

## Paragon Services Newsletter



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## Introduction

**In our Newsletters, we are introducing you to our Preferred Service Providers, and in this issue we are pleased to introduce you to Legal Risk LLP, who is an industry leader in risk management for lawyers.**

They are practising solicitors in the UK specialising in Professional Regulation and Professional Risk. European and international law firms, as well as many of the top UK firms, come to them for advice on what steps they need to take to comply with the increasingly onerous regulatory obligations in England & Wales. They focus on the new regulatory risks to which all firms, irrespective of the domicile, will be exposed to when practicing in the UK.

From a market perspective, we are also pleased to include an overview from **Lloyd Fielder**, who heads up **Beazley's** global Lawyers' Professional Liability Team. Beazley has been underwriting LPL business for more than 20 years. Today Beazley insures a third of the Am Law 200 and nearly half of the Am Law 100 ranking of the largest law firms in the United States, as well as hundreds of Regional, Specialist and smaller firms.

## New Best Practice Resource available to you - Policies, Procedures and Forms Web-Site Library

**For those of you that we have not had a chance to invite yet, we would like to let you know about our Policies, Procedures and Forms Web-site Library where you and your peer firms can:**

- Share professional standards / risk management policies, procedures and forms;
- Take advantage of the knowledge and experience of your peer firms and specialists from the risk management field;

- Have the opportunity to discuss these policies, procedures and forms with the author firm;
- Share and benefit from any modifications and improvements made, which can only serve as added value to all participant firms.

The size and practice profiles of the current participating firms include a selection of full service law firms (ranging from 185 attorneys to 1000 plus attorneys), and a specialist Intellectual Property firm (500 plus attorneys). We estimate that we have at least 200 documents already!

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The idea is that this is a reciprocated arrangement and in order to join, all we ask is that your firm participate by furnishing copies of your own documents to the library, allowing us to expand our growing collection.

If you would like to receive further information on how to become a member, please contact:

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We are always looking at ways to improve our Newsletter so if you have any suggestions for areas you would like to see included in future issues, please let us know. We are also very interested in expanding our network of Service Providers and would greatly appreciate any recommendations.

*The articles included in this Newsletter are published without responsibility on the part of the publishers or authors for any loss occasioned by person acting or refraining from action as a result of any views expressed therein.*



# Regulation and risk in London law firms: some differences from the USA

By Francis Dingwall | Partner, Legal Risk LLP Solicitors

## Formality, and the new Code of Conduct

Lawyers coming to London will know that the stiffness and formality traditionally associated with the English legal profession no longer prevails. But they might be struck by the formality of the client engagement procedure in this jurisdiction. Rule 2 of the Solicitors' Code of Conduct 2007 requires solicitors in England & Wales to write a formal client engagement letter at the outset of the client relationship.

The Solicitors' Code of Conduct 2007 was introduced as part of a new system of regulation for the profession. Traditionally, there had been a cosy arrangement whereby solicitors were regulated by the Law Society which also represented them. The functions of regulation and representation have now been split, and the role of the Solicitors Regulation Authority is to protect the public interest, rather than to advance the profession's own interests. Compliance with rule 2 is high on the regulator's agenda.

## Informing the client

The essence of rule 2 is that a solicitor must address the project management aspects of the retainer, and spell out how the project is to be taken forward. On costs, the solicitor is expected to inform the client at the outset what he is letting himself in for, as best the solicitor can. The underlying idea is that solicitors should give their clients the information necessary to enable them to make decisions about how – and if – their matter should proceed.

How strictly the rule will be enforced does depend on the circumstances, but firms would be well-advised to use the client engagement letter to sort out the costs in advance.

This regulatory requirement makes commercial sense in the Credit Crunch. Client solvency has become a significant issue, given that even major financial institutions can fail. Even solvent clients are feeling the pinch, and may now scrutinise lawyers' bills in a way they would not have done, when the good times rolled. Suing clients for fees is a high risk option: it often leads to a counterclaim for professional negligence. So it makes sense to address the costs exposure as part of the client engagement process.

## Costs pressures from the Court, as well as from the client

In the USA, lawyers only need to focus on their own clients' costs, because generally there is no costs recovery from another party. Here, where a successful client can expect to recover his reasonable costs from his unsuccessful opponent in litigation – and conversely pay his opponent's costs if he loses – the solicitor must have an eye not only on the potential costs exposure to the opponent, but also on the reasonableness of his own costs in the eyes of the Court.

So the solicitor faces costs pressure from the Court as well as from his client. No solicitor would wish to hear said of them, what Floyd J said of a Magic Circle firm in the recent BlackBerry litigation, **Research in Motion UK Ltd v Visto Corporation**:

*"There is one very striking feature of this case. Visto's estimated costs for the whole of these proceedings are some £1.6 million. Yet RIM's costs are estimated at £6 million... This is a quite staggering disparity...[The Court] will use its powers to ensure that the litigation is run in a way that does not cause parties to expend unnecessary sums..."*

## Client Due Diligence

Before the solicitor gets as far as the client engagement letter, he should follow a client engagement process which treats client solvency as part of Client Due Diligence. Client Due Diligence goes further than solvency checks, just as the Money Laundering Regulations 2007 go beyond checking the client's identity: both disciplines require solicitors to investigate the purpose and intended nature of the business relationship with the client. In hard times, this becomes doubly important. AIRMIC, the Association of Insurance and Risk Managers, warned that the Credit Crunch may be a 'breeding ground for fraud'. American Lawyer magazine reported on the case of a senior partner in a global law firm who has been charged with fraud, where the US government is also seeking forfeiture of a staggering \$2.4 billion. Much the same picture emerges in a number of major fraud investigations underway in the UK.

## No waiver of conflicts

Conflict-checking may be more controversial in recessionary times when work is thinner on the ground, as solicitors become reluctant to turn anything away. The issue is governed by rule 3 of the Solicitors' Code of Conduct. The feature that might surprise a lawyer coming from the USA, is that conflicts may not be waived, except in the limited circumstances noted below. There are no circumstances in which information barriers (or 'Chinese walls') will cure a conflict.

Under rule 3, the circumstances where a solicitor may act for two clients in situations of conflict are limited to two: where the different clients have a substantially common interest in relation to the matter, or the clients are competing for the same asset, and in both cases the rule specifies further conditions. A different regime applies when acting for seller and buyer in conveyancing, property selling and mortgage related services.

## Limitation of liability

Most states in the USA prohibit attorneys from limiting their liability to clients. In contrast, rule 2.07 of the Solicitors' Code of Conduct permits limitations of liability for negligence (but not for fraud), provided that they do not limit liability below the minimum level of professional indemnity insurance cover, and provided that they are brought to the client's attention in writing.

The effectiveness of the limitation will also be subject to the Unfair Contracts Terms Act 1977. The Act broadly requires that clauses limiting liability must be 'reasonable', and establishes criteria for reasonableness.

If the retainer qualifies as a 'contentious business agreement' under section 60(5) of the Solicitors Act 1974, a limitation of liability will be void.

What amounts to a 'contentious business agreement' is not defined in the law or by judicial decision, but it probably does not cover every retainer to conduct contentious work.

### Risk management

A firm may not seek to limit its liability to a figure below the minimum level of professional indemnity insurance cover (currently £2 million for a partnership and £3 million for an LLP), and most firms will have far higher levels of cover. But these days, it is less difficult to imagine that a major insurance company would collapse, than it would have been twelve months ago. Partners have to confront the spectre of personal liability for professional negligence claims. That brings loss prevention - usually referred to as 'risk management' in the UK - up to the top of the agenda.

In this jurisdiction, the Solicitors' Code of Conduct 2007 had already put risk management on the agenda, in rule 5.01(1)(l). Rule 5 requires principals to implement systems for the management and supervision of their practice. It reflects the view of the Regulation Working Party that "business management is as central to the proper delivery of services to clients as professional competence".

Rule 5.01(1)(l) specifically requires the principals to make arrangements for the management of risk. Firms should have arrangements in place for assessing the risks attached to each area of their operation. The rule is aimed at ensuring risk is addressed in the firm's overall management framework.

To address the risks, firms need to establish (1) a framework for risk management (possibly involving a risk manager and/or a risk management committee), (2) a culture of risk management, and (3) a process of risk management.

The process should include the five key steps, (a) identifying the risks to which the firm is exposed, (b) assessing each risk, (c) responding to the risk, whether by avoiding it, limiting it, designing defences to reduce or minimise it, (d) reporting on the management of the risk, and (e) monitoring the process. Firms should fix targets for risk management, e.g. identifying the areas of risk that will be targeted in the next 12 months.

There is helpful guidance in the newly-published British Standard 31100 (code of practice for risk management). The Australia/New Zealand Standard (AS/NZ 4360:2004) covers some of the same ground, and includes helpful and readable guidelines. Both are comparable to the standards US risk professionals may be familiar with, such as the COSO Enterprise Risk Management-Integrated Framework.

### The future: regulation and external investment

The legal market in England & Wales is much smaller than the USA's, but it is not fragmented by the multiplicity of separate State by State jurisdictions. That fragmentation may hold back US firms from a key development on this side of the Atlantic: the development of multi-disciplinary practices and Alternative Business Structures which enable external investment into firms. Preparations towards such vehicles are well underway following the passing of the Legal Services Act 2007. The Credit Crunch may dent the short-term profitability of firms in London, but few doubt the long-term prospects, and City firms are using the downturn to develop their long-range strategies in this direction. It makes London an exciting place to practice law.

## Why this recession may be different for law firms

By Lloyd Fielder | Head of Beazley's Global Lawyers' Professional Liability (LPL) Team

Economic downturns invariably focus law firm attention on many things, including their own productivity and profitability, the scope for increased malpractice allegations and the need to reinforce good risk management practices. Insurers are interested in how firms plan and implement their response to these challenges of mutual concern. Many of the risks will be familiar to those who have gone through previous downturns e.g. the heightened possibility of firms' pursuit of unpaid bills provoking complaints or suits, the risks of redeploying lawyers from dormant to active, but unfamiliar, practice areas and the challenge of maintaining appropriate rigour of client and matter intake. In addition to the lessons that can be derived from previous experience, we have also highlighted some of the exposure issues we see arising specifically from this recession, and have suggested how firms might address them, based on reasonable expectations of its depth and extent.

The dramatic shrinkage in credit has created severe problems for law firm clients. Following the onset of the credit crunch in the late Summer of 2007, numerous deals have suffered severe strain as parties look to withdraw or renegotiate terms. Issues have arisen in relation to the performance of, and levels of disclosure around, the financial instruments that had underpinned the US mortgage market, notably mortgage-backed securities. We have seen examples of law firms being criticised or sued in relation to the drafting of documentation for such transactions. In private equity buy-outs, for example, deal language has been scrutinised, with the possibility of vendors or reluctant purchasers/lenders looking to their lawyers when they are unable to complete, withdraw from or renegotiate deals in changed circumstances. We do not suggest that law firms will be proven to have made more mistakes, but that during times of financial stress and disappointment in business transactions their work will be held to greater scrutiny, and any areas of ambiguity or uncertainty targeted.

We also see the possibility of claims emerging relating to hedge funds. As the overall returns

from this sector have suffered and funds have collapsed or withheld redemptions, lawyers who have provided services to them or their investors could be pursued, especially where the funds themselves have minimal assets or insurance cover. Lawyers could face particular problems where it is argued they were involved in marketing or investor introduction, or acted as a conduit for fund communications. Indeed, firms should be generally aware of the heightened risk where instances of corporate malfeasance or financial fraud are alleged and the depth or duration of the firm's relationship with the alleged perpetrators renders it more difficult for the firm to claim it could not have been expected to detect wrongdoing. The benefit of hindsight often allows firms' behaviour to be more easily impugned.

But there are even bigger concerns that may affect all law firms. In 2007, the US Supreme Court's decision in *Stoneridge* was welcomed as providing a generally effective barrier against lawyers and other advisors being tagged with liability in fraud cases where there was no active knowledge or participation.

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## Why this recession may be different for law firms continued

The plaintiffs' bar lamented this result, as it deprived them of a pool of litigation targets. Now we have heard suggestions that a combination of the plaintiffs' bar and US Congressional aides are working to craft legislation that would circumvent the protection afforded by Stoneridge and other judgments. There is a possibility that such an initiative could form part of wider financial services reform. A reduction in such protections could render firms more susceptible to suits where fraud is revealed, which tend to occur more frequently during a downturn.

Another concern relates to the Foreign and Corrupt Practices Act ("FCPA"), US legislation designed to combat and punish the bribing of foreign governments and authorities. There has been an uptick in enforcement actions in US in the last couple of years, which has been mirrored by other nations. Within the last two months, we have seen the largest settlements of FCPA matters by a non-US and a US company (\$800m and \$579m respectively). There is an expectation of greater action against bribery

worldwide as authorities wish to be seen to be clamping down on the "bad guys". Moreover, the extent of government investment in private sector companies, both in the US and abroad, could lead to the revelation of questionable practices as they gain greater access to corporate information. Lawyers, and especially those with foreign office networks, could be drawn into such issues, where, for example, the existence of problematic arrangements were overlooked on due diligence for a foreign corporate acquisition. Firms may want to pay particular attention to the controls and governance of foreign qualified staff and correspondent firms.

### What steps can Law firms take to minimise some of these risks?

Close monitoring and review of the business process surrounding accounts receivable should be employed, since in the past slow payers were a possible "red flag" to dissatisfaction or financial problems at the law firm's clients. The financial strains being encountered unquestionably

contribute to slow paying, but suggestions of malpractice are utilised as a negotiation tool to leverage unpaid bills downward. Maintaining close scrutiny over and taking early action on larger and older receivables is essential to neutralise this problem.

At this time, in our view, it would be prudent for firms to review their client intake risk management procedures, to reiterate their importance to colleagues and to pay particular attention to lateral hires and any clients they bring to the firm.

In such challenging times we understand the need for law firms to consider difficult measures to reduce their costs, whether via layoffs of attorneys, cutbacks in their administrative workforce or savings with service providers. However, we believe that maintaining the cost commitment to loss prevention and risk management are prudent cost measures a firm can take to mitigate risk and demonstrate effective firm and financial management.

## Paragon Risk Management Services

**Paragon Services** is dedicated to providing our clients with as many additional resources as possible. Throughout our travels we are meeting with all types of law firms and risk management specialists and we constantly hear about the current risk management issues and 'who' is working with 'who' to resolve these. If we can help you and your firm with any risk management plans, please do not hesitate to contact us.

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## Some Key Conference Dates to be aware of:

March 4 – 6, 2009  
Legal Malpractice and Risk Management Conference  
Chicago

April 19 – 23, 2009  
Risk & Management Society Inc (RIMS)  
Orlando

May 27 – 30, 2009  
ABA – 35th National Conference on Professional Responsibility  
Chicago