modification or reversal of existing law and does not constitute an abuse — a far reaching and onerous obligation, compounded by other detailed provisions.

More claims are being litigated through the bankruptcy legislation, though professional liability insurers do not yet seem to be feeling a major impact.

Another field of practice affected by increased regulation is the giving of federal tax advice. US Treasury Department regulations impose ethical rules on lawyers giving such advice to their clients.

The third area of increased regulation on the agenda related to debt collection is where American lawyers appear to be increasingly exposed to claims by debtors where there is any material error in a pre-action letter of claim.

Waiver of attorney-client privilege in regulatory investigations was a concern — the incentives to 'come clean', in terms of more lenient sentences, have to be balanced against the risks in subsequent class action and other litigation, and waivers for regulatory purposes only may be ineffective. Selective waiver to regulators is unlikely to be effective — it is inconsistent because the purpose of legal professional privilege is free disclosure with the lawyer, which is compromised by the waiver. After the conference, on 5 April 2006, the US Sentencing Commission voted unanimously to rescind its policy authorising and encouraging prosecutors to require corporations and other business entities to waive the attorney-client privilege and constitutional protections in order to receive 'credit' for 'cooperating' in government investigations, and the American Bar Association is urging the US Department of Justice to adopt the same approach.³

Claims environment

While the types of claim have generally shown little change, claims by insurers against American law firms were noted to be on the increase — an issue only too familiar to law firms in

the UK, where the climate has changed for defendant practices which were once almost immune from claims, not to mention claimant firms exposed to the traumas of claims arising from the collapse of The Accident Group, a failed introducer of personal injury claims, which has resulted in several group actions by insurers against over 600 law firms.

A recent survey by the American Bar Association also noted an increase in large claims — those over US\$2 million. A similar pattern has been noted by insurers in the UK.

Remarkable to a British observer was the extent to which professional liability litigation turns on expert evidence as to the practice of law, which is rarely countenanced in the courts in England.

Tactics in pursuing professional liability claims were discussed, with one speaker commenting that threatening a claim against a former associate may encourage cooperation. Another claimant lawyer tactic, related to that, is to create a conflict, because insurers dislike paying for two sets of lawyers to defend a claim.

Predictions for 2007 were varied. Electronic document disclosure issues are expected to become a major topic. The work is frequently outsourced to specialist e-discovery companies. There have already been substantial client-lawyer disputes, with one client withholding substantial fees to a major law firm following a reputable e-discovery firm's failure to review 57,000 documents in a Securities and Exchange Commission investigation. In another case, a financial institution blamed its lawyers for inadequate disclosure following its loss of substantial litigation, with an award of US\$650 million and US\$850 million in punitive damages.

The recommended solution for risk management was to make the clients engage the electronic discovery people direct.

Insurers expect severe claims in transactional practice and particularly mergers and acquisitions, and more large claims.

Concerns were expressed about commoditisation of legal work, a practice which is on the increase in the

UK, where many areas of traditional practice, even for large commercial firms, have undergone significant change. With it comes increased risk, as the relationship with the client becomes more arms-length, and the opportunity for multiple errors repeating themselves is a serious problem, particularly given the fact that similarity of claims may mean they are treated as one for the purpose of calculating policy coverage limits under so-called 'aggregation clauses'.

From a practice development point of view, commoditisation was seen as a threat because of the difficulty of being credible about work at the top of the legal 'pyramid' if you are visible doing work at the bottom of it.

There was an interesting discussion on arbitrating fee disputes and legal malpractice claims. There are issues on the extent to which a client can be required to exclude access to the courts, which may mean, in theory at least, that the client needs separate advice on the lawyer's retainer, and wide variation between states on whether arbitration clauses are enforceable at all, or limited to fee disputes. Putting that to one side, cynics asked whether, in practice, parties wanted their claims arbitrated by a judge who was too old to hold office.

'substantial assistance' in the client's breach of fiduciary duty, the implication being that it might fall short of the dishonesty required to be proved in England.⁴

Disclosure to auditors by corporate entities needs to be considered carefully, because auditors may in some ways be regarded as adversaries, given their role in protecting the public interest: clients should insist on a confidentiality agreement with auditors and disclose in reliance on it, with provision for the auditor to let them know if there are any proceedings seeking to challenge it. In this context, Australian readers will be aware of the case of *789Ten Pty Ltd v Westpac Banking Corporation*,⁵ in which Justice Bergin determined that legal professional privilege did not apply to solicitors' representation letters obtained by auditors.

Managing conflict of interest risk in the face of problems posed by lateral partner hires was the topic of another session. Disclosure of confidential information, it was said, is nearly always a breach of duty to the partnership quite apart from ethical considerations. There is therefore a need to establish procedures to limit information on the target firm, limit who will receive it and document what information is received (or not) —

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There appear to be significant increases, in some states but not all, in lawyers being found liable as accessories to clients' breaches of fiduciary duty, a concept long recognised in English law, though only arising in a relatively small number of claims in practice, given the requirement to prove dishonesty to establish such liability in England and the caution which is required to be exercised before pleading dishonesty. The American courts seem to require

there have been a number of instances of hiring firms facing actions by the firms from which partners are leaving for procuring breaches of contract.

Lawyers should not overlook their overriding duty to clients — even clients' identity may be confidential. Although in theory they could obtain client consent, both ethics and partnership law may preclude premature solicitation.

Firms should document in advance who owns the intellectual property of

the firm. Hiring firms should have no contact with non-partner staff until partners in the target firm are told of the plan.

Firms are often remiss in their investigation of a lateral's personal background — a fact which prevails worldwide, it would seem, as evidenced by Legal Risk's *2006 Survey of the Top 100 United Kingdom Law Firms, Professional Indemnity and Risk Management* (see (2006) 5(4) *LPM* 52 for the survey results).⁶ Despite significant improvements over the three years of the survey, there are still woeful inadequacies in the checks being made as to claims and disciplinary records, CVs, references, cover for prior practice liabilities, and current practising certificates (astonishingly, to my knowledge, in two cases involving major global law firms).

Taking on a lateral hire partner with a client following is the acquisition of an asset. It is essential to develop a business plan. Thought should be given to the need to sign confidentiality agreements. Disclosure issues cause problems, because information is needed to investigate possible conflicts.

Insurance environment

Hurricanes Katrina, Rita and Wilma were reported to have had little impact on insurance rates, although they might have prevented a reduction in rates which may have happened otherwise. Intellectual property was identified as an increasing risk area, as insurers in the UK have also noted.

Particular concerns noted by insurers were an increase in third-party, non-client liability, dilution of the 'but for' test in relation to causation in liability claims, and an expanded assignability of malpractice claims. This is something rarely encountered in the UK, at least, though I have encountered it in two major multi-party claims in which I have acted — it was a major issue which reached the House of Lords in the litigation following the collapse of thousands of equity release schemes⁷ and arises again in The Accident Group litigation referred to above.

The variety of reported cases on issues such as rescission, non-disclosure, coverage and whether unserved proceedings can count as a

The US is perhaps ahead of many jurisdictions in identification of conflict issues, though Australia appears to be more advanced in meeting some of those challenges through effective information barriers.

In practice, a case list will only include the best bits, and firms should ask about former representations going back 10 years.

Acquiring firms should do a background check, including a detailed questionnaire — with a note on each page saying 'Do not provide confidential information' to mitigate the risk of claims for inducing breach of contract.

Enquiry should also be made about disciplinary proceedings, even imprisonment, and disqualification from practice. Conflicts should be considered in relation to both new hires and new business.

claim under a professional indemnity appeared to be on a par with the scene in the UK and probably elsewhere.

Interestingly for those with an eye for finer points of policy wording, most US policies are now written on a 'claims made and reported' basis, meaning that there will only be cover if the claim has been both made and reported to insurers during the policy year, which must heighten the risk for firms changing insurers, which is when policy problems tend to occur in practice.

The effect of mergers and acquisitions of insurers and new entrants to the market remains to be seen.

Risk management environment

As one of a number of delegates from the UK, it struck me that the issues of law firm risk management were developing at about the same pace as in other common law jurisdictions — ahead in some respects, behind in others, no doubt reflecting different needs, and different challenges in practice and in the courts.

The US is perhaps ahead of many jurisdictions in identification of conflict issues, though Australia appears to be more advanced in meeting some of those challenges through effective information barriers.

Termination of retainers was identified as a particular risk issue at present, with specific comment on the need to firm up on disengagement letters when advising on leases to ensure that the client knew precisely where the obligation lay for any future action, such as rent review or other notices.

One attorney was said to have exposed himself to a claim when he described himself as ‘world class’ when he was anything but — a point which might strike a chord with those who have seen examples of over-hyped advertising by law firms.

Encouragement of team working, long adopted by UK law firms, was seen as a key factor in avoiding large claims. One might add that remuneration systems are key to the success of this if they are not to inhibit enthusiasm for the concept, and a partner from one leading global law firm spoke with convincing enthusiasm on the merits of lockstep as a means of rewarding partner contribution.

Strategic practice group management requires consideration of everything connected with business planning and marketing, client intake and matter management. Key elements include communication, professional development, case allocation, quality control, financial management and knowledge management.

For firms with a geographical spread, it was noted that where management is at the office level rather than practice group, it encourages more local work rather than national, a point to bear in mind when considering business

development strategies.

Training is key to managing risk, but has to take place in the context of the firm’s own particular business areas and those of the clients.

Key to avoiding claims is keeping clients happy, as happy clients are less likely to sue you.

General files were identified as a risk issue, and are certainly a problem in my experience. They usually mean that the lawyer has failed to identify the retainer and probably has no engagement letter in place.

Overall, an increased focus on proactive risk management by law firms was predicted for 2007. Where law firms worldwide would universally benefit is by adopting a standard framework for managing risk. ISO 9000 is an international standard adopted by some firms, first adopted by the predecessor practice of Pannone LLP in England in 1991, but is perceived as being more relevant to manufacturing industries.

The Law Society of England and Wales promotes its Lexcel standard, a risk management standard developed by lawyers for lawyers. Adoption of the standard is subject to external audit and, subject to client consent in the case of file inspection (in practice, freely given in the majority of cases).

Many English firms have found the Lexcel standard a useful starting point in managing risk, even if they do not yet feel ready to go the whole way by seeking external accreditation.

The standard covers the key areas of a legal practice, addressing the basic fact that risk management is a practice-wide issue. Areas covered are:

- structures and policies;
- strategy, the provision of services and marketing;
- financial management;
- facilities and IT;
- people management;
- supervision and operational risk management;
- client care; and
- file and case management.

The standard has been adopted in two other jurisdictions,⁸ and merits attention by any law society, Bar association or individual law firm

looking to manage risk effectively.⁹ An examination of the underlying causes of claims shows that all the areas covered may be relevant to the management of risk in a law firm — even missed time limits, for example, may be caused by lack of knowledge of the law (such as a time limit under an international convention), partners and associates each thinking the other is taking the necessary step (a staff communication issue), a client giving the lawyer the wrong date (client communication) or computer failure.

A strategy covering all aspects of practice is therefore essential for managing risk. ●



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Endnotes

1. <www.dca.gov.uk/legalsys/folwp.pdf>.
2. <www.legal-services-review.org.uk/content/report/index.htm>.
3. See statement at <www.abanet.org/op/greco/memos/sentencingcommission.shtml>.
4. See *Twinspectra v Yardley* [2002] 2 AC 164.
5. (2005) 215 ALR; BC200501177.
6. The survey can be downloaded at <www.legalrisk.co.uk>, News and Events page.
7. *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896.
8. Northern Ireland, and adapted under licence to local needs in Singapore’s PrimeLaw scheme.
9. A free booklet is available explaining how the scheme can assist in practice: *A Practical Guide to Managing Risk*, by the author, contact <info@legalrisk.co.uk>.

LAW 9000 — risk, insurance and assurance

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SAI GLOBAL

Risk and insurance

The insurance industry has ubiquitously applied the premise that a participating (insured) entity would be looked after should something go wrong. Regardless of what is being insured, it is widely recognised that high risk profiles attract increased insurance premiums.

If an adverse event is likely and/or its consequences significant, it stands to reason that insurance premiums for an entity operating in such high risk environments are bound to be relatively expensive. Consider, for instance, the manner in which many motor vehicle insurers have structured premiums to cover high risk profiles such as accident prone individuals and young males driving sports cars. In some instances, insurance to cover high risk profiles may even be denied.

This connection between risk and insurance is being taken to another level. For a growing number of applications, insurers are recognising the risk-mitigation benefits that assurance management systems can offer. There are examples even within the legal profession where this has translated to reductions in specific insurance premiums.

Risk and assurance

The connection between risk and assurance is fundamental but not always clearly understood. Unlike insurance, which takes effect in a reactive manner (that is, when an adverse event has already occurred), assurance takes a preventive approach, making sure systems are in place to minimise the likelihood of adverse events (see Figure 1).

In simple terms, assurance offers prevention and insurance represents a short-term cure. In any context, it is hard to argue against the notion that prevention is better than a cure. Focusing on assurance has the potential to yield far greater benefits than relying on insurance alone.

Legal profession case study

Law firms based in NSW represent approximately half of all legal practices operating in Australia. LawCover administers an industry specific insurance scheme for NSW-based firms.

On an annual basis, LawCover underwriters prepare a risk profile of each law firm that will apply for professional indemnity insurance through the LawCover scheme for the

ensuing year. A risk profile is an assessment of the likelihood of a firm notifying LawCover of an actual or possible professional negligence claim in the next insurance year.

A number of factors are considered in preparing risk profiles for participating firms; for instance, the size of the firm, claims history, risk management training and practice management certification. LawCover's claims statistics over the past 17 insurance years have consistently shown that over 80 per cent of claims and potential claims arise from two basic causes:

- a lack of common understanding between solicitors and clients; and/or
- an absence of (or failure in) work management systems designed to assist solicitors and support staff to deliver consistently high quality services.

Both causes point to problems in systems for performing and processing work. Practice management standards that require firms to describe, implement and review work processing systems and to measure outcomes can operate as primary risk management tools.

Risk management approach

Unlike ISO 9001 (a generic management system model), LAW 9000 incorporates specific legal industry requirements, such as terms of engagement, avoiding conflict of interest, precedents systems and the control of matter files.

Another important LAW 9000 requisite is a risk management plan,

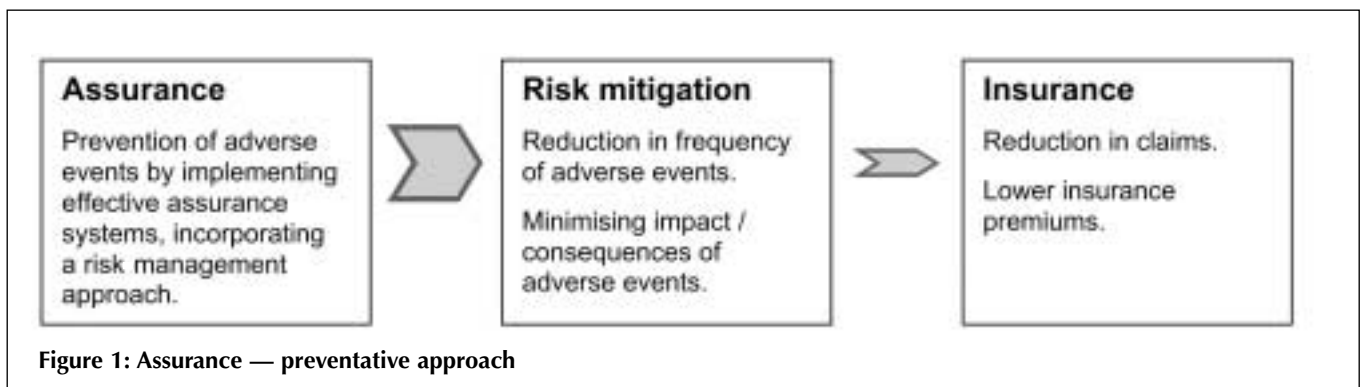


Figure 1: Assurance — preventative approach

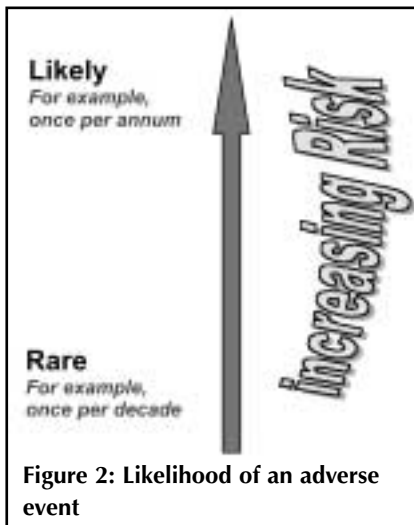


Figure 2: Likelihood of an adverse event

which is the basis of minimising the practice's risk profile.

Risks can be analysed from two fundamental characteristics:

- the *likelihood* of an adverse event (see Figure 2); and
- the *consequence* of an adverse event (see Figure 3).

Risk profiles can be established by evaluating the likelihood and consequences of business risks, and resultant profiles can help identify risk management priorities (see Figure 4).

Sources of risks are numerous and can vary from firm to firm. Examples include:

- changes in law, regulations or Legal Professions Act;
- economic or political circumstances;
- lack of effective management systems;
- increasing client dissatisfaction levels; and
- inappropriate and/or unethical staff behaviour.

The first step in a risk management methodology is to identify all sources of risk and then manage them. The risk mitigation process involves the following generic process:

- identify risks (what are the sources?);
- evaluate/analyse risks (likelihood, consequences and risk profiles);
- treat risks (explore alternatives and take preventive action); and
- re-evaluate risk profiles periodically (risks are likely to change over time).

Firms adopting an effective risk management approach have a practice management tool which can help keep them in business during times of change and uncertainty.

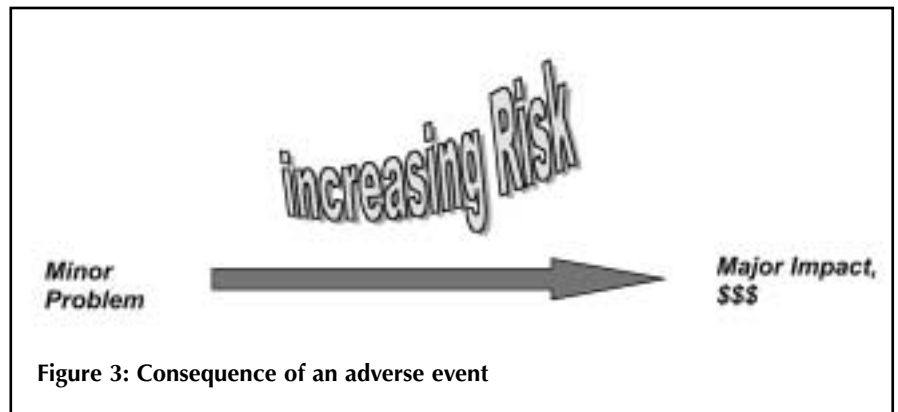


Figure 3: Consequence of an adverse event

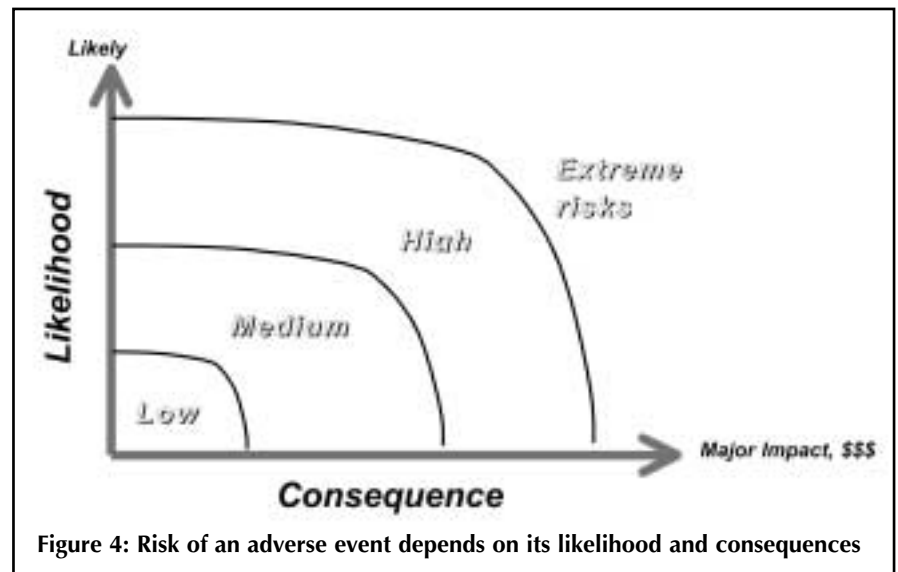


Figure 4: Risk of an adverse event depends on its likelihood and consequences

LAW 9000 certification

In NSW, LawCover offers insurance premium discounts for firms with a management system certified to programs such as LAW 9000, recognising that risk mitigation is an expected outcome of independently assessed, effectively implemented management systems.

The LAW 9000 program incorporates all the requirements of the International Standard ISO 9001, as well as requirements specific to providers of legal services. These industry specific requirements have been adopted from the previous QL accreditation scheme. LAW 9000 has successfully combined international best management practice with legal service specific requirements, providing recognition on the international level while maintaining relevance within the local legal industry.

SAI Global developed LAW 9000 in conjunction with QL Inc, the Law Society of NSW, the College of Law and

a working group of legal practitioners and regulators. In addition to these bodies, the LAW 9000 document enlisted additional external review from the Office of the NSW Legal Services Commissioner and representatives from both small and large national law firms.

Firms certified to LAW 9000 through SAI Global received both an ISO 9001 certificate and a LAW 9000 certificate. ●



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This article includes material presented on behalf of SAI Global during the 5th ALPMA Conference, October 2006.

Conclusive views on service entities

Roger Timms

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The Commissioner of Taxation has now provided his concluded views on the subject of service entities used by professionals such as lawyers, accountants and doctors in the conduct of their practices. Typically, such entities employ staff and own assets made available to the professional practice while carrying out various related administrative duties. Fees for such services are usually inclusive of a mark-up on actual cost, resulting in profit being generated by the service entity.

Professionals can take little comfort from the contents of the Australian Taxation Office (ATO) Taxation Ruling TR2006/2 and the accompanying explanatory booklet *Your Service Entity Arrangements* (the ATO Guide). The Commissioner's views as to the level of profit which could be generated by a service entity without the risk of audit have altered little from those expressed in the previous draft Ruling TR2005/D5.

The Commissioner continues to express an acceptance of the decision of the Federal Court in *FCT v Phillips* (1977) 7 ATR 345, but contends that for a service fee to be deductible it will be necessary to demonstrate that the benefits conferred on the professional practice by the service arrangement provide an objective commercial explanation for the expenditure incurred pursuant to the agreement. Where this requirement is satisfied, all of the service fee expenditure will be deductible pursuant to s 8-1 of the *Income Tax Assessment Act 1997* (Cth).

Where the benefits conferred on the professional practice are not immediately apparent, the ruling indicates that a broader examination of the circumstances will be required in order to determine the purpose behind the expenditure. This examination might include consideration of the subjective

purpose of the practitioner in incurring the expenditure. A broader examination of the arrangement will be required if the service fees:

- are disproportionate or grossly excessive in relation to the benefits conferred by the arrangement;
- guarantee the service entity a certain profit outcome without reasonable commercial explanation; or
- generate profits in the service entity without any clear evidence that the service entity has added any value or performed any substantive functions (for example, where there is no clear separation between the activities of the service entity and the professional practice).

Where the broader examination finds that the service fees are grossly excessive, it could be reasonably concluded that the expenditure was not incurred solely for the purposes of the conduct of the professional practice and therefore some or all of the expenditure may not be deductible.

Part IVA

Part IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) might be applied to a service arrangement in order to deny a deduction for service fees incurred by a professional practice. For Pt IVA to have application, it is necessary, broadly, that a taxpayer enter into an arrangement with the dominant purpose of obtaining a tax benefit. Factors which the Commissioner indicates may be relevant to a determination that Pt IVA has applications would include:

- the manner in which the service arrangement has been entered into, including any non-commercial aspect of the arrangement (for example, excessive services fees);
- a divergence between the form and the

substance of the service arrangement (for example, no clear differentiation between the service entity and the professional practice); and

- the impact of the arrangement on the ongoing profitability of the professional practice relative to what other possibilities existed (for example, excessive service entity profits at the expense of profit in the professional practice).

Asset protection

The Commissioner accepts that asset protection is an acceptable reason for the adoption of a service trust arrangement — this is inevitable in view of the decision of the court in *Phillips*. However, the Commissioner contends that a genuine asset protection objective will not be sufficient to ensure the deductibility of a service fee where the quantum of the fee is excessive.

ATO Guide

The ATO Guide outlines the circumstances in which the Commissioner recommends that taxpayers review their service arrangements. The ATO Guide states it is critical that service arrangements be reviewed if one or more of the following has occurred:

- the professional practice has paid service fees that are disproportionate or grossly excessive in relation to the benefits conferred on the professional practice;
- the level of profit obtained by the service entity exceeds those achieved by independent entities providing similar services;
- there is an arbitrary or fixed mark-up on some or all of the costs incurred by the service entity and charged to the professional practice;
- there is no clear distinction between

- the activities of the service entity and the professional practice;
- there is no evidence of an appropriate level of value being added to the professional practice by the operation of the service arrangement; and
- adequate records have not been maintained to evidence the service arrangement and the benefits which it creates.

Reviewing the service arrangement

The Commissioner indicates that the review steps should be as follows:

Step 1

Explain how the service arrangement helps the conduct of the practice.

Yes — go to Step 2.

No — review the service fee.

Step 2

Are the service fees correctly calculated compared to commercial benchmarks? (See Step 4 below.)

Yes — go to Step 3.

No — review the service fee.

Step 3

Have you documented the arrangement?

Yes — go to Step 4.

No — review the service fee.

Step 4

Service fee deductible.

Comparison of fees to commercial benchmarks

The ATO Guide contains a ‘comparable market rate’ and an ‘indicative rate’ (see Table 1 below). The comparable rates are the same as those in the draft Guide published with draft

Tax Ruling TR 2005/D5. Where the comparable market rate is adopted by a professional practice, it can be reasonably concluded that no ATO audit of the service arrangement will occur where a professional practice:

- adopts the ‘indicative rate’ approach;
- has no more than 30 per cent of the combined profit of the service entity and the professional practice earned by the service entity; and
- the ATO Guide indicates that the risk of audit is low.

The ATO Guide contains comments which indicate that the Commissioner will accept a different approach to the quantum of service fee for medical practices. Broadly, a fee equal to 40 per cent of practitioner’s fees will be acceptable.

Table 1: Comparative market rate and indicative rate

Arrangement	Comparable market rate	Indicative rate
Labour hire	Net mark-up on costs — temporary staff — labour hire fees that result in the service entity deriving a net mark-up of up to 5 per cent on the direct and indirect operating costs associated with on-hiring staff. Permanent staff — labour hire fees that result in the service entity deriving a net mark-up of up to 3.5 per cent on the direct and indirect operating costs associated with on-hiring staff.	Gross mark-up on costs — labour hire fees that result in the service entity deriving a mark-up not exceeding 30 per cent of salary and benefits of the on-hired staff paid by the service entity, if all direct and indirect operating costs associated with on-hiring staff are absorbed by this mark-up. Operating costs would be expected to represent about 18 per cent of salary and benefits. Net mark-up on costs — labour hire fees that result in the service entity deriving a net mark-up not exceeding 10 per cent on the direct and indirect operating costs associated with on-hiring staff.
Recruitment	Net mark-up on costs — recruitment fees that result in the service entity deriving a net mark-up of up to 5 per cent on direct and indirect operating costs associated with its recruitment activities.	Net mark-up on costs — labour hire fees that result in the service entity deriving a net mark-up not exceeding 10 per cent on the direct and indirect operating costs associated with its recruitment activities.
Expense payments	Net mark-up on costs — a mark-up of up to 5 per cent on direct and indirect operating costs associated with its expense payment activities.	Net mark-up on costs — expense payment fees that result in the service entity deriving a net mark-up not exceeding 10 per cent on the direct and indirect operating costs associated with its expense payment activities.
Equipment hire	Return on assets — the hiring fee results in the service entity deriving a return on assets not exceeding 7.5 per cent of the opening written down value of assets used in the hiring activity. (Note: the draft Guide provided for a return on assets of up to 9 per cent of the written down value of assets.)	Gross mark-up on costs — the hiring fee results in a gross mark-up not exceeding 10 per cent on the cost to the service entity of the equipment with all relevant costs relating to the equipment being met by the service entity.
Rental	Comparable market price — the rent is at market rates (plus finder fees where appropriate).	Comparable market price — the rent is at market rates (plus finder fees where appropriate).

ATO audit activities

The ATO will generally allow taxpayers until 30 April 2007 to review service arrangements. Additional time would only be granted in exceptional circumstances.

Where, at the end of the review period, a service arrangement is generally within the parameters contained in the ATO Guide, the Commissioner indicates that the risk of audit is low. Where this is not the case, an ATO audit might occur, including audits of prior year arrangements.

For cases which the ATO describes as 'high risk', audit activity will continue. These will be cases where each of the following three tests are satisfied in a particular year:

- service fees exceed \$1 million;
- service fees are more than 50 per cent of the income earned by the professional practice; and
- net profit of the service entity represents more than 50 per cent of the combined net profit of the entity and the professional practice.

Conclusion

Professionals who presently operate service entities now would appear to be faced with three possible alternatives:

- comply with the Commissioner's guidelines, a decision which may bring into question the benefit of maintaining a service entity

generating minimal levels of profitability;

- maintain existing arrangements which reflect higher levels of profit than contemplated by the Commissioner — in this instance rigorous review of the service arrangement and supporting documentation is essential; and
- wind-up the service entity — in this instance practitioners might consider an alternative business structure (for example, a unit trust) to replace the partnership with its associated service entity. ●



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Letter from London

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The new knowledge management strategy at A&O

We launched our new knowledge strategy in 2005 (see Figure 1). In working with the strategy, it became clear that it reduced to two central themes:

- *Insight: new knowledge creation* — producing innovative content aimed at strengthening and deepening client relationships; and
- *Toolkit: knowledge capture* — gathering and sharing our core knowledge to ensure lawyers can

navigate quickly to key transactional tools.

Why 'Insight'?

Much of the traditional debate about knowledge management (KM) in the legal profession portrays knowledge as an inert 'thing' which can be 'captured', 'edited' and 'distributed'. KM is therefore often seen as rather boring 'back-office' work preoccupied with indexes, IT systems and a ritualised nagging of senior fee earners

to contribute more of this 'thing' to online systems.

The challenge we set ourselves was to look closely at how knowledge is *created*, not just at how it is captured. Seeing knowledge as an activity, rather than as inert matter, our interest became the way in which distinctive insights may be created and deployed to deepen client relationships. What matters most to us is the creation of opinionated, well researched knowledge which offers a position on



Figure 1: Knowledge strategy

complex questions affecting our clients.

For example, it is not enough for our knowledge staff to follow developments in financial law and regulation, important as that is. These developments need to be analysed in the context of market trends, such as the growth of hedge funds and private equity, or the convergence of securities and loan markets. Finally, if we are to update clients about developments in the law or in regulation, at the very least we should have made the effort to relate it to their organisation and its business, and this requires detailed research into their areas of trading activity, growth priorities and so on.

We don't see these issues as outside the proper terrain of knowledge management. We are therefore seeing a much greater convergence of knowledge management, business development and business research functions in a joint pursuit of superior business intelligence. This is not to say that the *capture* issues are unimportant or unchallenging to us — far from it (see Figure 5 on p 93) — but this focus on insight is what we see as a differentiating factor in our approach to KM.

What underpins our thinking?

Talent before process

If you pick up any copy of a *McKinsey Quarterly* or the *Harvard Business Review*, you are likely to find an article engaging with one or other of the following themes.

- Globalisation, information technology and shrinking transportation costs mean that labour intensive production is under pressure in high-wage countries.
- Anything that can be standardised or commoditised will be subject to intense competitive pressure on price and eventually moved to a low-wage environment.
- Modern complex businesses have a greater need for talented workers — doing things that cannot be automated — to boost their productivity and competitive advantage.

Indeed, Issue 4 of the 2005 *McKinsey Quarterly* looked specifically at the last point, suggesting a

revolution in business staffing towards so-called 'complex interactions'. Complex interactions are jobs that typically require people to deal with ambiguity — there are no rule books to follow — and to exercise high levels of judgment. Such roles require the drawing on of deep experience and insight, often called 'tacit knowledge'. While more complex interactions are *tacit*, more routine roles can be seen as *transactional*. Most jobs of course mix both kinds of activities.

According to McKinsey's research, during the past six years, the number of US jobs that include tacit interactions as an essential component has been growing two and a half times faster than the number of transactional jobs and three times faster than employment in the entire US economy. To put it another way, 70 per cent of all US jobs created since 1998 — 4.5 million, or roughly the combined US workforce of the 56 largest public companies by market capitalisation — require judgment and experience. The balance is tipping towards complexity, in part because companies have been eliminating the least complex jobs by streamlining processes, outsourcing and automating routine tasks.

There is of course a message for KM here. If the source of value is increasingly complex interactions which draw on insight rather than routinised knowledge, the KM function in a law firm must foster a culture in which insight is created. It is quite wrong to think that because insight can

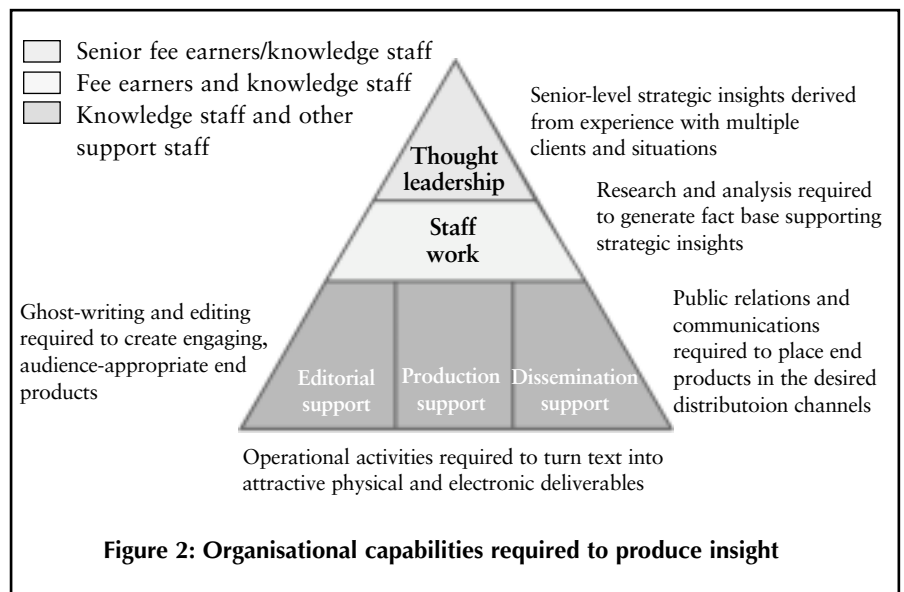


Figure 2: Organisational capabilities required to produce insight

only come from senior transactional lawyers — this is generally correct — there is no role for knowledge staff in procuring it (see Figure 2). The people with the greatest capacity for insight in any firm will be the busiest. Organisations such as McKinsey go to great lengths to facilitate the exploitation of the insights of these busy people through editorial practices, such as presenting them with ghost-written first drafts of insight pieces.

Stuck in commodity thinking

Present-day KM in law firms tends to be a combination of ‘commodity’ and ‘experience’ based approaches. These terms are taken from management theory on professional service firms which organises firms’ capabilities on a spectrum from ‘commodity’ at the left to ‘expertise’ at the right, with ‘experience’ in the middle. The idea is that over time firms will drift to the left because pressure from clients and competitors turns yesterday’s lucrative cutting edge expertise into today’s experience, and tomorrow’s commodity. The theory goes that firms will want to avoid over-dependence on commodity in favour of cutting-edge work because of factors such as fee rates, the busyness levels required to get a decent return, and the risk of de-skilling lawyers.

The theory is over-simplistic because much of what appears to be commodity work is often highly complex, or flows directly into cutting-edge work. It also takes no account of the realities of offering a full range of services to large clients in areas such as banking and finance. But the theory is useful as a way of deciding where the KM activity of a law firm should be directed. For example, the commodity approach encourages improvement in the efficiency of lawyers through a focus on standard form agreements, checklists or, more adventurously, automation of drafting and other working practices. The experience approach suits those areas which are less standardised and focuses on the capture and utilisation of past experience, for example, searchable know-how databases, taxonomies, deal precedent systems, briefings and so on.

A good KM strategy must be flexible

enough to provide high levels of support for these different requirements. But there is an increasing awareness that commodity or experience approaches have been too dominant in law firm KM. The need to foster complex interactions with our clients requires original thinking about the core skills of those involved in knowledge management work in law firms.

Old and new order

Another way of explaining the move to insight is to think in terms of an ‘old order’ and a ‘new order’ in KM.

The key features of the old order are that KM is:

- linked closely to the research function and to information categorisation;
- concerned largely with updating (law or standard agreements) and the production of briefings;
- something that ‘belongs’ to professional support lawyers (PSLs);
- a *support* to existing client relationships;
- a *support* to e-business;
- not about the way lawyers actually advise or manage deals; and
- very tied to information technology (IT) and search technology (so much so that some see KM as a branch of IT).

Insight-based KM is less about capturing and applying past experience to present problems, and more about how a law firm can differentiate itself through distinctive knowledge. The key features of this ‘new order’ approach are that KM is:

- an integral part of business

development and e-business thinking;

- much less concerned with routine information gathering and briefings;
- the joint responsibility of partners, associates and know-how lawyers;
- the *largest part* of what ‘added value to clients’ means;
- one of the *drivers* of innovative e-business products;
- a partner with finance in improving the management of deals; and
- tied much more to people networks than IT systems.

What’s behind the new order?

Client relationships

First, there is a growing awareness that firms can only differentiate by their distinctive expertise and their approach to client relationships, not by strong transaction management experience alone. We articulate this as operating at the ‘pinnacle of practice’, doing the most interesting and demanding work for the most interesting and demanding clients. This is not just about differentiation in a marketing sense, but also about proving premium value to clients and resisting any move to view law firm services as simple commodities. Demonstrating thought and expertise leadership in core practice areas is vital and an important counterweight to the idea that the expertise sold by law firms is a commodity. The link between knowledge and relationship levels is demonstrated in Figure 3 with the high end being ‘trusted adviser’ status.

Figure 3: Knowledge characteristics of relationship levels

	Focus is on	Energy spent on	Client reviews	Indicators of success
Service based	Answers, expertise, input	Explaining	Information	Timely, high quality
Needs based	Business problem	Problem solving	Solutions	Problems resolved
Relationship based	Client organisation	<i>Providing insight</i>	<i>Ideas</i>	Repeat business
Trust based	Client as individual	<i>Understanding the client</i>	<i>Safe haven for hard issues</i>	Varied; for example, creative pricing

No room for generic updating

Second, the bulk of law firms have recognised that much of the routine updating provided internally, and to clients, is becoming a generic commodity that delivers no competitive advantage. Some firms have gone as far as to outsource some of the legal updating that would have been a cherished possession of know-how teams. Again, there is a feeling that we must focus on the content which distinguishes us by reference to our unique expertise and knowledge of our clients' concerns. This becomes particularly important as legal publishers and other industry groups attempt to aggregate the publications content of many law firms in single 'publications portals'.

Being at the cutting edge of legal and market developments

Finally, and implied by the above comments, it is a key part of our strategy to maintain thought leadership in our practice areas, at both the execution and strategic end

Figure 4: What differentiates a great PSL? The things that matter now at A&O

- Establishing context: goes beyond routine information gathering and research in order that A&O remains at the pinnacle of practice.
- Commercial creativity: ability to see patterns in disparate information, identifying underlying issues and opportunities for our clients.
- Internal and external client focus: consistently asking the 'so what?' question in relation to knowledge material.
- Taking initiative: alertness to future possibilities and the drive to act now to keep A&O ahead of the game.
- Communicate clearly: ability to organise thoughts and research in a systematic, methodical way.
- Developing others: commitment to a long-term learning and development culture.
- Authoritative influence: ability to influence others by personal thought leadership.
- Collaboration: ability to work across internal silos to deliver superior services.

of our clients' concerns. It is not acceptable to say that PSLs can initiate and manage this activity. Partners and senior associates have to join with senior know-how staff in discussing the forefront of new developments in the law and the market, by being closely involved in consultation processes on new legislation, market practice and so on. This is also part of ensuring that PSLs gravitate to these tasks and see them as equally important to the routine maintenance of experience-based knowledge. Senior know-how staff can play an extremely valuable role in ensuring that a firm is the first to identify the implications of new legal and market developments. Figure 4 demonstrates some of our new thinking on knowledge staff roles. This has been used to design an entirely new career progression for our PSLs, with promotion now dependent on demonstrating the higher grade skills.

Profitability and risk: two important aims of general knowledge strategy

Most in law firm KM are familiar with Philip Wood's celebrated 'Fountain Guides'. Philip, former head of the A&O Banking practice and head of know-how, codified large parts of the firm's transactional work into concise practice manuals. Ever since,

Figure 5: Toolkit projects for 2006

- Re-design of the fee earner interface to our online know-how to create improved access and use.
- Roll out of our new 'wiki' software to provide collaboration spaces where knowledge on new legislation and specialist practice group content can be shared (this follows successful pilots late last year).
- The re-launch of the Fountain Guides in a new format, incorporating e-learning.

A&O has taken very seriously the need to distil its core transactional knowledge. The aim is to exploit the competitive gain of being a truly global firm, rather than an alliance, serving our clients in whatever way and wherever they need premium legal services.

The 'toolkit' stream of our KM also picks up on two important aims of our general knowledge strategy.

Profitability: to be an efficient service that increases the profitability of our practice areas

This aim recognises that there is still a valid role for KM in building efficiencies around those parts of our work that have standard elements. The 'drift to the left' described earlier means that the cycle towards commodity is a natural one in law firms, particularly in finance work where many standard product lines started their life as highly bespoke types of work. KM has a very valuable role to play in making the more commoditised work streams as efficient as possible, for the benefit of clients and the firm.

As well as fairly straightforward things like improving automated document assembly, better time recording for PSLs, access to know-how and expertise through the fee earner desktop within defined times, this aim also promotes greater integration of finance and KM. The challenge is to reconcile the need to promote standardisation in certain areas with an overall KM strategy that promotes creativity and insight.

Risk: to manage risk in our advice and documentation

A KM strategy must accept an obligation to work with law firm compliance professionals to manage risk, given the numerous legislative and regulatory interventions now upon us, from insider dealing to copyright policies. But insight is also highly relevant here because, while being fully cautious of all risk areas, lawyers must continue to advise confidently and creatively for their clients. As I have heard it put: 'the requirement is to be creative but also to be right'. Risk issues are also extremely high on clients' agendas and offer great opportunities for law firms to provide insightful thinking. ●



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Getting the client relationship review meeting right

Winning new clients is harder and more costly than ever. Developing and deepening relationships with 'right fit' established clients is an increasingly attractive and effective business development strategy.

Our extensive research confirms that most substantial clients value — and expect — periodic relationship reviews.

We are often asked how to conduct an effective client relationship review meeting. Getting these meetings right is very important. Feedback obtained is essential input to:

- improve service delivery;
- prepare future proposals;
- reveal risks for you to address; and
- uncover business development opportunities.

Relationship reviews conducted by high level partners can be great relationship builders, especially if carefully planned and executed to elicit frank, forthright and fierce feedback. Expert, independent facilitation often proves invaluable.

First, the basics:

- have a clear agenda;
- plan a series of 'open questions'; and
- thank attendees for participating.

Next, discuss your *objectives* for the meeting. For example:

- we want your full and frank feedback on how we're going ...;
- we want to understand exactly what you need and expect from us so we can advise and serve you better ...; and
- we want to know about any problem areas we may need to address

From here, *move to specifics*. Include topics and questions selected from the list below.

Understanding your business

- How well do we understand your organisation, the business environment in which you operate and the challenges you face?

- Have we come to grips with your concerns, problems and priorities?
- What work do we need to do on this?

Quality of advice

- Do we consistently provide the right advice? Is it practical and tailored to your situation?
- Is our work effective in helping you to achieve your objectives?
- What improvements do we need to make?

Our relationships with your people

- Do we always take a keen interest in your matters and treat you as an important client?
- Are our people always straightforward, direct and honest with you, and is their behaviour always completely ethical?
- Have we formed productive working partnerships with your key players?
- Do you feel we consistently work in your interests?
- How should we improve our relationships with your people?

Willingness to help

- Are we always ready and willing to help?
- Do our people respond in accordance with your priorities?
- Do we keep you properly informed?
- Are we easy to work with?

Tangibles

- Are our letters, opinions, advices and contracts clear and easy to follow?
- Is our technology up to the right standard?
- What aspects of the presentation of our people, facilities, premises and documents do you suggest we work on?

Review of recent cases

- I'd like to turn to a couple of matters which we've handled for you recently to get your detailed assessment of how we've done. Taking these cases one at a time, and thinking back over the case

(name the case, outlining the key points), what, if anything, do you think we did especially well? (Probe out fully.)

- What aspects of our handling of this case fell short of your expectations? (Probe out fully.)
- How do you suggest we improve our performance on similar matters in the future?

Value for the fees paid

- Does our work represent good value for money to your organisation?
- How does our value for your money rate compared with other law firms and professional advisers?
- Are you happy with the style, frequency and presentation of our bills?
- What should we do to improve the value we deliver?

Opportunities for expanding relationships

- How do you recommend that we promote our services to your organisation?

Effectiveness of marketing initiatives

- What suggestions can you offer to improve the effectiveness of our value added services and marketing initiatives?

Working together better

- Are there barriers or obstacles in working effectively together?
 - What would we need to do to become your ideal professional service firm?
- At the end of the interview:
- thank your client;
 - promise action on key items;
 - indicate a timeframe for feedback; and
 - explain what will happen next.

Getting all-important client relationship reviews right will help you along the path to a pre-eminent position as preferred legal services provider and strong competitor.



Linda Julian,
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recent publications



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