CHAPTER 1

What Is Risk Management (or Loss Prevention) Anyway?

RISK

There are two ways to look at risk management.

The definition of "risk" used in previous editions of this book was "any danger that, if not controlled, may lead to consequences unintended by and harmful to a law firm or practitioner. This includes professional discipline, malpractice or other claims for disgorgement of fees or money damages, and other allegations of wrongful conduct in the course of law practice."

But there is another view that is frequently easier to "sell" to lawyers and law firms. If the object of a law firm is to provide legal services to clients and generate fees with which to reward the firm's lawyers, then risk is "*anything* that interferes with the ability of the firm and its lawyers to provide legal services and generate profit from doing so."

One way of making the subject of risk concrete is to relate it to the subject of fee disputes. Let us count the ways in which a simple fee dispute involves risk.

- Every moment a lawyer has to spend fighting to collect a fee that she believes she has already earned could be spent doing productive and billable work for another client.
- If a lawyer or firm is in the middle of a fee dispute while a matter is ongoing, a huge barrier has been raised that impedes the ability of the lawyer to provide—or the client to accept—ongoing legal services. Fee disputes erode the trust that is the essential glue of a productive attorney-client relationship.
- If the dispute rises to the point where the firm sues the client for its fee (or the client, anticipating such a move, initiates a malpractice claim), all kinds of additional risks arise. First, even if the virtually inevitable malpractice claim is meritless, the firm must notify and probably make a claim under its professional liability policy (even though the policy will not cover the fees or costs associated with the fee claim, or the loss of fees). Second, there is usually a reason that clients refuse to pay: either they lack the funds or they

have a legitimate complaint. Either way, the firm may well not recover any of the missing fee. Meanwhile, the cost of pursuing such claims in human terms (the loss of more time that could have been billed to paying clients) and in hiring a lawyer or losing the productive value of a litigator from within the firm will diminish the value of even a completely successful outcome or, more likely, will equal or outweigh the ultimate value of even a partially successful outcome.

But the risks of fee disputes do not end there.

- Once a lawsuit starts, the parties are entitled to *discovery*. Now the client looks at every scrap of information in the firm's files, including the time sheets and e-mails among lawyers. If there's an ill-considered entry or e-mail, the client shifts from claiming malpractice to alleging fraudulent billing. That allegation very quickly hits the media.[1] So now the firm faces two additional risks: damage to its reputation and the questioning of its billing practices by *every* client.

This example demonstrates that risk is pervasive in the operation of every law firm, but, if properly managed, the firm can serve clients well and be profitable. In risk management terms, and as discussed in the Introduction, this means first that the firm must do more effective client intake management to identify clients who are likely to prove problematic and to limit intake to clients that the firm is best equipped to serve and who are able and most likely willing to pay for those services. Second, the firm should use clear and comprehensive engagement letters to describe the scope of services to be provided. Third, the firm should manage the billing and collection process actively to identify problem clients before the amount at issue is great and to consider withdrawing from representation and abandoning the fee claim as the quickest way of avoiding a problem and getting back to productive work. Finally, if the decision, for whatever reason, is to proceed with a suit, the firm should take the time to review all the work performed to assess the merits of the inevitable malpractice counterclaim as well as time and billing records and internal communications to make sure that the potential for embarrassment does not outweigh even a large account receivable.

If we were to discuss the traditional risk of malpractice claims, many of the same considerations would apply, including the financial costs implicated in defending claims, hidden costs such as time and billings lost from productive activities, damage to reputation, and increased future costs of insurance. Accordingly, recognizing that every client and matter carries potential costs as well as profit gives substance to the meaning of risk in law practice. The actual management and oversight of the way services are delivered, and of the lawyers who are providing those services, are an equally important component of a risk management program. Here again, managing the delivery of legal services enables law firms to make *positive* virtue out of risk management—serving clients better and generating more profit.

RISK MANAGEMENT

The term "risk management" refers to the establishment of institutional (firm- or practice-wide) policies, procedures, or systems (sometimes called risk management tools) designed to identify and minimize risk within the firm and its practice.

Ideally, every risk management tool (policy, procedure, or system) should

- establish uniform standards
- be capable of ready monitoring for compliance
- involve the minimum of intrusion and expense into other operations of the law practice consistent with maintaining the efficacy of the tool

To be effective, risk management in law firms requires more than the development and application of risk management tools. The firm must also have a culture that both promotes awareness of the kinds of risks that the firm's practice necessarily entails and actively supports compliance with the policies and procedures that the firm has adopted. Of course, it is impossible to eliminate or avoid all risk. Law firms can, however, realistically seek to manage risk within acceptable parameters.

LOSS PREVENTION

"Loss prevention" and "loss control" are more traditional terms used by the professional liability insurance industry, and they are synonymous with risk management. It is worth noting in this context that risk management is not a new phenomenon to anyone—except, relatively speaking, to lawyers. If you reflect on the history of the insurance industry, going back even to its roots in Lloyd's coffee parlor in London in the 18th century, a crucial element of underwriting has always been to seek to reduce the insurance risk by improving the safety of the product or service being insured. Because the shipping industry was the first to seek insurance, there was a drive to improve shipbuilding and navigation techniques. Subsequently, improving safety has become a key element of all underwriting; hard hats for construction workers and seat belts and air bags for passengers in automobiles are obvious examples of modern-day risk management tools generated, or at least strongly supported, by insurers.

Risk management is so well developed in the accounting profession that it goes beyond the elements suggested in this book, often involving regularly scheduled mandatory external reviews—conducted by competitor firms. This comparison is important because it helps to correct the mistaken notion that risk management is needed, and effective, only when a product (such as an architect's plans) or a risk to life and health (such as a doctor's treatment) is involved.

WHY RISK MANAGEMENT MATTERS

Addressing this foundational question, one of the authors wrote in an article about this subject (referred to hereafter as the "Davis Georgetown article"):[2]

> There are four reasons why law firms take risk management seriously. First, it enables them to improve the quality of the services they provide to their clients; second, and following from the delivery of improved services, it enables them to achieve greater profitability; third, the adoption of effective risk management systems gives law firms enhanced access to the professional liability insurance market; and, fourth, risk management, as the words suggest, helps law firms to identify and manage risks which, if not addressed, present the threat of significant adverse consequences.

It is vital to recognize that the first two objectives are in every sense positive incentives. Almost by definition, lawyers are generally hostile to being managed and to accepting management responsibility. The usual refrains from lawyers are, "No one is going to tell me how to practice law" and "I didn't go to law school in order to become a manager." To get law firms and lawyers to accept the principles of risk management, it is important to demonstrate that it is in their individual and collective self-interest to do so. Accordingly, all risk management systems, policies, and procedures need to be designed and implemented in ways that actively assist lawyers in providing professional services and that, to the greatest extent possible, demonstrably improve efficiency and profitability. Not unrelated to the issue of profitability is the third reason law firms take risk management seriously—their professional liability insurers either require them to do so or take positive note when they do so of their own volition. From its origins in a coffee shop in London, insurance has always had as its key component the management of risk. Professional liability insurers have learned that the practice of law is in this respect no different from a construction site. Just as insurers require construction workers to wear hard hats, they are increasingly focused on law firms' adoption of appropriate risk management systems, from client intake through practice management. The availability of coverage, the size of deductibles, the limits available, the terms of coverage, and the price of malpractice insurance are more and more dependent on law firms' ability to demonstrate to underwriters that they have adopted and institutionalized appropriate risk management systems.

The next two sections of this chapter are also taken in part from the Davis Georgetown article.

LAW FIRM GENERAL COUNSEL: THE CRITICAL PREREQUISITE FOR EFFECTIVE RISK MANAGEMENT

The most important component of an effective risk management structure in law firms is the designation of a general counsel. The role traditionally had a variety of labels, including ethics partner, risk

management, or loss prevention partner. The importance of this role derives from its four essential functions. The first and most important function of the individual designated as general counsel is to act as the law firm's "lightning rod." In other words, the general counsel's first responsibility is to be entirely open to receiving reports of any kind of problematic issue that might constitute a risk to the firm in the broadest sense, as defined above. The sooner problems are identified, the more likely they are to be resolved without serious adverse consequences. Accordingly, the person selected to act as general counsel must have strong interpersonal skills, as well as the appropriate background or training in legal ethics and professional responsibility. The second function is to act as the firm's lawyer, and in particular to advise management on all issues relating to professional responsibility. A vital subset of this second function is the oversight of client intake—and particularly the resolution of all conflicts of interest. The third function is to oversee the defense of claims asserted against the firm and its lawyers. The fourth function is to develop, promulgate, and enforce appropriate risk management policies, procedures, and systems throughout the law firm.

Just as important as the designation of a general counsel are the development of a policy and the training of all lawyers and staff relating to their individual obligations toward the general counsel. It is vital that employees understand that their loyalty obligations are not to individual superiors but (1) to the firm's clients, to protect them from any form of inadequate service or inappropriate conduct; (2) to individuals in the firm, whether to render needed assistance or to prevent them from pursuing inappropriate goals; and (3) to the firm itself, to protect its reputation. Because these priorities may not always be obvious to any given individual lawyer or staff member, an explicit policy dealing with reporting obligations, as well as training of new hires at every level of the firm and regular reinforcement of these values, is essential to the establishment of an effective risk management culture within a law firm.

HOW RISK MANAGEMENT HELPS FIRMS SERVE CLIENTS BETTER, IMPROVE PROFITABILITY, OPTIMIZE ACCESS TO INSURANCE, AND IDENTIFY AND MANAGE RISKS

A prime example illustrating how risk management systems can help to accomplish all four of these objectives when effectively implemented—and avoid the kinds of risks that all too frequently arise in the absence of such systems and of an appropriately supportive culture—is client intake management. As explained in the Davis Georgetown article,

> [w]hen lawyers accept engagements from clients who subsequently sue their firms, leave their firms with substantial unpaid receivables, or cause their firms to be sued by disgruntled third parties, it is all too easy to blame the individual lawyers for poor client selection and lack of adequate due diligence. In reality, however, when these situations arise it is usually the absence of

effective and appropriately supported risk management systems within the firm at large that is the real culprit. Furthermore, firms that fail to consider either the adequacy of their client intake management infrastructure or the adequacy of the firm's culture in supporting and encouraging compliance by its lawyers with its chosen systems unquestionably increase the likelihood that such painful episodes will endlessly recur.

If a law firm wishes to have a client intake management system that enables it both to represent clients it can profitably and effectively serve and to avoid engagements with inappropriate clients, then the firm will have to address four broad issues:

1. Does the Firm Require Every Lawyer Seeking to Accept an Engagement from a New Client to Obtain Adequate Information about the Prospective Client?

Law firms that have sought to perfect their client intake systems have found that they must obtain four distinct kinds of information about prospective engagements. First, is the new engagement likely to involve the firm in any kind of conflict of interest, broadly defined? Second, is the engagement one within the competence and expertise of both the firm and the individual lawyers who will work on the matter? Third, does the client have the means to pay fees appropriate to the successful conclusion of the matter? Fourth, are there any indications that the client will prove to be otherwise unworthy or inappropriate or will present special risks to the law firm?

If a firm desires an effective intake review, then the firm's management or its designees, independent of the introducing partner, should assess all new clients regarding each of these issues, based on adequate information that the introducing lawyer must produce as a prerequisite for the firm's evaluation. Such information might cover the following subjects:

Identity of the Client. Analysis of malpractice claims reveals two common causes of disputes between lawyers and clients. First, when representing entities, especially small or closely held businesses, the lawyer believes that she represents the entity but the individual owners or principals believe that the firm is representing them individually and owes them independent duties of care. And since the determining factor will be what the plaintiff reasonable believes, the law firm will usually be on the short end of the stick. Similarly, when lawyers take on multiple clients in the same matter (joint representation), absent extremely carefully worded and comprehensive disclosure and waiver language, the resulting conflicts of interest can be fatal to any defense. For these reasons, the use of engagement letters that address this issue is critical.

Competence. It sounds trite, but it isn't. Lawyers' professional liability insurers refer to the problem of taking on inappropriate work as

"dabbling." Especially in hard economic times, law firms and individual lawyers do it to show that they are busy or at least occupied. But taking on work that is outside a firm's or an individual lawyer's area of competence invites trouble. At best, even if a successful outcome is achieved, it will often be impossible to generate a fee that does not enrage the client because of the cost of the learning curve necessary to get there. But even more problematic is the greatly increased risk that malpractice will be committed precisely because of the unfamiliarity of the subject matter.

Scope of Services. It is critical that both the lawyer and the client understand precisely what services the lawyer will provide—and the limits of those services. Absent this clarity, and wherever there is uncertainty, the problem of the client's reasonable belief crops up again.[3]

This concept of limiting the scope of employment is hardly revolutionary. Rule 1.2 of the Model Rules implicitly recognizes the parties' right to control the scope of representation, and the commentary to Rule 1.2(a) states this explicitly:

> The scope of services to be provided by a lawyer may be limited by agreement with the client or by the terms under which the lawyer's services are made available to the client. . . . In addition, the terms upon which representation is undertaken may exclude specific means that might otherwise be used to accomplish the client's objectives. *Such limitations may exclude actions . . . that the lawyer regards as repugnant or imprudent.* [Emphasis added.]

Assignment of Staff. Given discussions of competence and scope of services, it follows that, whatever the urgings of the introducing partner (whose practice may be in an entirely different field) or even of the client, the firm needs to retain the authority to assign lawyers competent to work on the matter. Clearly, such a requirement is part of the same duty to provide competent counsel.

Ability to Pay. Every client comes with a potential price tag of at least the amount of the firm's insurance deductible, so the question whether the client can pay the bills is of heightened significance. Left to their individual devices, and without independent review of this aspect of intake, individual lawyers will all too often ignore it and take on impecunious clients just to stay "busy."

Engagement Letters. The fact that some lawyers and firms continue to resist the use of written engagement letters does nothing to reduce the importance of such letters or their value to those who use them.

The need for a written engagement letter is emphasized by a New York case involving the leading bankruptcy firm of Weil, Gotshal & Manges. The firm had accepted an engagement subject to an oral limitation that it would not be required to represent this particular client in any issue relating to lender liability because doing so might require the firm to take positions adverse to the interests of the firm's other clients.

Because the limitation was not in writing, the court explicitly declined to allow the firm to withdraw from the engagement when the client sought to have the firm assert lender liability claims.[4]

2. Has the Firm Developed an Appropriate Managerial Screening System That Enables It to Undertake Independent Review of Every Prospective Engagement?

There are three vital attributes of a successful client intake management screen. First, with respect to every new client and each new matter for new and existing clients, there must be an independent review on the part of the firm of the information provided by the lawyer seeking to open the matter. Firms establish such mechanisms in a variety of ways: by committees, by delegating the function to practice leaders, and, most efficiently, by establishing an independent new client and matter intake review structure. Second, this independent review must assess all four of the information groups discussed in item 1 (conflicts, competence, ability to pay fees, and client worthiness). Third, this management process must operate in real time with sufficient speed to enable the firm to make the necessary judgments before work is commenced on the prospective new matter.

In addition, when potential issues are raised as to the advisability of acceptance of a particular matter or client, the system must provide for the speediest possible review and resolution of such issues. For instance, if conflict waivers are required, not only should standard forms be available, but help in drafting appropriate disclosure and waiver language should also be readily available from the general counsel's office.

3. Does the Firm's Culture Appropriately Reward Compliance with Its Client Intake System—and Punish Noncompliance?

There are many ways in which law firm culture can operate to enhance or, in the worst instances, effectively disable client intake management systems. For example, compensation structures, such as those that operate on an "eat what you kill" basis, are likely to lead lawyers to try to undermine or avoid independent review of the decision to bring on new work. Similarly, hourly quotas or guidelines may encourage lawyers with insufficient work at any given moment to seek to take on matters that they are unqualified to handle. A culture that treats the firm's most powerful partners as heroes and encourages or permits them to ignore established client intake management oversight systems serves to undermine those systems, often rendering them useless in the situations when they are most needed. In contrast, compensation structures that reward collegial behavior and adherence to firm policies and systems are likely to gain the most utility from those systems. One among many indications that a firm's culture appropriately encourages adherence to client intake management procedures is a well-established general counsel whose role in overseeing client intake

generally, and the resolution of conflicts of interest specifically, is well understood throughout the firm.

4. Does the Client Intake System Encourage a Positive Relationship between the Client and the Lawyers Who Will Be Providing Service?

There are two discrete elements of a client intake system that can be made "user friendly" from the client's perspective. First, the initial client intake interview or meeting must be thorough to fully develop the information required for the firm to make its intake decision, as discussed in item 1. This is important from the client's perspective because it demonstrates that the firm is serious, interested in examining the prospective client's problem, and in making a considered decision as to whether it can assist the prospective client, as opposed to a cursory discussion giving rise to the belief on the part of the prospective client that the law firm is principally interested in the matter as a source of fees. Similarly, effective client intake management should require the preparation of an engagement letter, following an approved form that details all the essential aspects of the prospective engagement. Well-crafted letters help to establish realistic expectations on the part of the client. The system should also require the client's countersignature as a condition for undertaking the engagement.

ADDITIONAL RISK MANAGEMENT TOOLS

Practice Group Management

One risk management structure that large firms have increasingly adopted in recent years is the establishment, or development of the role, of practice groups. In some firms practice groups continue to be seen mostly as a collective marketing vehicle. In fact, they can—and should—be used to oversee the nature and quality of the services being provided to clients. For many reasons, practice group management—properly implemented—should be considered a positive and integral part of the way a firm practices law and provides services to its clients. First, it is the only way to be assured of maintaining a universally high standard of client service over time. Second, it forms the basis for continuous training of all lawyers within the group. Third, it enables firms to incorporate clients into the risk management structure rather than leaving them, like separate and untouchable fiefdoms, within the personal domain of individual partners. Fourth, in a well-organized practice group, when mistakes are made, they can be identified and dealt with promptly—and almost always before devolving into calamities and crises. Fifth, effective practice management is a tool for improving profitability, both because it focuses marketing efforts and because it makes for satisfied clients, who in turn pay their bills, bring additional business, and refer other clients. Accordingly, when

presented to the outside world as part of a firm's commitment to providing work of consistently high quality, this aspect of risk management has the potential for becoming a positive marketing tool.

Firm Management and Risk Management Oversight

An absolutely critical—but too often overlooked—element in the risk management equation is the need for law firm management to actively manage the firms' lawyers. All too many firms can attest to the perils of failing to manage and oversee all of their partners, especially their senior "heavy hitting" ones. Indeed, in the last several years a few prominent firms have faced the public dissemination of allegations of a senior partner's engaging in improper or outright fraudulent billing practices. If such activities in fact occurred, it would suggest that the firms' management structures were incapable of identifying or controlling these practices. Many of the other large claims against law firms attest to the continuing shortcomings in the way that firms actually manage what their lawyers do and how they behave.

For risk management practices to succeed, it is essential that the need for risk management be accepted by everyone in a firm, from the most powerful partner on down. A program that is recognized as being for the common good can operate as an effective brake on dangerous activities, including engagements having the potential to harm the firm.

As discussed earlier in this chapter, many firms (including almost all large firms) have institutionalized their risk management functions by appointing a general counsel for the firm. There can no longer be any doubt that a properly empowered, appropriately staffed, adequately supplied office of general counsel is a critical component of risk management for those firms. Apart from functioning as a lightning rod for the early identification and resolution of problems and issues, the general counsel should also monitor all other components of the firm's risk management policies, procedures, and systems, from client intake to file destruction.

NOTES

1. Nathan Koppel, *A Lawyer's Charges Open Window on Bill Padding by Law Firms*, Wall St. J., Aug. 30, 2006.

2. Anthony E. Davis, *Legal Ethics and Risk Management: Complementary Visions of Lawyer Regulation*, 21 Geo. J. Legal Ethics 95 (2008).

3. *See* AmBase Corp. v. Davis Polk & Wardwell, 8 N.Y.3d 428, 866 N.E.2d 1033 (2007).

4. Heller Fin., Inc. v. Apple Tree Realty Assocs., 1994 WL 16858121 (N.Y. Sup. Ct. Nov. 18, 1994) (order).