Risk Update

Legal Risk LLP Solicitors

NEWSLETTER No. 24, November 2008

Practise what we preach

Conscious that it is often a case of "the cobblers' children have no shoes" with lawyers, we have followed the advice we give to our clients, and we have converted to an LLP. Our updated logo and style communicate the fact that we are practising solicitors who provide legal advice to lawyers and other professionals: lawyers' lawyers. We also have a new website, **www.legalrisk.co.uk**, to enable us to use it to provide interactive services to our clients. This now has additional resources including conflicts of interest with a collection of UK and international materials as well as our existing anti-money laundering and professional indemnity and other resources. Further resources will be added over the coming months.

Credit crunch risks: pre-Christmas seminar

Managing risk through the credit crunch and emerging unscathed requires fresh thinking – if they are anticipated, many of the risks can be mitigated or avoided altogether, and we are presenting a **seminar** with Baker Tilly in London on 15 December 2008 at 5.30pm entitled '**Credit crunch: new challenges, new risks**'

For booking details see **www.legalrisk.co.uk/Pages/Event.aspx?id=249&EventID=27**

Referral *arrangements* - not just fees!

The Solicitors Regulation Authority's threat of a crackdown on compliance with Rule 9 of the Solicitors' Code of Conduct 2007 – which covers referral *arrangements*, not just those where fees are paid, raises compliance concerns for many firms, including city firms. We have undertaken reviews for many firms, but recognise that with the credit crunch affecting many practices, a lower cost solution may be needed. We will shortly be launching an online self-audit tool, using the new version of our compliance-diagnostic tool Desktop, expected cost from £250 plus VAT. To pre-register for information contact **info@legalrisk.co.uk**

Anti-Money Laundering: Annual Review and Law Society Seminars

With the anniversary of the Money Laundering Regulations on 15 December 2008 it is time to audit the first year's compliance. Regulation 20 requires firms to establish systems and monitor them. We have reviewed many firms. Regulation 21 requires firms to train staff: it is not much use training them unless you have confidence that they have learned from it.

Ideally, following practice in the financial services sector, firms would produce a board report on each of the points in Regulation 20, including an analysis of reporting levels across offices and practice areas and any 'incidents', training and testing of staff.

Of particular concern is the issue of Enhanced Due Diligence *and ongoing monitoring*, required by regulation 14 in cases of Politically Exposed Persons and non-face-to-face clients and other high risk situations. Our experience is that in practice firms are doing little more, if any, due diligence, and we suspect that financial pressures will cause them to do less rather than more going forwards. This must be a particularly serious problem with regulatory consequences in the case of firms doing volume conveyancing for distance clients under investigation over mortgage frauds. Are these cases even identified in your records?

Continued ....

Key items In this issue ...

- Credit crunch risk seminar – 15 December 2008
- The Lawyer – Risk Management Conference and Conflicts Masterclass 16 - 17 March 2008
- Anti-money laundering - your first annual review under the 2007 Regulations
- Our new website, including new Conflicts resources
- Compliance: lessons from Australia
- SRA Practice Standards and Conduct investigations

Insurance renewal - page 3

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Anti money laundering (continued)...

There has been press coverage of the recent FSA fine on the Money Laundering Reporting Officer of Sindicatum Holdings Limited; inadequate client acceptance and due diligence procedures were the key issues.

Some of the larger firms are having external audits, including testing of staff and we have done this for a number of firms

We will soon be launching two online tools – a self-audit for the Money Laundering Reporting Officer, expected cost from £250 plus VAT, and online testing for staff. To pre-register for information contact info@legalrisk.co.uk

Legal Risk LLP partner Sue Mawdsley will be presenting the Law Society's update seminars for Money Laundering Reporting Officers around the country between November and February. These sessions build on previous training and include detailed scenarios reinforced by our experience as practising solicitors. For details see the Events page on our website www.legalrisk.co.uk/Pages/Event.aspx?id=249&EventID=26

"Less said best": a high risk strategy when notifying circumstances

There are important lessons to draw from the Court of Appeal's judgment in **HLB Kidsons (a firm) v Lloyd's Underwriters and others** [2008] EWCA Civ 1206, on issues relating to the notification of circumstances.

An employee at Kidsons developed concerns that tax schemes the firm had developed were (a) flawed, and (b) incorrectly implemented. Internal investigations dispelled concerns about the flawed nature of the schemes, but did not altogether dismiss concerns about implementation. Kidsons made a limited notification of the circumstances. In the early stages, Kidsons had adopted a tactic of 'less said best' towards the insurers.

When claims subsequently came in, it was alleged that the schemes were flawed, ie. point (a). The insurers declined to cover the claims, on the grounds that they fell outside the notification.

The first instance decision was that Kidsons' notification was limited to implementation on one scheme. The Court of Appeal has found that the notification was broader than that, but still limited to the implementation of the tax scheme. The notification did not cover the flawed nature of the schemes, so the insurers were not liable to indemnify Kidsons for these claims relating to that aspect.

On the issue of when an Insured becomes aware of circumstances which may give rise to a claim, the questions to ask are, according to Rix LJ (paragraph 72):

> *"(i) Have such circumstances come to the attention of the insured (during the policy period) so that he can be said to be aware of them?*
>
> *(ii) Are such circumstances such that they 'may give rise to a loss or claim against them'? The latter question is an objective one; the insured may have his own views about the complaint, but the question has to be looked at objectively."*

For circumstances to come to the attention of the insured, it is enough for an employee to express concerns. It does not matter that the firm's principals do not believe that claims might ensue.

There are important practical lessons to draw from the decision.

1. It is only natural that an Insured firm will want to avoid alarming their insurers when they discover a problem, but cannot tell whether a claim will materialise and how serious it might be, particularly if negotiations are underway for the renewal. But if you play it down, you risk not being covered for the ensuing claim.
2. Do not wait until the renewal period, to make notifications. If you make the notification promptly and it turns out to amount to nothing, the insurer may be prepared to discount it by the time renewal arrives.
3. Listen when your employees express concerns, and do not interpose your own beliefs as to whether a claim may arise, when notifying your insurers.
4. Beware the wishful thinking that may cloud an internal report on a problem, and in particular, do not take any reassurance from what the authors of the original work product may say.
5. Regularly remind your staff of their obligation to inform the relevant partner, as soon as they become aware of a mistake, claim, complaint or circumstances which may give rise to a claim, and warn them that they should not attempt to judge for themselves whether the mistake etc. will give rise to a loss or claim.

We have advised numerous firms on internal procedures for notification, and on whether/how to present notifications to their insurers. We also advise both insurers and their insureds in policy coverage disputes.

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Solicitors' renewal: "Then they came for me"

Large firms generally appear to have fared well on the recent solicitors' professional indemnity renewal, with a few notable exceptions who met with substantial increases. We will shortly be sending out our questionnaire for our annual Top 100 survey. This enables the top 100 firms to obtain a true picture of what is happening in the marketplace, from an independent source.

Meanwhile, many small firms struggled on the renewal. Some faced premium increases of 100% or more. It is thought that over 100 firms had to apply to the Assigned Risks Pool because they were unable to obtain cover in the open market. Many firms called it a day on or before 30 September, to take advantage of the run-off terms in their existing policies. The latest figures from the SRA show that 375 firms closed in September 2008; there is always a spike at that time of the year, but this year the figure was nearly 40% higher than the average for the previous three years (though the figure includes a few LLP conversions). We advised many such firms – where the principals wanted to join another firm – on how to ensure that the new practice avoided becoming the successor to the one closing down (which would have led to the new firm taking on responsibility for insuring the old one).

Why did small firms face such difficulties? Why did a number of insurers turn their backs on this segment of the market altogether? The Law Society has established a 'PII Crisis Group' to look into the issue. Clearly underwriters were wary of High Street firms which handled conveyancing, even where a conveyancing questionnaire had been completed. Commentators in the marketplace suggest that another factor was the way some small firms are structured: insurers shied away from anything that looked remotely like a sham partnership.

One explanation for the difference in treatment may lie in the different underwriting approaches taken towards large and small firms. The underwriter simply does not have time to take a 'bespoke' approach to the small risks; there is not the time to weigh up the quality of the small firm's operation. This had a significant impact on firms who had had SRA investigations. And many small firms took a relaxed attitude to their renewal, leaving it to the last minute, lulled perhaps by the easier market conditions which prevailed in previous years.

Small firms would be well advised to put their house in order now, so that by next September they can demonstrate that they are well-run, professional outfits; and in particular, so that they can demonstrate 'at a glance' that they have an effective risk management system up and running.

Will it be the turn of large firms next year? We foresee some hardening of rates and a few more facing difficulties following credit crunch-related claims.

Mindful of the economic pressures that firms large and small are facing, we are developing an online self-audit programme to help firms establish a risk management system, and then monitor it. To pre-register for information contact info@legalrisk.co.uk.

BS31100: code of practice for risk management

In our July 2008 issue, we mentioned the imminent publication of BS31100, and commented on it. It was finally issued last month: www.bsigroup.com/en/Shop/Publication-Detail/?pid=000000000030191339 (price £100). What is best about the code, is its emphasis: the working assumption is that risk management can help you achieve your business objectives. That emphasis is timely, because the banking industry has just been forced to acknowledge how wrong it was to treat risk managers as 'spoilsports, nannies, naysayers':

> *"If a risk manager said no, he was immediately on a collision course with the business line. The risk thinking therefore leaned towards giving the benefit of the doubt to the risk takers".*

Risk management is about handling opportunities as well as risks, so that businesses can manage them and reap the rewards.

Credit crunch risk: its tentacles spread far

For an example of how far risks associated with the credit crunch spread, consider this anecdote. A well-known plc was apparently forced by the credit crunch to secure a £2 million loan against its European factory premises. The unforeseen effect of the mortgage is said to have been to increase the levy payable by its pension scheme to the Pension Protection Fund from £62,000 to over £600,000. One can understand if clients are looking at where the blame should fall for matters such as this.

In the blaze of urgent transactions designed to shore up collapsing balance sheets, corporate lawyers need to be vigilant for knock-on effects.

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People risk: employee stress

The Court of Appeal's decision in **Dickins v O2 plc** [2008] EWCA Civ 1144 is timely, because stress may be a by-product of the credit crunch, and of a period where employees are under threat of redundancy. The defendants were held liable in negligence for the stress-induced psychiatric illness of a former employee.

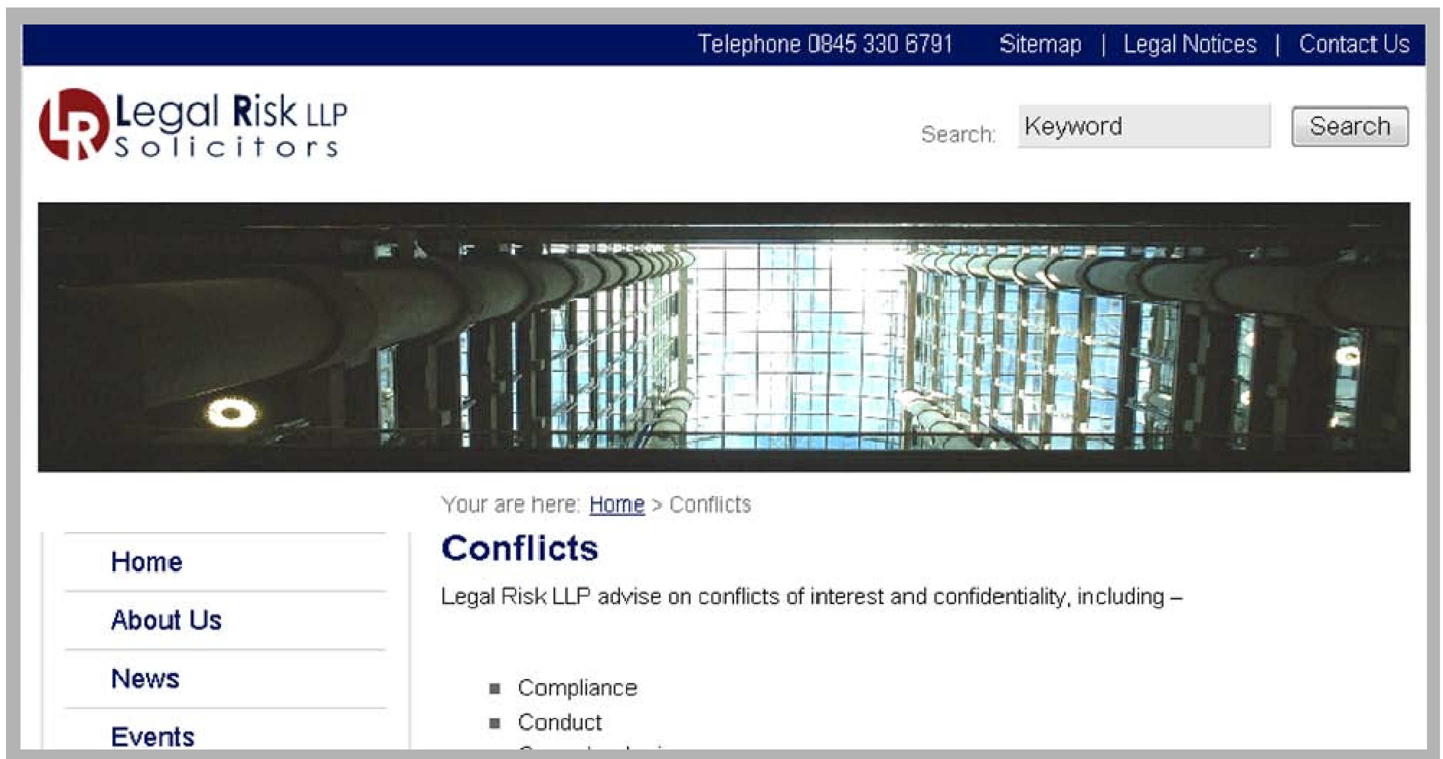
LawCare, the charity which provides health support and advice for lawyers, has reported a marked increase in referrals by solicitors suffering from stress and related problems. www.lawcare.org.uk

Conflicts of Interest and Confidential information

You may work closely with chief executives of corporate clients, act for them in personal matters and acquire confidential information. Does that mean you cannot act for the company against them, if and when they fall out? It is likely to be a time when the company most needs your help, and an opportunity to establish a working relationship with the new chief executive. This happened in **Simon Winters v Mishcon de Reya** [2008] EWHC 2419 (Ch).

On the facts, at the time when the outgoing chief executive had imparted information to the solicitors, it had not been confidential between him and the company, although it had been confidential as against the rest of the world.

Our new website now has a page devoted to Conflicts of Interest with extensive resources including links to rules and cases world-wide - www.legalrisk.co.uk



Legal Risk LLP partners will be presenting **The Lawyer Strategic Risk Management Conflicts Masterclass** on 17 March 2008. This will focus on the issues affecting larger firms. Booking details on www.legalrisk.co.uk/Pages/Event.aspx?id=249&EventID=25

We are advising a number of firms on SRA investigations into conflicts issues. We also have extensive experience of conflicts litigation.

Continued ...

The wizard of Oz: how the NSW Regulator improved law firms' complaints records, by requiring self-assessment (and how we can do the same here)

Rule 5 of the Solicitors' Code of Conduct 2007 (business management) requires the partners in a firm to make arrangements for its effective management. In New South Wales, the legislature introduced a similar regime for incorporated legal practices in 2001, focussing on the management of the firm as a whole. Firms are required to implement appropriate management systems, in other words an 'ethical infrastructure'. The NSW Regulator identified ten straightforward objectives for good management: avoid negligence, improve communication, avoid delays, comply with trust account rules, etc.

How to test whether firms attain the objectives? The answer that the Regulator in NSW came up with in 2004 for incorporated legal practices, was compulsory self-assessment, with ratings from NC 'not compliant' to FC plus 'fully compliant plus' on each of the ten objectives. Where they assess themselves as NC, they are required to outline the action they will take to comply.

The process usually results in a dialogue between the firm and the Regulator about what management systems are appropriate for that particular firm, and a study found that 56% of the firms studied were prompted to make changes to their management systems as a result of the self-assessment process.

The impact of management-based regulation, coupled with the innovative self-assessment regime, has been assessed in a very readable research report by Christine Parker of the Melbourne Law School, University of Melbourne and her two co-authors.
www.courtwise.nsw.gov.au/lawlink/olsc/ll_olsc.nsf/vwFiles/September2008_Research_Report.doc/$file/September2008_Research_Report.doc

The findings of the report are striking. "On average, the complaint rate for each firm *after* self-assessment was one third the complaint rate *before* self-assessment". The researchers looked for other factors that could explain this result, but found none. This suggests that firms successfully use the self-assessment process to implement and maintain appropriate management systems.

The results in NSW indicate that self-assessment would be an effective tool in England & Wales, to assist firms in complying with rule 5 (business management).

At Legal Risk LLP, we have developed our own online self-assessment tool, Desktop. As well as getting senior management to answer questions on a topic, we ask fee-earners and support staff to provide their feedback. This can be invaluable on an issue such as supervision, where supervising partners may genuinely believe that they make themselves available, but where junior staff find them inaccessible.

We have developed a programme of ten questionnaires on relevant topics, one to be completed each month. The results of each monthly questionnaire will enable the firm to see what, if anything, needs tightening up. It may prove useful evidence to show to professional indemnity insurers on renewal, if the anticipated hardening of the insurance market materialises. And it will help to identify any areas of weakness which might otherwise only be exposed by a review by the Solicitors Regulation Authority's Practice Standards Unit.

The first self-audit Desktop questionnaires, to be released shortly, will cover referral arrangements and anti-money laundering. For advance information contact info@legalrisk.co.uk

SRA Practice Standards and Conduct Investigations

As well as the routine Practice Standards visits, which are intended to cover all firms in due course and are now encompassing large city practices, many firms are finding themselves subject to conduct investigations which can be far reaching.

We are advising many city and other large firms on preparation for Practice Standards visits to put their houses in order. We are also acting for a number of top firms on conduct investigations into matters such as conflicts, confidentiality, breach of Law Society guidance on preventing matters such as fraud against lenders, and secret profit allegations such as CHAPS fees and other charges which have erroneously been treated as disbursements.

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