

Hiring and firing

How recruitment can damage your wealth



The role of HR directors in recruitment and retention is obvious, but their relevance to risk management may be less clear. **FRANK MAHER**, partner at Legal Risk, reveals some worrying issues surrounding the dangers of recruitment and succession that will make the worth of a good HR director obvious to all.

What part can a law firm's human-resource director or partner play in minimising the firm's professional-indemnity costs – the third highest overhead for most practices? The answer lies in two key areas:

- Recruitment;
- 'Successor practice' issues, which can effectively make the firm liable for another firm's claims.

Recruitment

Millions of pounds can be at stake – even in comparatively small firms – if they get the recruitment of just one person wrong.

Incredible though this may seem, the reality is that few firms carry out all the checks they should when taking on staff, particularly when making lateral hires of partners and teams.

As one law firm found to its cost last year, this can make them almost uninsurable. Imagine the scenario: a firm is focused on serving its large corporate clients and punches above its weight in corporate work, but is short on commercial-property expertise. The senior partner, with his eye rightly focused on the big picture, surveys the scene and decides, with the head of corporate, that internal growth in property will not satisfy the short-term need. He knows a property lawyer, who is a partner in another local firm, and they arrange to meet up with the head of property.

The target partner has a client following, which they perceive as essential, and soon afterwards the deal is done.

The problems then begin to emerge. Less than a year after the partner joins the firm, three £1m claims come in with some unsavoury allegations of conflict of interest and related misdeeds. The firm decides enough is enough and encourages the partner to go on his way, taking his clients with him.

At this point, the problems have scarcely begun. The firm applies to renew its insurance. The insurers are less than happy about the year's claims; indeed, they were already becoming wary of the partner concerned when he was at his old firm, which they also insured.

The firm's insurance brokers look for cover elsewhere but the insurance market seems less than interested. At this point, the

Firms in the ARP are likely to have severe difficulty finding any top-up insurance, and practising with only £1m cover would be unacceptable for most partners in commercial firms, let alone the difficulties of satisfying requirements of some clients who may insist on additional cover being in place.

Fortunately, a new insurer in the market is prepared to cover the firm but only with a significant hike in premium and a vastly increased excess on the policy.

The problems are exacerbated because in an ideal world you would audit the files to see what else may be lurking and notify anything adverse to the existing insurer before renewal. This would have the effect of making any subsequent claims fall under the

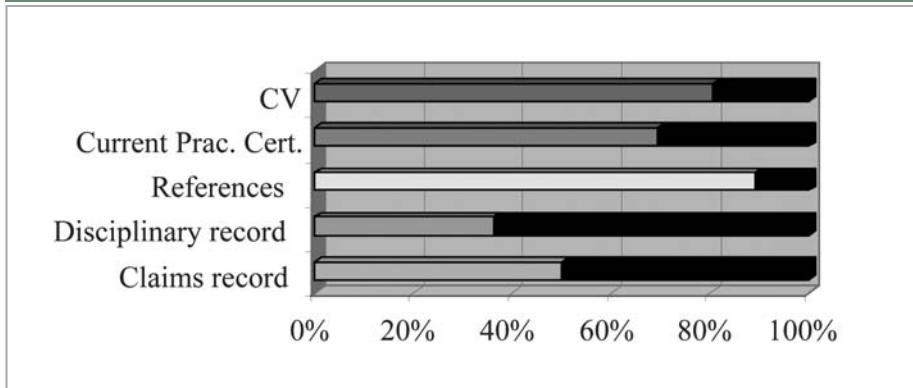
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firm is heading towards the assigned risks pool (ARP) – the Law Society's 'sin-bin' for the uninsurable. Premiums for this are high and assessed on a sliding scale – with 25 per cent of gross fees for the first slice. By way of example, a firm with turnover of £30m would pay a premium of nearly £2.8m for just £1m cover, albeit on an 'each and every claim' basis.

existing insurer's policy, giving some comfort to a new insurer, all being well, that it would not have to deal with claims from the ex-partner's files. This in turn would help minimise the premium.

Where the problem lies is that in the scenario outlined above, the partner may have taken the clients and the files with him on leaving the firm, meaning any audit is

Figure one: Top 100 law-firm checks on lateral-hire partners



impossible. Getting rid of the partner does not get rid of the problem.

Some due diligence at the recruitment stage would have gone a long way to avoid these problems. Research by Legal Risk¹ found that few top-100 law firms do anything like the due diligence they could when making lateral hires.

As the chart in figure one shows, although most of the 36 firms respondents said they checked the curriculum vitae (81 per cent) and references (89 per cent), but rather less checked for current practising certificates (69 per cent), yet a number of firms have been caught out on this to the writer's knowledge, including one multinational firm.

Where firms really fell short on their due diligence, however, was in checking the disciplinary record (36 per cent) – for the cost of a simple telephone call to the Law Society² – and the claims record (50 per cent). While independent verification of the claims record may present problems, the very least the firm can do is ask the incoming partner the question and have him or her sign for the accuracy of the answer. The point is important, not only because past performance may be a guide to future performance, but because some insurers record claims against individuals concerned: a bad claims record against individuals at their previous firms may be taken into account by the insurers in assessing the premiums of firms they join.

Bear in mind, too, that many claims are stress related, for example, missed time limits, where a fee earner has simply not got round to the job in hand despite being fully aware it needed attention,

and even some dishonesty cases where people have behaved in unexpected ways, either due to financial pressure or general workload issues. Past history of stress-related problems is an issue to consider when recruiting.

These insurance issues lead on conveniently to the next topic – successor practices.

Successor practices

All law firms in England and Wales are insured for the first £1m of claims on terms that have to comply with the Law Society's Minimum Terms and Conditions for professional-indemnity insurance³. These have been in force with minor changes since

the abolition of the Solicitors Indemnity Fund in 2000.

One of the aims of these provisions is to ensure that the public is protected, and this includes cover for claims against firms that have ceased to exist. To achieve this, the terms go to some considerable lengths to find a practice that is in some way connected with the firm that has ceased to exist. This is not just about retiring sole practitioners: even larger firms can occasionally go under and the dissolution of Garratts, the legal arm of

Andersen, is a reminder that it can be a big-firm issue too.

The rules aim to find a 'successor practice' – a firm that is then fixed with all the claims baggage of the firm that has closed. If a claim comes in, the partners in the successor practice have to meet the excess and the firm's claims record will be affected.

The rules are complex and it is important to note that once you have become a successor practice, there is generally not a lot you can do to unscramble the position.

Where your firm is intending to take over another practice, it will generally not be an unreasonable consequence if the firm that takes the benefit (of clients and future income) also takes the burden (in the form of the insurance and claims risk). But the rules are complex and can bring about unintended consequences, in one hard case, because of an advertisement several years earlier, even before the profession contemplated the demise of the Solicitors Indemnity Fund.

Examples of cases where the firm can become the 'successor practice' include taking on a sole practitioner – even in a support role, such as a librarian. Another situation is where the firm takes on the majority of partners from another firm. This is not as straightforward as it first sounds.

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The 'majority' does not have to be more than half – the *Concise Oxford English Dictionary* definition includes 'the greater in number'. So, for example, if a 20-partner law firm folds, and one firm takes on a niche team of five partners, while the rest go off to other firms or set up on their own in groups of three or four with the odd one retiring or becoming a district judge, the firm taking five partners could end up as successor practice with all the consequences, almost certainly unintended, that entails.

RECRUITMENT CAN DAMAGE YOUR WEALTH

Case study**Successor practices: Could it be you?**

Tom Hacker had built up a highly profitable personal-injury practice, Accident Express, with his partners Richard Dibley and Harold Muston. The firm had enjoyed considerable success since ditching conveyancing and crime in the mid-nineties and generated profits of which many of the partners in even the larger firms in town could only dream. Dick had retired a couple of years ago and Harry had taken a full-time post as chief executive of the claims consultants who referred most of the firm's work.

Attempts at bringing in new blood had been unsuccessful as the firm was known to be something of a sweatshop. Those young assistant solicitors who had come had not been up to the job of taking over, and the partners had rather taken the view that the firm ran much better on an army of paralegals. If only Tom could find someone to take over from him, allowing him to do a bit of consultancy to keep his formidable wife in the lifestyle to which she had become accustomed, all would be well, he thought. He could then go sailing as often as he liked and keep out of her way.

There had been a few problems in recent months, which he could do without and sorting out an exit strategy while the going was good seemed rather a good idea.

The solution came quicker than he might have hoped. Parratt & Co was a firm that aimed to succeed. A three-partner firm 20 miles away, it had been anxious to gain a proper foothold in the personal-injury market, as they saw their own efforts on the subject so far to have been rather lame.

Jim Young had just become the senior partner of Parratt & Co and was anxious to make his mark on the practice. He had been wondering for some time what would happen to Accident Express as Tom was not getting any younger and was now running the practice on his own. He decided the time was ripe and picked up the phone to fix up lunch with Tom. Tom realised that his opportunity might come sooner than he had dared hope.

Lunch turned out to be something of a misnomer for the occasion. The wine flowed, the hours passed, and lunch gently evolved into an evening meal. Nine hours after the two sat down, they went their separate ways, agreeing to ask their accountants to speak to each other in the morning with a view to progressing matters. If there was a deal to be done, Tom said it should be done quickly to avoid the risk of gossip and damaging speculation and Jim was in no fit state to differ.

A mere fortnight later, with the accountants fresh from dipping their timesheets in the pot, the two men struck the deal. Tom would join Parratt & Co on 1 May as a consultant working three days per week for the first year then reducing to two days per week, and Parratt & Co would pay him a handsome sum for the practice.

Spring turned into summer and renewal time for professional indemnity was soon upon Jim. He set about filling in the form, copying it from last year's as he had done several times before. It all seemed fairly easy, just updating the income figures and attaching the claims summary, which was as pleasantly short as ever, when it dawned on him that he needed to include the Accident Express details on the form

too. Tom was off that week so he asked Brian, his practice manager, to sort it for him as he was going to be away himself for three weeks. It would be a pretty simple task as the brokers would no doubt just be getting a quote off their existing insurers, Geneva International, with whom they had been insured since the end of Solicitors Indemnity Fund and who had also insured Accident Express, and that would be that.

When he came back from his holiday, much refreshed and rather pleased with his achievements so early in his term as senior partner, there was a note on his desk from Brian asking him to speak to him first thing about the renewal. Assuming the brokers had found a better quote elsewhere and just wanted clearance to make the move from Geneva International, he quickly picked up the phone to call Brian.

Brian was rather less cheerful. There was a problem, he said. Geneva International had declined to renew cover. The brokers were having some difficulty finding cover. With turnover just short of £2m, this would mean a premium of nearly £400,000 if they could not find cover and ended up in the sin-bin of the assigned risks pool.

Jim, now feeling rather less refreshed and his holiday already disappearing into a distant memory, set about finding out why. It turned out that the conveyancing department of Tom's old firm, long since disposed of, had been causing a few rather difficult claims from banks. One in particular was pursuing substantial claims in relation to the conversion of a baronial hall into flats. The developer had gone into liquidation. The management company had not been set up properly and there were all sorts of issues over the liability to repair the fabric of the building, a not inconsiderable expense.

Worse still, the bank had discovered that the buyers of the flats were nearly all connected with either the developer or Tom, the valuer who had reported to them could only have done so on the basis of a 'third gear' valuation or worse, and the statements of case were laden with allegations of fraud and conflict of interest by all sides, including Tom and his former partners, Dick and Harry. The bank had reported the matter to the Law Society a couple of years previously and disciplinary proceedings against the three were now under way. Having taken Tom on, Parratt & Co were the 'successor practice' under the Law Society's Minimum Terms and Conditions.

Sorely troubled, Jim's thoughts turned to ditching Accident Express and unscrambling the whole deal. But that was not a solution, because it would still leave Parratt & Co as successor practice.

Eventually, the brokers announced that they could find cover for £200,000 but that was not the end of the story. All claims relating to Tom and his former partners were to be subject to a £75,000 excess.

It was at last dawning on Jim why Tom had been so quick to sign up on what had seemed such advantageous terms. In his haste to do the deal, which had seemed so good at the time, he had not thought to speak to his brokers first, not given a second thought to checking Tom's disciplinary record with the Law Society, and failed to ask about Accident Express's claims record. Tom was also rather concerned, as he had given Parratt & Co an indemnity against any excesses on claims, not that Jim was shedding any tears for Tom.

Check the successor-practice position before you do the deal.

Holding your firm out as a successor practice - not just to clients, but even, for example, to the Inland Revenue - can be a key issue in determining liability in this area. One stray e-mail to a client, or one ill-thought-

its policy. His intention was to hand over clients and ease his way into retirement. Only when the claims came in did he realise that he was stuck with £50,000 excesses, as opposed to the £3,000 he had been

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out press release, can be enough to cause irreparable harm. There are other provisions in the rules that are beyond the scope of this article.

Sometimes a firm will take on new recruits knowing about the successor-practice consequences that flow, but ask the new recruits to indemnify the firm against possible claims liability. This can cause problems too, because unless a deal is done with insurers, the excesses on their claims will be at their new firm's level. In one case, the writer dealt with, a retiring sole practitioner joined a firm as a consultant. The firm he joined had a £50,000 excess on

liable for in his old practice. The partners had failed to take on board that the indemnity they had from him was only as good as his assets and, as far as their insurers were concerned, the liability to pay was theirs; recovery from the consultant was not their concern. Had they addressed the issue, their insurers might have agreed to a smaller excess on claims from the consultant's old practice.

The moral of the story is to consider the insurance implications when recruiting, particularly at partner level. The case study [see box opposite] is an example of the problems that can arise in practice.

The message is that if you are responsible for human resources in your firm, you have a real contribution to make in saving on the firm's professional-indemnity cost. Recruitment due diligence, successor practice and other insurance issues, can all play a significant part in reducing the firm's professional-indemnity risk - even before moving on to consider other critical issues, such as stress, supervision and partner-to-partner review. ■

References:

1. Top-100 professional indemnity survey 2004
2. Telephone 0870 606 2555
3. Additional cover is required for Limited Liability Partnerships. The Minimum Terms and Conditions can be found on www.lawsociety.org.uk by searching for Professional indemnity in the Site Map.

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