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Growth pains

Frank Maher discusses how to manage the potential client, criminal and financial risks of taking on new clients in foreign markets

What are the key issues for law firms looking to expand their international client base? I shall seek to answer this question by exploring the risks facing law firms in new foreign markets (particularly client, criminal and financial risks) and how to manage these risks effectively.

The starting point when assessing the risk of overseas practice is the same as for any other aspect of risk management. A widely-used definition of operational risk is: "Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events".

The issue is therefore wider than the risk of negligence claims. It is possible to lose money, or fail to achieve intended profits, in any number of ways. For example:

- failing to ensure your firm is paid in full, promptly and without deduction of local taxes;
- exchange rate risks, meaning that fees agreed in a foreign currency are worth less than expected;
- losing a client due to cultural differences, as your firm did not understand what the client wanted;
- inadequate court systems preventing your firm from suing for unpaid fees; breaking laws in another jurisdiction, resulting in civil or even criminal penalties;
- a foreign government appropriating assets or imposing new restrictions on practice;
- unexpected liabilities under foreign employment legislation (such as pensions or redundancy costs);
- data protection reporting obligations and compensation arising from loss of personal data;
- failure to plan for business continuity of each office, resulting in temporary or even permanent closure of an office because of fire, flood, terrorism or the police preventing access; and
- business failure, as demonstrated by the failure of many large law firms recently, notably Howrey and Dewey & LeBoeuf in the US and Halliwells in the UK.

"Risk management is about achieving positive outcomes, not just avoiding negative ones"

The risk of failing to achieve intended profits shows that risk management is about achieving positive outcomes, not just avoiding negative ones.

Some of these issues may affect our reputation, which is our most important asset that has been built over many years, but is capable of being lost in seconds. Andersen closed not because of a large claim, but because of damage to its reputation over Enron and Worldcom.

How these risks impact on your practice will depend upon whether you are merely providing advice to clients who are abroad or are opening an office there, or perhaps doing something in between, such as working with clients through an association, a joint venture with a foreign firm or a 'best friends' relationship.

The countries that you choose to target will also affect the risk considerations.

In addition, looser relationships such as networks carry risks.

If you are in a joint venture with other firms, you will need to consider how you guarantee consistent quality.

Client risks

You are probably addressing about 80 per cent of your risk management requirements if you are:

- acting for the right clients
- on work you are competent to do
- with the right resources for the work
- with a clear written agreement at the outset as to what is included and excluded in the engagement and
- have an agreement on the price to be paid for the advice.

Foreign clients may bring several risks. First, who is the client? Is it the foreign law firm or its client? You need to be absolutely clear, not least to identify who will pay your bill.

Conflicts rules in the USA are very different in practice from Europe. Clients, particularly American ones, may impose burdensome provisions on conflicts that can extend the definition of 'client' to include subsidiaries and associated companies, even when the client itself cannot provide a definitive list.

American clients are not used to lawyers limiting liability contractually, though this is increasingly common in the UK and to a lesser extent elsewhere. German law firms may offer clients two charging rates, one with a limitation of liability, the other without.

The cultural expectations of people from other countries may also be very different. Asian businesses typically expect their corporate deals to be formalised in much shorter documents than in the West – perhaps only four pages for a multi-billion-dollar transaction. Producing a large document may cause them to perceive a breach of trust, losing the client as well as the deal.

Clients may impose demands in relation to the firm's risk management – information security, business continuity or diversity, for example. These are increasingly expected from large corporate or public sector clients. In the USA and UK, clients may even audit the firm for information security: in doing so, they are guarding their own reputation.

> **"The collapse of large corporations and financial institutions can result in criminal investigations into the work of their advisers"**

Clients in other jurisdictions may be more willing to sue – some firms in Istanbul have recently noted a greater willingness on the part of US and UK clients to sue for alleged negligence.

Claims used to be almost unknown outside the US and UK, but are now more common. Claims may be harder for outsiders to defend in foreign countries.

There is an increasing trend towards more high value claims. As governments are short of cash and become more aggressive in their collection of tax, tax-related claims are a significant issue in many parts of the world.

However, the effect of the global financial crisis on claims varies from country to country.

Criminal risks

Acting for clients in developing countries exposes your firm to the risk of being involved in transactions that damages its reputation and expose it to financial risk.

The collapse of large corporations and financial institutions on which a foreign economy is dependent can result in criminal investigations into the work of their advisers.

Transparency International's corruption perception index, global corruption barometer and bribe payers index are useful tools to consult when assessing the risks in foreign jurisdictions.

Note however that specialist or local knowledge of a country with a high risk of money laundering does not negate the risks, though it may help with identifying and managing the risks.

Anti-money laundering compliance is often perceived by lawyers as a business prevention measure, but it is in fact a valuable part of the client engagement process. Compliance helps firms to identify the right clients for their practice and monitor their activities.

Consider how the target country's anti-money laundering systems compare with your own. This is where firms fall down most in practice – by wrongly seeing anti-money laundering compliance as purely a client engagement issue.

Circumstances may change, such as the ownership of the client or the source of funds for an acquisition. But, risk management is a culture, not an event, and must run through the whole of the retainer.

Financial risks

This has become a significant issue, and the Icelandic financial crisis and problems in the Eurozone demonstrate that sovereign risk – the risk of a country defaulting on its obligations – cannot be ignored.

Lehman was allowed to fail and we have also seen the Dutch bank DSB fail, so banking risk is a major issue, particularly if you hold

client funds and do not take precautions to ensure the risk of bank failure remains with the client rather than your firm.

You will need to consider professional indemnity insurance issues if you are opening an office in an overseas location, entering into a joint venture or doing business in the US and Canada, because there may be limitations on your cover.

In some countries, you will also need to consider local bar requirements for cover. Exchange control (such as in Brazil) can give an added layer of complexity, meaning that cover has to be purchased locally.

Managing risks

You will need a strategic plan. Consider the risks, take advice on those where your knowledge is insufficient and create a risk plan. Ensure someone is responsible for it and for dealing with every risk identified.

In the UK, the Solicitors Regulation Authority requires law firms to have a formal governance structure for managing their own risks. You need someone responsible for risk, answerable to the firm's management.

The largest law firms have risk teams, generally of five to ten people, including a dedicated risk management partner or general counsel; the very largest firms have up to 40 people. These teams have responsibility for client engagement, including anti-money laundering and conflict checks, and other risk issues. These teams develop expertise and should be more efficient than leaving each partner to do their own new client and matter checks.

Creating a risk register

Many firms are following their corporate clients in creating a documented risk register. This is a living document that can be compiled in an Excel spreadsheet and forms an action plan that is kept under constant review.

"Risk management is a culture, not an event, and must run through the whole of the retainer"

A risk register does not have to be complex and does not require sophisticated or expensive software. It is probably easiest to maintain in a spreadsheet. There are commercial products available which are hosted by external providers, but many firms will be uneasy about sensitive data being hosted externally.

Preparation of the risk register should not be the work of one person alone, or it will only represent that person's perception of risks. Those best able to understand the risks faced by a practice are those involved in each aspect of it. There should be structured discussions with heads of practice areas and departments, including the firm's support functions such as human resources, information technology, finance and accounts.

How many entries should the risk register contain? It can be long or short, depending on the level of detail that goes into it, but in practical terms it's best to have less than 100 entries: if there is too much detail, nothing will ever happen.

The risk register should identify operational, regulatory, people, financial and strategic risks. Score each of them, say on a one to five scale (low to high), for both impact and likelihood of occurrence. Multiply the scores and it will help your firm to prioritise actions, focusing initially on those risks with both a high impact and high probability.

Make a named individual responsible for dealing with each risk you identify. Then keep the whole process under regular review, say every three months.

Be prepared

It's important to keep your risk response plans up to date. As changes to the regulation of legal professions are imposed by the International Monetary Fund and the EU on countries that have received financial support, requiring the establishment of independent regulators in place of self-regulation, an increasing burden of regulation on lawyers can be expected elsewhere too. Other pressures will come from the regulatory requirements imposed on your clients and by your clients themselves. mp

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