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C-Zone

A weekly overview of claims, compliance, company and career issues

CPDZone

Brokers are exposed to professional liability claims if they advise client law firms that have merged or taken on new teams without a full understanding of their changed risk profile

The changing risks that spell danger for brokers

When law firms merge or hire specialist teams there are risks not only for the firms themselves, but their brokers too. The new operation will have a new risk profile which will substantially affect their cover and, if brokers are unaware of the full facts they could face substantial professional liability claims.

Brokers need to be brought in early to assess the changes. Often law firms consult their brokers late in the day when such a deal nears completion, so if any advice is to be given it will be in haste, and often after the event.

There are two aspects to mergers and team hires in which care is needed.

First, the addition of new work types, new offices, new locations and even new people may alter the dynamics of the practice and the level of risk. An obvious case is a merger with a US or other overseas firm. But there are many mundane situations, such as the addition of a volume conveyancing department, which may make a huge difference to the firm's risk profile.

Brokers should also ensure that their client law firms do due diligence on the partners they acquire. Many top firms do not do all the checks they could, as revealed in Legal Risk's Top 100 law firm surveys.

One example is of a partner recruited by a top firm. He had been on the wrong end of litigation at a previous law firm. His actions there resulted in the firm becoming liable for £8.25m in repayments and £41.25m in damages for deceit.

The partner and the firm also faced claims of £44m for breach of duty. In addition there were substantial legal costs.

The allegations were withdrawn after they agreed terms settling the action. But Mr A later went on to commit fraud of breathtaking proportions, stealing several million pounds from his new firm's clients.

Lateral hire partners in branch offices seem to be particularly high risk if they are the only

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partner doing that type of work. Here too, another top firm had its fingers burned when a new partner became involved in serious mortgage fraud on a grand scale, emphasising the need for close supervision of lateral hires to ensure proper control and integration.

The second aspect of a merger causes more difficulty in practice. This is the issue of successor practice liability under the Law Society's minimum terms and conditions of insurance. The rules are written in difficult language and their application can be complex.

The effect is that where Firm A has ceased practising, the rules will try to identify another firm, Firm B, as successor, making Firm B liable to insure Firm A's risk. The consequences include:

- Saddling Firm B with Firm A's claims record
- Making Firm B's partners liable to pay excesses on any future Firm A claims
- If Firm A had a poor claims history, Firm B would be potentially uninsurable.

Even worse, the rules can sometimes make more than one firm successor, which can mean there are excesses on two policies in the event of a claim. Thought needs to be given to whether the incoming partners are to benefit from the firm's top-up insurance too.

But in a normal takeover, the acquiring firm may be happy to accept successor liability as part of the bargain. Sometimes the incoming partners will indemnify the firm against excesses on future claims from their old practice.

The point to watch here is that the excesses may be rather larger than they are used to, and the firms may not be able to afford them, leaving their new partners out of pocket.

Firms – and their brokers – often make the mistake of assuming they can simply dictate in contractual documents who will be the successor, but the rules do not work like that. Great care is needed if the parties are going to try to manipulate the outcome contractually.

Like tax, insurance issues on mergers may open up opportunities for planning. It can be possible to circumvent some of the harsher consequences of the rules, provided the right steps are taken in advance, and there can be real opportunities for saving money in the long term.

Do not be deluded into a false sense of security if both firms involved are covered by the same insurer and it indicates it is happy with the proposal. In those cases it may refer a successor practice to a run-off insurer.

Consider the following examples which illustrate some of the issues involved in merger and personnel changes.

Global scheme

A transatlantic merger includes the London office of the overseas firm which does not practise English law, but includes English solicitors. It is insured under the firm's global scheme with US insurers.

The provisions relating to international practices are complex, but the risk is that if the foreign firm's London office should have compulsory cover under English regulations, but has failed to obtain any, it may be deemed to be in the assigned risks pool and liable to pay a hefty default premium (£500,000 in this example), and the English solicitors may have committed a disciplinary offence.

Your client takes over a niche three-partner aviation practice. It decides, on advice, not to become a successor practice as there have been a few claims problems. But holding out as successor is a key way in which a firm can be

PI checklist for law firm changes

The issues apply as much to top firms as high street practices.

- Risk of fragmenting small firm causing successor liability for whole firm
- Occasional risk of dual insurance
- Consider implementing a 'laundry list' of notifications.
- Large firm acquires small or niche firm
- New work type may alter risk
- Large firm usually assumes responsibility for primary liability
- Smaller firm's claims record will be material
- Smaller firm's wider insurance record also material, for example, unpaid excesses, non-disclosures
- Outstanding claims and any cover issues may also be important
- Consider size of excess and indemnities
- Consider top-up position
- Dual insurance risk (two excesses)

landed with successor liability, though that is not the only criterion in the rules. A large claim comes in. The aviation firm's insurer contends it is no longer on risk, and the claim is covered under the acquiring firm's policy. That firm is liable for the excess (subject to any right of indemnity) and its claims record is damaged irreparably.

So, the message is, plan properly and make sure you understand what the risks are, and how they might be managed. In particular, look out for ways in which the deal might be structured for maximum advantage.

If you dive in and get it wrong, you may end up shouldering your client's wrongly acquired claims exposure for years to come. IT

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