



# Risk Exposure Trends: Ten Issues Confronting Law Firms

A low-angle, upward-looking photograph of several modern skyscrapers with glass facades. The buildings are set against a pale, overcast sky. The perspective creates a sense of height and architectural scale.

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The legal profession is undergoing fundamental changes and law firms must adapt to the challenges presented in the current environment. New technologies and business models are offering services at lower cost, driving down both fees, as well as a demand for law firm services. Clients are assuming an increasingly active role in the attorney-client relationship and demanding more value at lower prices. Meanwhile, the ABA and courts are scrutinizing draconian rules in the context of recent and emerging issues in the practice of law.

Lawyers are being encouraged to embrace the positive aspects of change, shed outdated practices and acquire new insights. Equally important, they should recognize the risks associated with operating in today's market and business culture, addressing those vulnerabilities through development of tools and strategies to manage them.

In *Top Ten Risk Exposure Trends for Law Firms*, a 2017 Bloomberg BNA webinar sponsored by CNA Insurance, Michael Barrett, Risk Control Director, CNA Lawyers Professional Liability Program, noted when asked to comment on the current state of the legal market:

Recently I came across a quote from a French essayist, Joseph Joubert, which stated, 'We must respect the past and mistrust the present, if we wish to provide for the safety of the future.' Now Mr. Joubert was the inspector general of universities under Napoleon, so it's safe to say that this quote was not inspired by today's markets or the legal profession. However, I think this concept provides a relevant context in which to begin a conversation about these current topics.

### 1. Understanding the Legal Market

Since the 2007-2008 economic downturn, the demand for law firm services has declined slightly.<sup>1</sup> Corporations have retained more work in-house, as new delivery models, such as automation and online research and filing, have emerged. Many clients are allocating legal work among various legal service providers, rather than pursuing one-stop shopping at law firms. At the same time, law firms have simply tried to offset losses by raising their rates. But collected realization rates have declined steadily, as clients seek to renegotiate invoices after services have been rendered. In 2016, law firms collected less than 83 percent of their billings, the lowest average realization rate on record.<sup>2</sup>

Expenses also fail to be managed appropriately, with firms continuing to expect to match the strong income growth patterns of the five years before the recession. In that period, growth in direct expenses, comprising fee-earners' compensation (attorney salaries, bonuses, partnership distributions) averaged 18 percent, while overhead—



including non-lawyer staff wages—increased by an average 10 percent. Both trends consistently outpaced income growth over that period. Law firm hiring increased, in a tight labor market, yet incomes continued to decline. But a sharp correction followed in 2008-2009, when deep cuts were made to both legal and administrative staff. After adjustments, expense growth has been relatively steady since 2010.<sup>3</sup>

Law firms should pursue deliberate and informed long-term strategies designed to manage market risks. Such strategies must include investment in expert advice with respect to evolving trends in law firm operations. In addition, recognition of how fundamental changes in the industry, with a focus upon client-driven relationships, will result in new approaches to pricing and billing models, talent management, productivity and work processes. In the immediate term, pressures from uncollected fees and gaps in operating expenses must be monitored and managed, in order to address the potential risk exposures that may arise.

## 2. The General Counsel

Every law firm, regardless of size, should consider hiring or appointing a general counsel (GC). The GC role provides a level of objectivity on issues relating to firm interests and also performs functions that are not possible for its member attorneys.

GCs can actively manage risk areas, including conflicts of interest, ethical concerns, client disputes, vendor disputes, internal disputes, and partnership sensitivities. When a firm faces outside claims or litigation, partners may become distracted from their customary work. However, the GC can alleviate their burden by managing such matters as document requests, litigation holds, depositions of firm personnel, and coordination with litigation counsel regarding substantive issues. By addressing client issues proactively, GCs can thus help to minimize the costs associated with malpractice defense and indemnity. John T. Cofresi, Claims Consultant, CNA Lawyers Liability Program, advised webinar attendees that firms with a GC typically saved \$1 million in such costs compared to those without.<sup>1</sup>

GCs also give lawyers access to confidential legal advice on issues related to their practice, especially pertaining to ethical issues.<sup>4</sup> Historically, these communications have not been fully shielded from disclosure under the attorney-client privilege. Rather, they fell within one of two exceptions: (1) the fiduciary exception and (2) the conflicts rationale. Under the fiduciary exception, if an attorney seeks legal advice regarding a client representation, that attorney is acting in his or her own client's interest. Therefore, the client should share in the advice.<sup>5</sup> Alternatively, under the conflicts rationale, an attorney's need for confidential advice was construed as a matter of "self-interest" and deemed to create a conflict, thus precipitating the duty to disclose, Cofresi said. Trends, however, have now shifted in favor of shielding communications with a firm's in-house GC.

<sup>1</sup> Rotunda, Ronald D. *Law Firms Creating In-House Ethics Counsel*, VERDICT, Legal Analysis and Commentary from Justitia, Nov. 3, 2014, citing *The Professional Lawyer*, v.20, no.2, 2010 Summer, P.1.



In 2016, a New York appellate court held attorneys' consultations with the firm's GC were not subject to disclosure in a legal malpractice and breach of fiduciary duty case.<sup>6</sup> The court reasoned that the attorneys' communication with the GC was privileged and not subject to disclosure under the "fiduciary exception" because the attorney receiving advice was the "real client." The court opined that protecting the communications between the GC and its attorney-clients was critical to encouraging unfettered communications.<sup>7</sup>

Three years earlier, the ABA articulated the same position, commenting that consultations do not create an "inherent conflict" against clients, even if a potential conflict is discussed. Indeed, the ABA noted that clients benefit when lawyers have a forum for discussing ethics and professional responsibility questions candidly.<sup>8</sup>

The ABA also stated that where a conflict exists, the client must be advised and given the option to discharge the attorney. Privilege should not be available, however, if the consultation is motivated primarily by the desire to shield attorneys from the consequences of misconduct.<sup>9</sup>

Cofresi advised the webinar's attendees that, to preserve privilege, firms should:

- ensure that the GC did not work on any matters related to the advice being sought,
- create a separate internal file for the consultation,
- treat the communication as privileged, and
- verify that no client is billed.

Engagement letters should also clearly disclose to clients that attorneys working on their matter may need to seek confidential internal advice.

### **3. Outside Counsel Guidelines**

Many client organizations—large, small, commercial, governmental, or not-for-profit—are adopting outside counsel guidelines (OCGs) to manage their attorney engagements. These OCGs evolved from simple billing guidelines into comprehensive rulebooks to govern all aspects of the engagement. John B. Harris, partner, Frankfurt Kurnit Klein & Selz, observed in the webinar that the trend reflects a "shift in the balance of power in attorney-client relationships" toward the clients.

Law firms should understand the risks posed by OCGs. The firm's general counsel should carefully review each client's OCG. Barrett also advises that, "[S]olo practitioners and small to mid-size firms might consider having an outside general counsel review the terms of guidelines in circumstances where the guidelines pose oppressive indemnity provisions or when the terms of the guidelines may contravene general law firm policies. Firms should be wary of forming conflicts with a number of current clients at the expense of bringing on one new client with overly broad OCGs." Contrary to lawyers' understanding, OCGs often purport to supersede where inconsistencies

arise in engagement letters. Therefore, a law firm's commitment to be bound by terms outside the engagement letter must be deliberate and carefully considered.

Potential conflicts between OCGs and existing client agreements require thorough examination. When lateral attorneys join the firm, the firm must check whether they have agreed to any OCG guidelines from their previous work, Harris advised. Most OCGs prohibit advance waivers or expressly preclude firms from representing certain competitors or even an entire type of business. They may require the firm to withdraw in case of a "thrust upon" conflict (arising from a merger or acquisition that turns a pre-existing client into a party with interests adverse to the new client) lacking a consent option. Under some OCGs, entities related to the firm's existing clients, regardless of the extent of control, may be considered "clients," thus potentially creating conflicts under the OCG, where none exists in case law.

Many OCGs impose broader indemnities than firms would traditionally provide.<sup>10</sup> They may require the firm to cover third-party damages or losses for which the client shares responsibility. An OCG might demand indemnification beyond the firm's liability insurance, or require the firm to get specific insurance policies such as cyber coverages and excess coverage. OCG may also require that the firm or attorney have its insurance from an insurance carrier with a particular rating as well. Harris further counseled that open-ended or catch-all indemnity provisions should be replaced with references to the malpractice law of the relevant jurisdiction.

Regarding proprietary information, some clients demand heightened confidentiality or data sensitivity. Others try to influence the firm through prescriptive provisions, seeking to prevent activities that are inconsistent with the client's perspective, culture and values, even if the activity is unrelated to the engagement and permitted under rules of professional conduct. Such provisions can inhibit a firm's participation in advocacy or civic work, *amicus* contributions, or *pro bono* service.

Firms should try to negotiate terms that reflect their own policies and prior commitments. If clients refuse to modify the OCG, the firm should consider whether to continue or decline the engagement.

#### **4. Engagement Letters**

A well-crafted engagement letter is critical to good risk management because it memorializes the attorney-client agreement, including scope of representation, fee structure, conflicts of interest, and dispute resolution.<sup>11</sup> Cofresi cautioned that if poorly defined, these issues can lead to serious risks such as fee disputes and malpractice suits. The *ABA Model Rules* provide that a lawyer may limit the scope of representation if (1) the limitation is reasonable under the circumstances and (2) the client gives informed consent.<sup>12</sup>



Sometimes, when a client has not protected its interests with proper care, it will try to hold attorneys responsible for any resulting harm. Attorneys can address this risk by establishing clear limits in the engagement letter. In one malpractice case involving novel issues relating to a lawyer's duty to investigate insurance coverage, a client argued that the attorney breached a duty to advise it about the adequacy of its insurance coverage. Interestingly, the client had told the attorney that coverage was not available.<sup>13</sup> Where they are ethically permitted to do so by state rules of professional conduct, Cofresi noted that law firms are encouraged to include a clause in their engagement letters expressly disclaiming any obligation to advise the client regarding insurance.

If a firm represents a client on multiple matters, each matter should be treated as a separate engagement. For the purposes of determining the statute of limitations period with respect to malpractice claims, the relationship is less likely to be construed as "continuous representation," according to Cofresi.

Where possible and appropriate, an engagement letter should contain an agreement regarding dispute resolution such as arbitration, which offers an efficient mechanism for resolving disputes equitably and avoids the specter of a public court battle. The choice of arbitration also presents the added benefit of having an experienced professional, typically a retired judge, serve as the finder of fact, thereby mitigating concerns about whether complex issues and arguments may be too complex for a jury to comprehend. CNA's claim experience has revealed that lawyers and law firms have fared well before arbitrators, especially regarding nuanced arguments relating to causation and damages. As the governing rules vary among jurisdictions regarding the enforcement of arbitration provisions between a lawyer and its client, the law in the applicable jurisdiction should be researched before utilizing this mechanism.

## **5. Scope Creep**

Traditionally, various services encompassed in legal representation were handled by a single lawyer or firm. Now, services are often unbundled and parsed into specialized areas. In some instances, the scope of work may be limited by its nature to a single discrete task, such as drafting a will or a short-term residential lease-agreement, or registering a small business. Others are large and complex matters, which the client has chosen to disaggregate and allocate to multiple legal service providers in an effort to minimize costs.

Barrett emphasized that the lawyer should realize that limited scope does not mean a limited duty of care or diligence. Attorneys have certain non-delegable, non-waivable

ethical obligations to clients. For example, in the context of a large, multi-state litigation, a firm engaged as local counsel solely to handle local court procedures may not blindly follow instructions from national counsel. Rather, it must use its own independent judgment.

Limiting the scope of representation is a sensible way to avoid conflicts of interest, but a thorough conflict analysis must be performed, with any limitation delineated clearly in writing. If there is a change in scope it should be formalized in writing immediately. Not only is it important to define the scope in writing, but to respect those limits in practice. Otherwise, Barrett said, the attorney's performance of tasks beyond the scope of the engagement letter may be reasonably construed as a representation of the willingness to broaden the scope of the engagement.

## **6. Lawyer Mistakes**

The *ABA Model Rules* require that a client be kept "reasonably informed"<sup>14</sup> about the status of a matter and impose a duty to disclose if the lawyer's conduct has created a conflict of interest.<sup>15</sup> The *Restatement of the Law Governing Lawyers* requires the disclosure of any "problems" with a case or any activities of the lawyer that give rise to a "substantial" malpractice claim.<sup>16</sup>

Generally, trivial errors that are promptly corrected by the lawyer need not be disclosed. If the lawyer's conduct creates a conflict of interest or gives rise to a potential malpractice claim, however, a clear duty to disclose arises.<sup>17</sup> Between these extremes is a vast gray area that covers most issues perplexing to lawyers. Therefore, each circumstance must be considered in its own context. A lawyer should consider seeking advice from his or her own in house or outside counsel.

## **7. Collections and Fee Disputes**

Attorneys shy away from the issue of fee collection, due to the potential for alienating the client. But a frank discussion is far preferable to a formal fee dispute, which is likely to occur if the problem festers. Detect signs of problems early. If the client avoids discussing the fee or delays paying the retainer, he/she will probably resist paying the remaining fees as well.

Firms should create and implement clear strategies for preventing and addressing fee disputes, and consider declining a client who cannot afford their services. When collection attempts fail, consider negotiating a payment plan. Document all attempts to collect and to negotiate. If negotiating, state clearly in writing that any willingness on your part to accept a reduced fee is solely for negotiation purposes and can be withdrawn any time.

If all such measures fail, filing a fee suit may not be worthwhile. For example, if the client is judgment proof, or if the fee amount is not substantially larger than the firm's insurance deductible, the financially sensible option is to forgo it. In many states, a counterclaim alleging malpractice may be compulsory. The lawyer or law firm must be prepared to face that prospect. If possible, lawyers should wait to file the lawsuit until after the statute of limitations on malpractice has expired. Lawyers filing a fee suit should review the client file closely and ensure that it is in perfect order. The file will become discoverable in future litigation and will reflect upon the lawyer's reputation.

## 8. Unfinished Business (*Jewel*) Doctrine

Given the recent spate of high profile partnership dissolutions, firms interested in adding some of the exiting partners to their own rosters should carefully assess the risks.

In *Jewel v. Boxer*, a California appellate court ruled that when a partnership dissolves, its pending matters or "unfinished business" were a partnership asset. Therefore, future earnings from work on those matters belong to the former partners of the dissolved firm (to be paid according to the pre-dissolution profit distribution ratio) and were not payable to the firms that were joined by the individual partners working on those matters.<sup>18</sup>

The doctrine has been criticized for its impact on departing lawyers. Historically, other firms have enthusiastically taken on former partners of dissolving firms. Of course, one key incentive was that lawyers bring with them their work in progress, as well as associated fees. The *Jewel* decision, however, neutralized this incentive. Notably, recent cases have declined to follow *Jewel*. In 2014, the New York Court of Appeals held that firms do not "own a client or an engagement" but are paid "for services actually rendered."<sup>19</sup> The same year, a California federal court held that "neither law, equity nor policy recognizes a law firm's property interest in hourly fee matters."<sup>20</sup> In 2016, the Ninth Circuit certified the unfinished business question to the California Supreme Court.<sup>21</sup> As of the date of this publication, that decision is pending. If *Jewel* is overruled, California law will align with current law in New York. If not, there will be continued uncertainty resulting from these expressly conflicting standards.

## 9. Cybersecurity and Scams

In many states, lawyers have – in addition to their duties to preserve client confidences and safeguard property in their possession (e.g. IOLA funds or IOLTA accounts) – a duty of technological competence. The ABA also directs lawyers to keep abreast of the risks and benefits of the technological aspects of their practices. As of March 8, 2017, twenty-seven states have adopted a duty of technology competency for lawyers, the speakers said.

Firms should, therefore, implement sound cybersecurity policies. A 2016 malpractice claim resulted from a hacker accessing an attorney's email account and impersonating



her to induce her client to transfer funds.<sup>22</sup> Simple measures, such as multi-factor authentication, may have prevented this occurrence.

Also, beware of cyber scams known as “phishing,” “social engineering,” and “spoofing.” The scammers send emails disguised as messages from legitimate entities and trick people into downloading malware or revealing sensitive information, including account numbers and passwords. Both social engineering and spoofing are phishing techniques employed by hackers.

Social engineering involves a sustained level of human interaction to build trust, often followed by a sudden urgent request for money. For example, a scammer pretending to be a client induces the lawyer to deposit a fraudulent check and then asks to have money transferred. The request is always urgent, and it arrives shortly after the check is deposited because the money must be transferred within the provisional availability period (as permitted by the Electronic Funds Availability Act) so the fraud is not discovered. The transfer is also always by wire and, almost always, to a bank located in a foreign country.

Spoofing, by contrast, involves an attempt to mimic a trusted source in an effort to induce an attorney to take action, such as disclosing confidential information, transferring client funds, or downloading malware. In a typical spoofing scenario, an attorney will receive an email that purports to be from a trusted/known source such as an existing client, a governmental agency, or even a financial institution. The most recent widespread spoofing scam against attorneys now involves emails that purport to contain a complaint or an invoice for past due registration/bar association fees. When the attorney opens the attachment, they then download malware that encrypts their data and prevents them from accessing it until they have paid a ransom to the hacker(s) – usually in bitcoin.

Scams have become extremely sophisticated and difficult to detect. Fake websites are professionally designed and appear indistinguishable from the entity being impersonated. A fake “client” may forward seemingly genuine documents relevant to his or her “case” and sign an engagement letter.

What can law firms do to protect themselves? It’s the little things that matter most, the speakers said:

- Examine websites and emails closely.
- Check URLs and email domain names.
- Never click links embedded in emails.
- Never reveal confidential information online.
- Never transmit funds to clients before the check clears.
- Develop a stated policy and disclose it in the engagement letter.
- Create and deploy an established protocol for money transfers.
- Implement firm-wide policies to defend against scams and provide training.



## **10. Enterprise Risk**

Some events, such as massive cybersecurity breaches, can paralyze a firm's practice. A comprehensive disaster recovery plan is essential, in order to resume normal functions with minimal disruptions, as well as to maintain the firm's reputation, client relationships, and employee morale. Mishandling disaster recovery efforts also may breach some agreements. Some states impose formal legal obligations as part of the attorney duty of care. These responsibilities may vary from state to state, requiring multistate firms to become conversant with diverse requirements. Predicting when disaster will strike is, of course, impossible, but advance planning and preparation can help to minimize its impact.

### **Final Thoughts**

It is a time of great opportunity and risk for law firms. The most important underlying tools for confronting these emerging vulnerabilities include continuous awareness, accurate information, and active management. Firms are urged to implement concrete strategies to address each type of risk, appoint the right personnel, seek expert advice, invest in new resources and technology, and create a firm culture where risk factors are not allowed to fester but are identified and confronted efficiently and thoughtfully.

## Endnotes

- <sup>1</sup> ["The 2017 Report on the State of the Legal Market Finds 10 Years of Stagnation. Changing the Industry; Says Innovation Key to Law Firm Success" \(Georgetown Law News\); 2017 Report on the State of the Legal Market \(Georgetown University Law Center & Thomson Reuters\)](#)
- <sup>2</sup> [2017 Report on the State of the Legal Market \(Georgetown University Law Center & Thomson Reuters\)](#)
- <sup>3</sup> [2017 Report on the State of the Legal Market \(Georgetown University Law Center & Thomson Reuters\)](#)
- <sup>4</sup> ["Attorney-Client Privilege Protects Communications with Law Firm GC" \(American Bar Association\)](#)
- <sup>5</sup> ["Supreme Court Examines the Fiduciary Exception to Privilege," \(American Bar Association\)](#)
- <sup>6</sup> [Stock v. Schnader Harrison Segal & Lewis LLP, 142 A.D. 3d 210 \(1<sup>st</sup> Dep't 2016\); "Attorney-Client Privilege Protects Communications with Law Firm GC" \(American Bar Association\)](#)
- <sup>7</sup> [Stock v. Schnader Harrison Segal & Lewis LLP, 142 A.D. 3d 210 \(1<sup>st</sup> Dep't 2016\)](#)
- <sup>8</sup> [ABA House of Delegates Resolution 103, Adopted August 12, 2013](#)
- <sup>9</sup> [ABA House of Delegates Resolution 103, Adopted August 12, 2013](#)
- <sup>10</sup> [Indemnity Provisions in Outside Counsel Guidelines: A Tale of Unintended Consequences, ABA Center for Professional Responsibility, 2016](#)
- <sup>11</sup> See [Engagement Letters: Four Key Terms to Reduce Risk \(American Bar Association\)](#)
- <sup>12</sup> [ABA Model Rule 1.2\(c\)](#)
- <sup>13</sup> [Jordache Enterprises Inc. v. Brobeck, Phleger & Harrison, Case No. S056954. \(Cal 1998\)](#)
- <sup>14</sup> [ABA Model Rule 1.4](#)
- <sup>15</sup> [ABA Model Rule 1.7](#)
- <sup>16</sup> ["Restatement of the Law Governing Lawyers, Section 20," LegalMalpractice.com, 2009](#)
- <sup>17</sup> See [Maples v. Thomas, 132 S. Ct. 912 \(2012\)](#)
- <sup>18</sup> [Jewel v. Boxer, 156 Cal. App. 3d 171 \(Cal Ct. App. 1984\)](#)
- <sup>19</sup> [Matter of In re: Thelen LLP, 2014 NY Slip Op 04879 Decided on July 1, 2014](#)
- <sup>20</sup> [Decision of U.S. District Court, Northern District of California, No 14-01236 14-01237 14-01238 14-01239, June 11, 2014 \(Consolidated cases of Heller Ehrman against multiple law firms\)](#)
- <sup>21</sup> [In Re: Heller Ehrman LLP, 830 F.3d 964 \(9th Cir. 2016\)](#)
- <sup>22</sup> [Mallard v. Doran, Sup. Ct., New York County, \(Index No. 153262/2016\)](#)