The Impact of the Credit Crunch on Lawyer Risk Management

It's Time to Review, Update, and Strengthen Your Risk Management Procedures

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Introduction

The worldwide economic decline has gone on long enough to require no description. Its effect on the practice of law is starting to hit home and is only beginning. In these troubled times lawyers need to anticipate the risks this creates for both the practice of law and the business considerations of operating a law firm.

The purpose of this article is to provide an overview of recent developments in malpractice claims driven by the economic downturn. This includes an evaluation of the enhanced risk for lawyers created by the credit crunch and identifies the practice areas most exposed. Next is an analysis of the risk management considerations most relevant to these developments. The article concludes with a recommended approach for reviewing and strengthening your risk management program.

The 2009 Legal Malpractice Environment

Background

Recent studies of legal malpractice and reports from insurers show that legal malpractice claims are significantly increasing. The consensus of opinion is well expressed by the ABA comment: "Attorney malpractice claims are escalating in numbers and intensity, making us wonder if clients [are] anxiously looking to recoup the hefty sums of money lost because of a struggling economy."[1] A malpractice plaintiff's attorney got to the core of what is happening when he stated, "Malpractice is a money driven area of law – more so than other areas. It has a very strong connection to the economic situation. In a downturn, you will see more people suing their attorneys over things like estates and divorces. Now, $200,000 is life or death."[2]

If the foregoing analysis of the increased risk of a malpractice claim seems outside of what you are seeing in your practice, it is important to appreciate that legal malpractice claims are known as 'long tail' claims. There is often a significant lag in time between when an incident occurs and when a client discovers that something may have gone wrong. In the current economy some clients are searching for any basis to collect from deep pocket sources and especially lawyers. Now is the quiet before the storm for many lawyers not already facing a claim. Do not let a false sense of security lull you into letting your risk management guard down.

Practice Areas With Increased Risk

In singling out practice areas with increased risk I do not want to lose sight of the fact that malpractice claims over all practice areas increase during a downturn. Even if you are not exposed to a more vulnerable practice area, this is no reason to conclude your risk of a claim has not increased.

What follows are the practice areas most frequently mentioned with enhanced malpractice exposure because of the economy:

- *Real Estate:* Claims include negligent advice in closings, negligent title searches, botched foreclosure actions, missed Master Commissioner sales, fraud, and third party claims that a lawyer was representing more than one party at a closing — not just a single client.

- *Debt Collection:* Debt collection actions are increasing exponentially. Lawyers failing to observe the requirements of state and federal laws governing fair debt collection to the letter are lucrative targets for debtors looking for easy money. Recognize that collection actions will be scrutinized more than ever for a potential claim against the collecting lawyer.

- *Bankruptcy:* Claims by clients, creditors, and bankruptcy trustees are often based on negligent advice, conflicts of interest, fraud, and any number of errors concerning the intricacies of bankruptcy law.

- *Business and Commercial Transactions:* Lawyers involved in any aspect of a business or commercial transaction gone bad are vulnerable to claims of negligent advice, conflicts of interest, failure to perform due diligence, breach of fiduciary duty, and fraud.

- *Family Law – Divorce:* Once again it is all about the money. Claims are often for failure to either identify all marital assets or failure to obtain a fair division of assets.

- *Estate and Probate:* Financially distressed people can be expected to attack wills and estate plans, often regardless of merit, on the off chance of recovering from the responsible lawyer.

Aggressive Claimants

From the foregoing list of vulnerable practice areas it is clear that there are a wide range of potential claimants. Of special concern are money-motivated claimants that are indifferent to the strength of their claim. These claimants, often desperate, insolvent, or angry, will have no trouble finding representation and will pursue a claim with a vengeance. Your risk management program must be geared to place you in the best possible position to fend off this kind of claim.

Risk Management in a Credit Crunch

Practicing law in hard economic times requires emphasizing these risk management considerations:

Problem Reporting: Time after time at the 2009 Legal Malpractice Risk Management (LMRM) Conference panelists stressed the need for every practice to have well established, non-threatening procedures for internal reporting of potential malpractice issues. At a minimum solo practitioners should informally stress to their staff to report problems to them. Preferably, do this with written instructions that are reviewed periodically with the staff. Larger firms should have a written policy designating a lawyer as the person to receive problem reports. The idea is to educate everyone in the firm, lawyers and staff, about the importance of reporting trouble by creating a firm culture of confidence and consultation.

Fee Disputes: In Lawyers Mutual's Spring 2009 newsletter we covered in detail how fee collection actions often lead to malpractice counterclaims. The following extract from that newsletter illustrates the problem and provides a checklist for evaluating whether bringing a collection action against a client is prudent:

> [M]alpractice claims are [frequently] in the form of counterclaims that started out as a simple collection action by a law firm. Most often these counterclaims involve small law firms that can least afford a cash flow interruption and, therefore, are motivated to sue for fees. Given the difficult economic times we are in, it is expected that more firms than ever of all sizes will be motivated to begin collection actions against non-paying clients.
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> ….
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> Malpractice counterclaims, while often lacking merit, are onerous to defend, can be expensive, and hurt firm morale. Typically, individuals and small businesses bring them. Motivation for the claim often is that the client cannot pay fees, is seeking leverage for a fee adjustment; or may be able to pay fees, but was surprised or disappointed in the outcome of the matter.
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> A good policy is to avoid suing clients for fees, but when seriously considering bringing a collection action, use the following checklist to evaluate how counterclaim proof you are:
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> - Was a good result obtained in the underlying case?
> - Is the size of the fee sufficient to warrant the risk of a malpractice counterclaim?
> - Has a disinterested lawyer of experience reviewed the file for malpractice?
> - How reasonable were your fees?
> - Will work on the matter as reflected on billing withstand cross-examination?
>   - Does billing indicate over-practicing?
>   - Too many meetings, telephone calls, and research hours.
>   - Billing for several lawyers reviewing or preparing to discuss the file.
>   - Over-qualified personnel for the work.
>   - Are entries vague?
>   - No names and no billing rates for the work done.
>   - Itemized bills use generic terms such as "phone call" or "meeting" with no substantive information.
>   - Subject to being misconstrued?
>   - Billing for "soft costs" (copying, fax) and general overhead (heat, air conditioning).
>   - All telephone calls take .3 hours; all dollar amounts are nice round numbers or end in five; and inserted along with all the routine itemized expenses is a charge for expert witness fees of several thousand dollars.
> - How much non-billable time will be spent defending any malpractice counterclaim?
> - Will any judgment obtained be collectible?
> - Will you recover more than you spend?

Prospective Client Screening: Another theme of the 2009 LMRM Conference was the need to strengthen client intake procedures to avoid problem clients. The standard screening criteria for prospective clients are:

- Has the prospective client changed lawyers or been rejected by other lawyers?
- Is the prospective client difficult about reaching agreement on fees? Does he appear to be price shopping? Does he refuse to give an adequate retainer?
- Does the prospective client have unrealistic expectations for the matter?
- Does the prospective client have an unreasonable sense of urgency over the matter?
- Has the prospective client done considerable personal legal research?
- Does the prospective client want to proceed as a matter of principle regardless of cost?

Added to these considerations risk managers recommend in these times that you learn everything you can about the quality of a prospective client before you take the matter – not just verification of the facts of the case. Do a background search to determine whether the prospective client has:

- Good credit and is financially solvent.

- A criminal record.
- Frequently filed claims for injuries.
- Retained numerous lawyers in the past.
- Ever sued a lawyer for malpractice or filed a bar complaint.

As an aid in making a background check do a Google search on the prospective client. Look for Websites, blogs, and participation on sites such as FaceBook, and MySpace. A surprising amount of information is readily available with a click of a mouse.

Finally, be especially careful to verify the identity of non-face-to-face prospective clients — those that contact you by phone, mail, or over the Internet. Scams targeting lawyers are everyday occurrences.

***Current Client Screening**:* Screening of prospective clients is a well-known risk management procedure. What many lawyers fail to do, however, is screen current clients for problems that can develop during a representation. Current client screening should include:

- Conducting Interim Conflict of Interest Checks: During the course of a representation a conflict check should be made anytime a new party is named, a new entity becomes involved, new witnesses are identified, or any other development that triggers conflict issues. This is especially important in business and commercial transactions. When the deal goes bad or the business fails, lawyers involved with any whiff of a conflict are sued either for malpractice or breach of fiduciary duty. These are difficult claims to defend and juries have little sympathy for lawyers perceived as disloyal or devious.

- Monitoring for Good Clients Gone Bad: Enron's fall from grace is a good example of a good client gone bad resulting in its lawyers being accused of breaching fiduciary duties owed to third parties and aiding and abetting the client in fraud. Business and commercial transaction lawyers are at greatest risk for such a claim. To risk manage this exposure, establish policies that screen for red flags signaling that something is amiss with a client or that a client is engaged in questionable transactions.

The following is a list of some of the factors to consider in evaluating whether a current client poses unexpected risks:

- Change in control – Has there been a sudden change of management or has management gone into weaker hands? Are the client's employees leaving the client or being laid off?

- Change in ownership — Has the client been acquired by a conglomerate or gone into bankruptcy? Successors, receivers, regulators, and trustees are not your friend, even if the client was.

- Unusual transactions — Does the client want to do a transaction with no apparent business purpose?

- Nature of client's business — Does the client owe fiduciary duties to customers and is the client dealing with other people's money?

- Change in relationship with the client – Has the client's behavior changed as reflected in sudden urgent requests for legal advice giving little time for response? Is the client tense, erratic? Does the client want to micromanage the matter? Does the client want a reduction in fees? In bad economic times clients can become desperate.

- Character change — Does the client expect you to bend rules, endorse a questionable scheme, cover up, or stretch the truth? Is the client uncertain of the source of funds for a deal? Is the client now willing to commit fraud?

- Change in fee payments — A change in payment habits is a frequent sign of trouble in a client. Accounts receivable building up could be a signal that the client is in financial difficulties. Do a solvency check before the amount of arrearages becomes significant. If you are about to enter a period of intense work for the client that will involve substantial billing, get a retainer supplement and make sure the client knows what is coming. If you cannot readily work out fee payments, consider withdrawing.

Do not rely on a client's continued good will. Clients change. There are changes in ownership, control, and circumstances. Educate firm lawyers and staff to be alert to these developments. If you become concerned that a good client is going or has gone bad, withdrawal is often the best risk management. If you continue the representation, be sure that the letter of engagement accurately defines the scope of representation and any changes in scope. Carefully document the file to record significant developments and the advice given. In delicate situations it is especially important that the advice given be reflected in a letter to the client. Do not expose yourself to a claim of fiduciary breach by third parties or of aiding and abetting your client in fraud.

New Matter Screening: In difficult economic times with new business dwindling it is tempting to accept new matters outside a firm's regular practice areas. Do not do this unless you are prepared to spend the time and resources necessary to develop the required competence to practice the matter. For example, if you have little experience with financial matters such as collections, wills and probate, real estate transactions, franchising, business startups, or bankruptcy law, now is not the time to dabble. Do a cost-benefit analysis before accepting new matters that involve considerable preparation time and expense. Consider whether the prospective client can afford all this extra cost.

Always consider whether there are short time limitations that apply to a new matter. A plaintiff's attorney at the 2009 LMRM Conference recommended that a new case not be accepted if it is within three months of the statute of limitations. His view was that this was just too short a time to identify and name all the parties. Accepting unrealistic time pressure to represent a client is an invitation to commit malpractice.

Business and Commercial Transactions: In addition to suggestions for transactions lawyers covered above, two considerations merit special emphasis.

- Make sure everyone (including you) knows whom your client is. In any ambiguous situation clarify your role early. If necessary to make your position perfectly clear, advise nonclients to get counsel. Make sure that officers and employees of business entity clients, no matter how high ranking, understand you represent the business — not them. It is critical to avoid any basis for someone involved in a financial transaction gone bad to accuse you of a conflict of interest.

- Thoroughly documenting the file has never been more important in financial matters. It begins with a detailed letter of engagement that specifies the scope of the engagement, what is not being done for the client, and what constitutes completion of the matter. The letter of engagement should be updated with any change in scope. Oral advice should be followed up in writing or at least documented in a memorandum for file. Document significant events occurring during the course of a representation. Be sure that e-mail concerning the representation is preserved for the file. If you do not have procedures in effect to organize and file or destroy firm e-mail, establish them now. Use letters of disengagement when the matter is completed unless the relationship is intended to be continuous. Continuous representations should be affirmatively established in writing so both the client and the firm know that it exists. Lawyers are often accused of malpractice by persons they considered former clients or long dormant clients for whom they had done no work for an appreciable period of time. Letters of disengagement avoid this problem in most cases.

Internal Controls: In these difficult times it is necessary to consider that firm members as well as clients can get desperate. Review firm internal controls for cash management and bookkeeping practices. A fundamental rule is that two people should be involved in a transaction. If one person receives funds another person should deposit them. Other control procedures to consider are:

- Have cancelled checks delivered to you unopened.
- Examine all cancelled checks as soon as the statement arrives. Watch for authorized signatures, endorsements, and payees.
- Require two signatures on large checks.
- Do not allow checks payable to "cash."
- Require supporting documentation for all checks.
- Approve all client billings and reconcile receipts.
- Control access to checkbooks.
- Divide bookkeeping responsibilities. The person paying the bills should not be the person who reconciles the account.
- Give receipts when accepting cash and keep duplicates. If possible, have cash payments witnessed.

Some Suggestions for Reviewing Your Risk Management Program

As an aid to risk management analysis the firm of Legal Risk LLP Solicitors has helpfully categorized the risks that lawyers face as follows:

- **Professional risks** (i.e. the risks posed by uncertainties in, ignorance of and noncompliance with, the law and legal procedures, such as the risk of missing a deadline);
- **Client risks** (e.g. the risks posed by uncertainties associated with clients, dependence on a small number of fickle institutional clients, exposure to conflicts of interest, risk of failing to comply with client care requirements,….);
- **Financial risks** (e.g. uncertainty as to whether the firm will make a profit, exposure to theft, uncertainties as to financial control of budgets, expenditure and cash flow, pressure on [fee] structure, … and client credit risks);
- **Regulatory risks** (e.g. the possibility of failing to comply with key regulatory requirements including [professional responsibility disciplinary rules]….);
- **Strategic risks** (e.g. uncertainties as to the firm's ability to compete successfully in the market for legal services, including changes in the marketplace….);
- **Operational risks** (the risks associated with the firm's back-office operational and administrative processes, confidentiality, document retention, IT, data protection, business continuity);
- **People risks** (the risk posed by uncertainties relating to the firm's human resources, principals and staff, including supervision, levels of competence and training, loss of key personnel, staff turnover, risks associated with lateral hires);
- **Physical risks** (e.g. injury to people including stress and disease, damage to premises, files, IT system and data);
- **Reputational risks** (arguably the sum of the above).[3]

Use the foregoing list to identify your firm's significant risks. Legal Risk then recommends they be addressed by establishing the following risk management policies and procedures:

- A **framework** for risk management (possibly involving a risk manager who may be a partner, the head of a department and managing partner and/or a risk management committee);

- A **culture** of risk management;
- A **process** of risk management to be applied. The process should include the following steps:
  - **— Identify** the risks to which the firm is exposed;
  - **— Assess** each risk, making an assessment of:
    - ◦ The likelihood and consequences of an adverse outcome;
    - ◦ What appetite the firm has for the risk;
  - **— Respond** to the risk whether by:
    - ◦ Avoiding it (by turning away the activity that gives rise to the risk);
    - ◦ Limiting it (e.g. by restricting scope of retainer, limitation of liability);
    - ◦ Designing and implementing defenses to reduce or minimize the risk (e.g. by supervision, diary system, monthly file reviews, annual appraisals);
    - ◦ Transferring or sharing it (e.g. by insurance….);
    - ◦ Retaining it (or retaining a residual element of the risk);
  - **— Report** on the management of the risk to the [designated person] in a prescribed form);
  - **— Monitor** the process.[4]

Lawyers Mutual's Website has the following risk management information that should be helpful in conducting your risk management review. Start with the *Risk Management & Professional Responsibility Law Practice Assessment*. To access it go to lmick.com — click on Risk Management ⇒ Subject Index and go to Checklists in the index.

In addition to the Assessment the following articles contain risk management information on particular subjects. They may be accessed by going to lmick.com — click on Risk Management ⇒ Bench and Bar Articles and select the desired article.

Risk Management for Firm Leaders And Managers:
- ✓ May 2007 — Boss Professional Responsibility
- ✓ July 2006 — The Ethical and Malpractice Risks of Impaired Lawyers and Their Unimpaired Associates.

Disaster Planning:
- ✓ May 2004 — Getting Physical – *Are You Ready for an Office Catastrophe?*
- ✓ September 2004 — What Happens To Your Clients If Something Happens To You?

Files:
- ✓ January 2003 — The Secret Life of Client Files
- ✓ September 2002 — Shredded Any Good Documents Lately?

Office Sharing:
- ✓ May 2002 — Sharing Offices — *The Ethical, Risk Management and Practical Considerations*

Internet Risk Management:
- ✓ May 2008 – The Impact of the Internet on a Lawyer's Standard of Care & Professional Responsibility — Part I
- ✓ September 2008 – The Impact of the Internet on a Lawyer's Standard of Care And Professional Responsibility — Part II
- ✓ January 2006 — Lawyer Website Disclaimers — *Fact or Fiction?*

Of Counsel and Contract Lawyers:
- ✓ January 1999 – Of Counsel
- ✓ Spring 1997 – Barrister In A Box – *An Overview Of How Contract Lawyers Fit Into The System.*

Business Transactions with Clients:
- ✓ September 2000 — Investing In Client.Com — *The New Economy or the Same Old Moral Hazard?*

Third Party Claims:
- ✓ Fall 1995 — Negligence Liability to Nonclients — *The Bermuda Triangle Of Lawyer – Client – Nonclient*

Risk Managing Malpractice Claims:
- ✓ January 2009 — Hard Economic Times Mean More Malpractice Claims
- ✓ January 2005 — Dodging a Blank! *Avoiding a Frivolous Malpractice Claim*

Summing Up

I urge you to take the time to make the risk management review that this article is intended to facilitate. The economic situation demands it. Additionally, there has never been a more important time to carry malpractice liability insurance. Currently there is a competitive insurance market in Kentucky that provides Kentucky lawyers with numerous choices. You know where my heart is, but whatever you do, do not go bare, *i.e.,* have no insurance. At Lawyers Mutual we have never been able to determine what percentage of Kentucky lawyers do not carry liability insurance, but we think many do not. This number could increase if legal business decreases, tempting insured lawyers to drop their coverage. In the current malpractice environment that is counter-intuitive and not prudent. Protect your clients and yourself.

ENDNOTES
1. ABA Journal, posted 2/17/2009.
2. Andrew L. Bluestone quoted in the article *Legal malpractice suits may surge*, Karen Sloan, National Law Journal, p. 4, 2/23/2009.
3. Legal Risk LLP Solicitors, *A practical guide to rule 5 of the Solicitors Code of Conduct 2007*, pages 21 and 22. The firm's Website address is www.legalrisk.co.uk.
4. Ibid.