



**Francis Dingwall and Frank Maher identify some of the challenges law-firm management teams should be addressing on their return from their summer break.**

If the financial world were a school, the events of last September would have been an explosion that destroyed the gleaming 'Lehman economics wing' (opened by former Lehman chief executive Richard Fuld himself). All the business studies pupils would have been sent home for the duration of the academic year, and those studying law would have been allowed to remain in their dowdy classroom. But, by the time exams came around this summer, they might be wondering whether a career in the law is such an attractive prospect after all.

And you, their parents or relatives (if law firm FDs ever encourage children to become solicitors...), will be conscious that it is a difficult time to be in the business of law. Every day practitioners are asking themselves: Does this business still stand up? If not: Is the firm still standing?

The profession is in 'survival' mode, and this article identifies some of the challenges we are identifying in client

law firms – both from a general risk perspective and in the regulatory context of inspections by the Solicitors Regulation Authority (SRA) – which law firm management teams should be addressing on their return from their summer breaks.

All firms can expect a visit from the SRA if they have not had one, and rumours that there will be no more routine inspections of large firms for the present are misconceived. We have even seen top firms having non-routine forensic investigations; so firms need to be on their toes at all times.

**Solvency, costs estimates and *MasterCigars***

The starting place for survival is solvency. Rule 5 of the Solicitors' Code of Conduct 2007 (Code) requires law firm managers (in general terms, the partners) to make arrangements for the effective management of 'financial control of budgets, expenditure and cashflow'.

The ‘cash at bank’ figure tells you if you survive today. The ‘bills delivered’ figure tells you if you will survive next month. Work in progress (WIP) tells you if you will still be solvent in three months time. Looking further ahead, the ‘value of work taken on’ tells you if the firm will be standing in six months time.

In our experience, solicitors are reluctant to put a value on work taken on. It is difficult to put an accurate figure on it, but it is vital in order to know how many fee-earners the firm should be employing.

We are practising solicitors, not management consultants, but we are concerned with a related issue, in the context of advising firms on professional regulation. Solicitors must provide the client with the best possible information about the likely overall cost of a matter at the outset (rule 2.03 of the Code).

In our experience, solicitors are too reluctant to estimate the costs. All too often they will say that it is too early. Or they will provide rolling, cumulative estimates, from stage to stage, which lock the client into a matter that they have no option but to pursue to its conclusion.

When solicitors do produce estimates, they are often inaccurate. In the ongoing *MasterCigars*<sup>4</sup> saga, the solicitors

If you add your voice to the SRA’s, and demand that fee-earners provide you with their best estimate of the value of ‘work taken on’, you may save them from themselves and from both the court and the regulator.

WIP and bills delivered can hold traps too, particularly in recession. Fee-earners who have to justify their continued employment may take a very short-term view. To disguise the fact that they are short of work, they may inflate the time they record. We have seen this in large firms; and the recent case of a former partner in an eminent Wall Street firm jailed for fraudulent billing of expenses to clients, shows that no firm can afford to be complacent.

Inflated billing may come to light when the time comes to bill, but even then it may not, and fee-earners may deliver an inflated bill that the client then challenges. Disputes over costs, and suing for fees, are often a prelude to a counterclaim for negligence, however specious. This emphasises the need for control on lock-up, and ensuring that interim bills are paid promptly or (terms permitting) the firm ceases acting. Serious billing errors can also have an unhappy knack of surfacing, entirely coincidentally, just as one of the firm’s best clients is retendering its legal services.



**All firms can expect a visit from the SRA if they have not had one, and rumours that there will be no more routine inspections of large firms for the present are misconceived.**

estimated their likely costs at £206,570. They came out at £1,084,934. The costs of the ensuing challenge of the solicitors’ costs by the client is reputed to have equalled the costs in dispute already – and it is not yet over. Fee-earners may find more reassurance in the latest judgment than they should. The judge ruled that the correct process is to determine whether, and if so how, the client relied on the estimate, before making deductions that reflect the effect that the erroneous estimate had on the client’s conduct.

The judge stressed that “... it is not the proper function of the court to punish the solicitor for providing a wrong estimate...”. Practitioners should, however, bear in mind that through rule 2.03, the SRA may be policing compliance and that the Legal Complaints Service may make inadequate professional service awards in case of breach.

One of the reasons solicitors have such difficulty estimating costs is because they are not skilled at benchmarking, nor at compiling comparables. Some firms require fee-earners to input estimates onto their case management systems so that alarms can ring when a certain proportion is reached. In principle that should help, although lawyers, who by their training are adept at finding ways round rules, may simply input a new, increased estimate – do you monitor changes in estimates?

Yet few firms have an effective internal audit function in our experience.

Clients are inevitably more focused on their legal spend in the current harsh climate. They want to know at the outset what it will cost, and they want to know that they are getting good value. Law firm economics suffer when clients call into question the pyramid structure of each partner supervising numbers of associates. Evidence from the US is that clients want their partner contact to do the work with the assistance of an experienced associate, but not large teams of associates. Yet leveraging with large teams has been the key to law firm profitability for many years. As one commentator observed: “The future shape of the law firm is not a pyramid.” Client secondments give rise to a host of difficult issues on liability, supervision, conflicts and other compliance – quite apart from the increasing desire of clients to see this as a ‘value-added’ (unpaid) service.

### **The SRA: Choking, nurturing or neither?**

Compliance with regulatory requirements is a survival issue. Peter Williamson, soon to be retiring as chairman of the SRA, recently warned solicitors not to ignore compliance and supervision during the recession. City firms may be forgiven

for believing that regulation has gone down the agenda in the light of messages that emerged earlier in the year.

There was criticism that the SRA has been taking a combative approach to regulation in the case of firms outside the City, and there were those who suggested that it was incapable of regulating City firms at all. Following comment in the Smedley Report in March 2009, a representative of the SRA indicated that the old style of visit by the Practice Standards Unit (PSU) would not continue for City firms. He has subsequently confirmed that the emphasis is on the words ‘the old style’. What will change in the short-term is the frequency and tailoring of the visits.

City firms, like all firms, should expect visits by the PSU and should ensure that they are well-prepared. In our experience, advising firms both before and after such visits, PSU visits can be searching and can lead to time-consuming investigations.

In the medium-term, if the Smedley report is adopted, City firms can expect a unit within the SRA that is familiar with the nature of City practices. The appointment of Charles Plant, a well-respected former partner from Herbert Smith, as the new Chairman of the SRA may make it less likely that the City firms will push for their own regulator. It is quite likely

(March 2001), which identified restrictions on entry, conduct and methods of supply in the legal profession. That, in turn, led to the Clementi report.

The LSA had a twofold aim: to assure the independence and better regulation of the profession, and to create an environment where alternative business structures could be introduced to compete. The two aims are in tension.

Pressures on lawyers to behave like businessmen increase inexorably, with mixed results at the high-volume end of the profession. Referral fees have proved problematic, and the problems are not confined to the much-publicised Miners Compensation Scheme cases. Nor, indeed, are they solely the preserve of volume personal injury and conveyancing firms, as most major city firms that have referral compliance issues to address will find; if not, it is probably only because they have not looked hard enough.

One point of note from the Miners’ cases was that the clients came to solicitors *after* they had entered disadvantageous funding arrangements, but ultimately the Solicitors Disciplinary Tribunal have found (subject to appeal) that a solicitor may be under a duty to advise a client on a document he or she has already entered into before instructing



**Pressures on lawyers to behave like businessmen increase inexorably, with mixed results at the high-volume end of the profession.**

that the SRA’s City unit will, at least initially, adopt a nurturing style towards the firms it is regulating, and this approach will be felt across the profession as a whole as the SRA seeks to strike the balance. However, that should not be mistaken for a ‘light touch’ approach.

In the longer-term, one possibility is that substantial firms will be required to self-certify compliance with the Code. Self-certification would be enforced by audits from the SRA, and any deficiencies could lead to severe penalties. This could well be more onerous, and considerably more expensive, than the exposure to ‘old style’ PSU visits by the SRA.

At present, we are aware of a small number of firms who require partners to certify compliance on a regular basis as part of their risk management process.

**Legal Services Act 2007: long-term survival**

It is easy to focus on short-term survival in a recession. The Legal Services Act 2007 (LSA) is perhaps the greatest long-term threat to the survival of the profession in its present shape, as well as providing new opportunities to lawyers and others. It has crept up on the profession in the main.

The legislation was the long-in-gestation response to the Office of Fair Trading’s report ‘Competition in Professions’

the solicitor. The circumstances were exceptional, but there is a risk that solicitors will find the increasing challenges of acting like businessmen ever harder to reconcile with the professional duty to act in the client’s best interests.

The solicitor will, nonetheless, have to compete with businesses of a very different nature, to which the profitability of legal work compares favourably with their other lines, particularly when acting for private clients and small businesses. In a world where ‘clients’ have, in many cases, become ‘customers’, traditional law firms face a significant challenge.

Firms should be actively looking at the threats and opportunities the LSA presents. We have a significant number of clients who are looking at these opportunities, but firms need to be cautious about ‘jumping the gun’, particularly having regard to the revised guidance notes to rule 1.03 of the Code on independence, which make clear that ‘independence’ means your own and your firm’s independence, and not merely your ability to give independent advice to a client.

The notes then list many examples that are very wide and could catch even firms that are not seeking to be adventurous – care is clearly needed.

### Survival and risk management

All firms should by now have a risk partner or manager, if not a team. Rule 5.01(1)(l) of the Code requires the principals (or managers) to make arrangements for the management of risk. The arrangements must be effective. Revelations by Paul Moore and now David DeMuro, heads of regulatory compliance at HBOS and Lehman Brothers respectively, cast doubt on the way risk management has been approached in recent years in the banking industry, without buy-in from the top. An individual who is the organisation's conscience can all too often be ignored. An organisation can conscientiously follow processes and yet be oblivious to risks that jeopardise its very existence.

This is not to say that money spent on risk management should be cut. The vehicle's brakes are not the best place on which to economise. The lesson of the credit crunch is that risk management should not just be operational. It should also be strategic, dynamic, thinking-out-of-the-box. Increasingly, the larger firms are compiling risk registers, in some cases seeking outside help to gain the benefit of a fresh look from the outside in, and experience of a wider cross-section of the profession.



**An organisation can conscientiously follow processes and yet be oblivious to risks that jeopardise its very existence.**

### Professional liability and the limitations of insurance

One aspect of risk management is the transfer of risk by the purchase of professional indemnity insurance. It is a vital part of your survival strategy.

In the forthcoming renewal (1 October 2009), insurers will be wary where a firm is exposed to mortgage fraud, both on domestic and commercial property. Some large commercial firms have already been hit hard as well as smaller practices. Mortgage frauds on an industrial scale have already come to light (in one case, an organised ring that reputedly processed 850 domestic properties), and there will be more. A deluge of claims by lenders is expected, with one firm that represents them already having to turn away work, so inundated are they.

The claims may not be confined to property. A former chairman of the Bar has suggested that claims may materialise against those lawyers involved in parcelling up the toxic assets that have poisoned the financial system. The defence that their involvement was only to execute the client's instructions may not hold water if they knew (or should have known) that their client did not understand the true nature of the assets being parcelled up.

If your firm is exposed, you should investigate the exposure now and make what notifications you can to your existing insurer. A new insurer may be willing to take you on if confident that the problems are already in the past. Considerable care is needed in drafting such a notification, however.

The solvency, and survival, of the insurers themselves is not beyond question. Smaller insurers might not receive the same support that the world's largest insurer required. Reports in the press claim that one insurer faces losses of \$2bn on directors and officers insurance. Legal Risk LLP's Top-100 Law Firm Professional Indemnity and Risk Management Survey 2009 ([www.legalrisk.co.uk](http://www.legalrisk.co.uk)) found that concerns over security of insurers delayed renewals for 16 per cent of respondents and 30 per cent of top-30 firms.

Insurer solvency may be a difficult issue to address directly, and hardly any firms will benefit from compensation if an insurer fails. It brings into focus the limitations of insurance and the need for firms to protect themselves in other ways. We have considered a wide variety of firms' approaches on limiting liability, and many are worth reviewing. In particular, they should not simply consist of liability caps, but should address the potential involvement of other defendants, a complex topic as became apparent from the recent case of *Nationwide v Dunlop Hayward* [2009] EWHC 254 (Comm).

### Beyond survival

As the investment banks are already finding, for those who have analysed their risks, addressed them and put in place a strategy to survive the downturn, the future may be bright. However, regulatory change and economic conditions together mean that the shape of the profession will almost certainly change at a faster pace than at any time in the past.

This time next year, the school may have a new 'law block', of a modern design and materials unimaginable today. It may be located next to a newly rebuilt and renamed 'Lloyds Economics Wing'. But that is next year.

For now, the law pupils – those that are still left – will remain in their dowdy classrooms, overlooking the burnt-out shell the 'masters of the universe' left behind. [FDLegal](#)

1. [2007] EWHC 2733 (Ch), [2009] EWHC 651 (Ch), [2009] EWHC 993 (Ch), [2009] EWHC 1295 (Ch), [2009] EWHC 1531 (Ch)



Francis Dingwall



Frank Maher

Francis Dingwall and Frank Maher are practising solicitors and partners in Legal Risk LLP. They may be contacted at [francis.dingwall@legalrisk.co.uk](mailto:dingwall@legalrisk.co.uk) and [frank.maher@legalrisk.co.uk](mailto:frank.maher@legalrisk.co.uk).