LAWYERS FOR THE PROFESSION®
Professional Responsibility, Risk Management and the Law Governing Lawyers
HINSHAW & CULBERTSON LLP

Identifying and Managing the Increased Risks Facing Law Firms in a Recession

By Anthony E. Davis And David J. Elkanich
Partners, *Lawyers For The Profession®* Practice Group
Hinshaw & Culbertson LLP

Lawyers face risk every day as an inevitable part of their practices. It is impossible to eliminate all risks, but by adopting appropriate risk management policies and procedures lawyers can control risk and simultaneously enhance the quality of service to clients and improve firm profitability.

The risks inherent in a lawyer's practice are amplified during an economic downturn. Lawyers face the likelihood of a reduced amount of business, which creates both income and overhead - particularly headcount - concerns. At the same time, lawyers and law firms are likely to face an increase in the number of malpractice claims, as well as claims brought by third parties alleging breaches of a fiduciary duty and fraud, and, possibly, claims by partners for management liability. Lawyers and law firms are often viewed as the last "deep pockets" when deals fail or formerly "good" clients go bankrupt.

This article will focus on a number of specific areas of risk that merit special attention during an economic downturn, and will suggest ways in which lawyers and their firms can prepare for and manage these heightened risks.

Developing and Maintaining Appropriate Client Intake Procedures

Client selection and intake is an area with the potential either for higher risk, or, if properly managed, enhanced profitability. Careful consideration of which clients are appropriate for the firm is enormously important in determining whether a law firm: (1) has the ability to handle a particular client matter effectively and to the client's satisfaction; (2) will be paid for the services rendered; or (3) will face possible litigation at the conclusion of the matter. All of these factors assume heightened significance during an economic downturn. Law firms should therefore assess how well they are dealing with the following principles of effective client intake management:

- Is the firm gathering sufficient information before deciding whether to accept prospective clients? In particular, is the firm assessing whether: (1) the client's matter falls within one of the firm's areas of practice; (2) the client has realistic objectives that are obtainable; and (3) the client is both willing, and able, to pay appropriate fees. Taking the time to gather the information necessary to answer these questions significantly reduces the risk that firms will take on work that they are not qualified to handle, and also ensures that clients and their lawyers are on the same page with respect to strategy and analysis.

- Is the firm carefully managing allocation and assignment of work to lawyers with the appropriate level of expertise? In difficult economic times, many firms and, within firms, many individual lawyers, face the question whether to branch out into unfamiliar areas of practice to make up for the loss of business in other areas. "Dabbling" creates multiple risks, including the heightened danger of errors and omissions, the temptation to bill clients for the "learning curve," which can lead to messy fee disputes, and the concomitant risk that the new work will be unprofitable.

continued

- Is the firm requiring independent partner level review (i.e., review by someone other than the lawyer seeking to introduce the client or matter) of the information assembled prior to acceptance of new clients? It is – or should be – axiomatic that individual partners should not be allowed to decide which clients or matters to accept without prior firm approval.

- Is the firm requiring adequate retainers prior to accepting engagements from new clients? A prospective client's objection to paying a retainer is a red flag that the prospective client is likely to be unwilling (or unable) to pay appropriate fees. Lawyers should affirmatively choose their pro bono cases rather than having them forced upon them.

Practice Management and Troubled Clients

A firm's obligation to review and analyze the appropriateness of its clients does not end once it accepts a new client. Firms need to establish a system of practice oversight that evaluates the status of all open matters, and clients' payment history, as an ongoing process. Good practice management ensures that every client is receiving high quality service at all times. On the other hand, permitting individual lawyers – however experienced – to manage "their" clients entirely unsupervised ensures only that if or when a problem develops, the firm will have been unaware of the warning signs of impending trouble.

During economic downturns there is a greater risk that formerly "good" clients will become "bad" clients. When this happens, disputes may arise between the firm and the client regarding the quality of, and the amount to be paid for, legal services. In addition, these situations may also generate claims by non-client third parties, such as investors and trustees in bankruptcy. For example, clients whose businesses fail may file bankruptcy or otherwise cause creditors and investors to lose money. In consequence, the client's investors and creditors may assert that the lawyers failed to properly advise the clients so as to prevent or mitigate losses, or that the lawyers actively assisted the directors/principals to commit fraud and/or breach of fiduciary duty. Good practice management can help individual attorneys identify these problems and deal with them, including documenting the advice being given, thereby establishing the necessary record to refute such claims. Among the indicators that a hitherto good client may be evolving into a high risk client are: (1) that a client is having financial difficulties; (2) that a client, who has historically paid its bill on a regular basis, is now slow to pay or stops paying fees altogether; (3) any sign of improper or unlawful activity by the client or its management; and (4) client complaints regarding the quality of services being provided, or increasing hostility from a client who has previously complained.

Accordingly, practice group leaders need to monitor all client matters systematically and regularly in order to help lawyers to identify warning signs as soon as they appear – and must be ready to intervene to ensure the firm is giving and documenting appropriate advice, or even, when necessary, requiring that the firm withdraw from engagements.

Maintaining Appropriate Financial Controls

Law firms and their individual partners are responsible for ensuring that their firms' financial controls are adequate to enable firms to weather the economic downtown. To that end, law firms should:

- Arrange for their outside accountants to review the firms' internal controls to determine whether those controls are adequate.

- Require, at a minimum, that two lawyers sign all checks and withdrawals from client and escrow accounts. No non-lawyer should ever be allowed to have signatory authority over client or escrow accounts.

- Ensure that client funds are deposited in designated client accounts that are federally insured. Although the FDIC has, for now, agreed to insure all client funds held in law firms' client or trust accounts, it will be important going forward to monitor the continuation of this unlimited insurance and, should the policy change, for firms to spread client funds in accounts at different banks limited to amounts that are covered by FDIC insurance.

continued

- Require regular, monthly reviews of client and escrow account bank statements by firm management to ensure that: (1) all client funds are being appropriately managed; (2) clients are provided an accounting for trust account receipts and disbursements; and (3) the client and escrow account ledgers balance at all times. While these safeguards are important in times of prosperity, they take on extra significance in times of economic hardship. When both law firms themselves and their individual employees may be experiencing financial pressure, it is vital that firms designate senior lawyers to oversee all of these elements of account management, in order to avoid both deliberate and inadvertent violations of the duties owed to clients and to the firm itself.

- Actively manage deteriorating receivables, which may be the first warning sign of the incipient "good client turning bad" described above.

Due Diligence in Lateral Hiring

In an economic downturn, the hiring of lateral lawyers may appear especially attractive. However, lateral hires are often risky investments. While the firm seeking to hire a particular prospective lateral may view her book of business and experience as a short term investment for a potentially significant long-term return, the lawyer seeking to join the firm may be a potential "Trojan horse," importing serious problems into the unsuspecting firm. Among the due diligence steps firms should consider are:

- Thoroughly review the lateral's client list for potential conflicts of interest with the firm's current and former clients.

- Investigate and verify the lateral's credentials. Even where the prospective lateral is "known" to others within the firm, the firm should check the veracity of the lateral's qualifications, bar memberships, and criminal record, and should conduct a bankruptcy and credit check (with permission, of course).

- Identify – and avoid hiring – laterals who are likely to have ongoing disputes with their former firms, because these will detract from the lawyers' attention to serving clients. Similarly, to the extent possible (and subject to confidentiality obligations), seek to establish whether the prospective lateral hires will be leaving their former firm in a weakened financial condition. If her prior firm fails or dissolves following her departure, the lawyer may be faced with potential significant personal liability or with significant claims for unpaid compensation or return of capital. Again, to the extent that those loose ends are unresolved before the lawyer leaves her prior firm, there is an increased risk that the lateral's time and energy will be diverted from serving clients after the lateral joins the firm.

- Set compensation in relation to actual collected dollars with no (or minimal) guarantees, other than a draw to cover the lateral's initial period of time with the firm. Guaranteeing earnings to new laterals can often put a strain on a firm's working capital, and end up causing the firm to experience a loss if the lateral's promised billings do not materialize.

- Establish the necessary infrastructure to integrate the lateral's practice and clients into the firm, and to oversee the work of the lateral. It is not sufficient simply to give a laterally hired lawyer an office, a computer and a secretary, and leave her to meet her (often inflated) billing targets. For every lateral hire, the firm needs to develop a plan that continues to be carefully managed after the lateral arrives. This should be a whole-firm commitment – the firm's existing lawyers, practice group leaders and support staff must be willing to give their time and energy to accomplish the integration of the lateral and her clients into the firm. The need for these efforts is every bit as important, and may be significantly more burdensome, when firms bring on entire specialty or practice groups.

continued

Firm Management in an Economic Downturn

There are a number of management steps that lawyers and their firms can take to assure their continued strength when confronting economically difficult times, including:

- Review the firm's partnership agreement. An inadequate or unclear partnership agreement can pose a significant problem in the event of lawyer departures (whether voluntary or involuntary).
- Make sure that the firm is adequately capitalized, and reduce debt, in order to ensure the firm is properly funded.
- Engage in a thorough, effective and continuing budgeting process which addresses both costs and revenues.
- Review and, if necessary, adjust the firm's compensation structure so that it is appropriately focused on collegial goals, rather than encouraging individuals to develop their own practices. An "eat what you kill" culture does little to foster collective goals, and a system that puts the interests of individual lawyers over the interests of the firm creates significant risk that lower quality clients may be accepted.

Conclusion

Law firms, like every other economic enterprise, are confronting the realities of economic recession. In such times, firms need to be diligent in resisting the temptation to "cut corners" in the ways in which they operate and practice. Firms intent on practicing law over the long haul need, instead, to take extra care to identify the increased risks of practicing during hard economic times, and to take the necessary steps to manage those risks.

Anthony E. Davis (New York) and David J. Elkanich (Portland, Ore.) are members of the Lawyers for the Profession® Practice Group of Hinshaw & Culbertson LLP.

The information, examples and suggestions presented in this material have been developed from sources believed to be reliable, but they should not be construed as legal or other professional advice. CNA accepts no responsibility for the accuracy or completeness of this material and recommends the consultation with competent legal counsel and/or other professional advisors before applying this material in any particular factual situations. This material is for illustrative purposes and is not intended to constitute a contract. Please remember that only the relevant insurance policy can provide the actual terms, coverages, amounts, conditions and exclusions for an insured. All products and services may not be available in all states and may be subject to change without notice. CNA is a registered trademark of CNA Financial Corporation. Copyright © 2009 CNA. All rights reserved.

RcRskLwFrmHinshaw409