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Mark Your Calendar

September 6-8, 2006

Fall 2006 National Legal Malpractice Conference
The Fairmont Chicago
Chicago, IL

April 25-27, 2007

Spring 2007 National Legal Malpractice Conference
JW Marriott Hotel
Pennsylvania Avenue
Washington DC

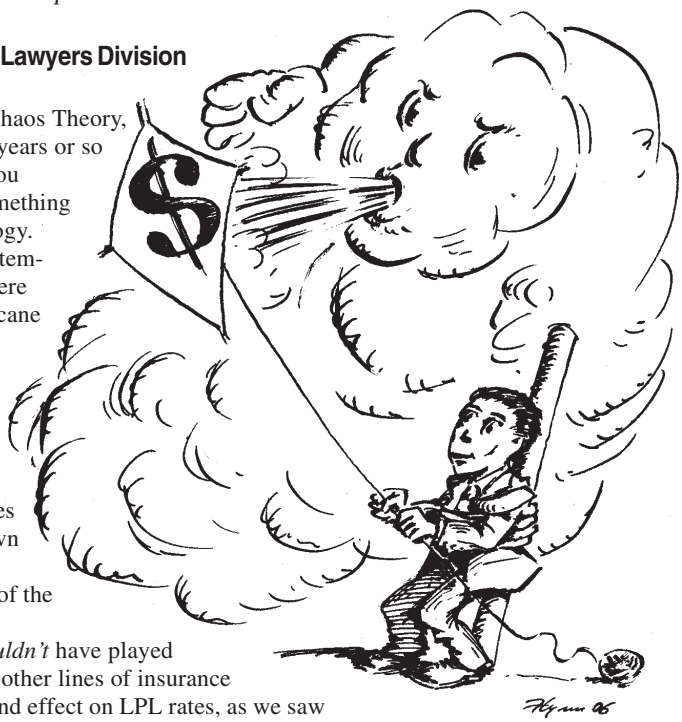
www.abalegalservices.org/lpl

Defending Liberty
Pursuing Justice

The Butterfly Effect, and Other Factors Affecting Your LPL Rates,

Or: *how a butterfly beating its wings in Brazil can cause a hurricane in the Gulf—and an increase in your malpractice premiums.*

by Dan Klauss, Aon Affinity Lawyers Division



With apologies to experts in Chaos Theory, the wild swings of the last 10 years or so of the LPL market can leave you wondering if maybe there's something to that whole "butterfly" analogy.

Seriously, though, last September, some LPL underwriters were opining that the dramatic hurricane losses would firm up the LPL market in 2006. Long story short: that hasn't happened, and the LPL market continues to get healthier. New insurers with credible programs are entering the fray—so your rates are actually likely to come down somewhat (unless you've had claims issues or you have one of the "red-flag" areas of practice).

That's not to suggest it *couldn't* have played out that way: serious losses in other lines of insurance legitimately can have a profound effect on LPL rates, as we saw in the aftermath of 9/11.

So what *are* the factors that affect LPL rates?

Factors Beyond Your Control:

LPL Claims experience: This factor is the most fundamental in determining whether LPL insurance is profitable, and LPL insurers continue to point to defense cost inflation and a rise in the number of high-profile, high-value "catastrophic" LPL claims as reasons why rates shouldn't come down significantly. What really unnerves the underwriting community, however, is what claims are *coming*: what's the next Savings & Loan crisis? Corporate governance and tax shelters are the recent problems, but what's on the horizon? E-discovery? It is this unknown factor that scares insurers away from LPL, and causes those who do write it to try and build "buffers" into their pricing to account for it.

Investment income: Much of the last soft market was subsidized by insurers' ability to invest premiums in fixed income and equity investments, thus creating another source of revenue. If the stock market remains strong, insurers will want to write more business to take advantage of it—and pressure to write more business means pressure to lower premiums. Rising interest rates exert similar forces on insurers: they devalue the insurers' *existing* fixed income investments, putting pressure on them to write premiums to make *new* fixed income investments to take advantage of the higher interest rates.

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Butterfly Effect

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Cost of capital: Capital tends to flow towards lines of insurance where the best return can be obtained. For instance, in the immediate aftermath of a Katrina, capital will be sucked from other lines of insurance to write Catastrophe insurance in anticipation of big rate increases in that class. This means LPL underwriters have to justify to management why capital should still be allocated to LPL—and they typically do that by promising higher profits (i.e., higher rates). Conversely, when other lines of insurance perform poorly, capital will flow *towards* LPL.

Competition in LPL: Established LPL insurers say they have the best sense of what pricing should be because they've paid the losses. New entrants typically have to compete (to some degree) on price to lure business away from established players, who then have to respond with price cuts, etc.

Factors You Can Control:

Your Claims: This is probably the biggest influence on premiums, so putting it bluntly, *have as few paid claims as possible.* Here's where you can have some influence:

- Decide how low your deductible really needs to be. Low deductibles seem great, but if insurers are paying out even small amounts of money on your policy every year or two because of them, this will cost you in the long run. Instead, choose a deductible that's high enough to capture as many of the "nuisance" claims as possible, but still low enough that you can afford to pay one or two—or three—in any given fiscal year. (A note of caution: aggregate deductibles give you *some* protection against multiple claims hitting all at once, but remember that the aggregate applies to a *policy* year; claims heat up at their own pace, and it's common to have claims from different policy years become active in the same *fiscal* year of the firm—and then an aggregate deductible won't be much help.)
- Similarly, decide whether you need "bells and whistles" like *First Dollar Defense*. It sounds great to have defense coverage that isn't subject to a deductible, but in this litigious era, mid-sized and larger firms should consider foregoing this type of coverage.

Your Areas of Practice: Before bringing in a new area of practice, ask your broker for input on how the area is viewed, so you can better assess the true costs of the acquisition. Intellectual Property, Securities, Plaintiff and Entertainment are some examples of areas that can result in a) higher rates, and b) some insurers refusing to quote you at all—limiting your ability to generate competition for your business. If you're already in those "red flag" areas, find out what specific concerns your insurers have and try to address them.

Your Application: In completing your annual insurance application, especially the Risk Management section, try and get a sense of what answer the insurer wants. If the honest answer to a question is "no" when you think they want "yes", try to explain *why* the answer is "no" (or if there isn't a good explanation, consider changing your firm's procedures). An example: an application asks the firm a) if there is a management committee, and b) how often it meets. The truthful answer is "no" and "N/A", but this is a firm with only 4 equity partners, all working within 50 feet of each other. No formal committee, no formal meeting schedule—but daily interaction between the firm's decision-makers, which is all the insurer wants. Similarly, if you've had claims, learn from them—and convey that fact in the application. The idea is to avoid a declination from an underwriter (which is difficult to undo once you get one). Consult with your broker about what "red flag" issues are raised by your application, and address them before the application gets submitted to insurers.

Your Website: If it overstates your firm's capabilities in various areas—an extreme example, Biotech IP—be prepared to answer insurers' questions about it.

Competition: Choose a good broker (one who has access to a good cross-section of markets, and can analyze the strengths and weaknesses of competing proposals) to try and generate "competitive leverage" for you. Remember, though, that LPL coverage is in no way standardized, so you'll be relying on your broker to report on policy coverage differences (e.g., some policies contain a conflict of interest exclusion), financial strength and intangibles (claims-paying reputation, credibility, commitment to the LPL market, etc.). Price is important, but lower premiums aren't worth it if your claim ends up being denied because of gutted coverage.

You could dwell on all the things that could go wrong—why, it's enough to give you butterflies (sorry)—but with any luck, current trends will continue and the market will stay healthy enough to suppress rates, but not so soft as to chase insurers out of the LPL business.

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Levit Essay Contest Award Winner Selected

Cassandra Burke Robertson, Texas Supreme Court Staff Attorney, was awarded the 2006 Levit Essay Prize for her winning essay "An Opinion Addressing the Innocence Requirement in Criminal Malpractice Cases. The prize includes $5,000 provided by the contest co-sponsor San Francisco law firm Long & Levit, LLP. The contestant also wins an all expenses paid trip to the ABA Spring National Legal Malpractice Conference, this year held in New York City.

This annual contest encourages original and innovative research and writing in the areas of legal malpractice law, professional liability insurance and loss prevention. The Levit Essay Contest is open only to law students and young lawyers and is a project of the American Bar Association Standing Committee on Lawyers' Professional Liability.

The 2007 contest topic will be selected in Fall 2006. Watch www.abalegalservices.org/levit.html for details.

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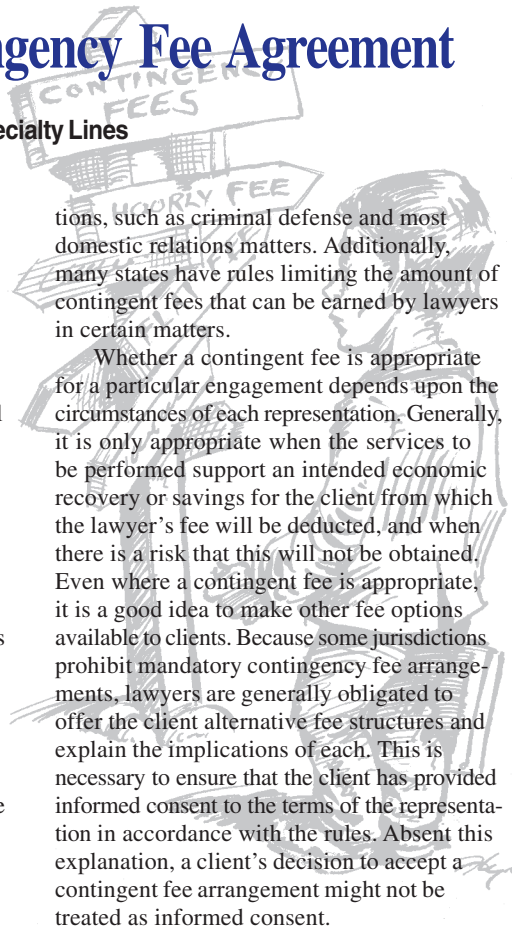
Comments and proposed articles should be directed to jnosbisch@staff.abanet.org. Views expressed are those of the authors and do not necessarily represent the policies of the American Bar Association. American Bar Association ISSN Pending.

Revisiting the Contingency Fee Agreement

by Michael J. Vahey, Esq., CNA Global Specialty Lines



Contingency fee agreements are being used increasingly by lawyers in practice areas where hourly fees have traditionally been used. This is in part because contingency arrangements can be a practical alternative that allows lawyers to tailor their fees to the circumstances and better serve their clients' needs. Contingency fee agreements also fulfill some valuable functions. They produce a *res* from which the costs of legal services can be paid by the client. Because clients may lack the resources to pay for services except through the proceeds of their claim, contingency fee arrangements often provide the only means for them to afford the services of a lawyer. Further, contingency fee agreements provide an additional incentive to lawyers to accept and diligently pursue only those matters that are meritorious.

However, contingency fee arrangements also give rise to the potential for conflict of interest or overreaching by the lawyer. Unlike other billing arrangements, contingency fee agreements give lawyers a direct stake in the outcome of their clients' matters, and can enable lawyers to collect a bigger fee than they otherwise could with another billing arrangement. While higher fees are often justified in light of the increased economic risks shouldered by lawyers in contingency arrangements, this perceived "windfall" to lawyers has nevertheless contributed to suspicion from the public toward the lawyers who earn contingent fees. Further, because of the inherent "hidden" incentives, contingency fee agreements are subject to special ethics rules and restrictions and tend to be more closely scrutinized by courts and other authorities.

Lawyers who charge contingency fees should be conscious of the heightened risks associated with such billing arrangements. Before entering into contingency fee agreements, lawyers should be familiar with all applicable ethics rules and ensure that their fee agreements comply with such rules and do not create unnecessary risk.

Is the Agreement Appropriate?

The first question to ask is whether a contingent fee is appropriate for that particular engagement. While contingency fees can be a useful tool for making legal services available and for satisfying client needs, they are not appropriate in all circumstances. Contingent fee agreements are prohibited in certain types of representations, such as criminal defense and most domestic relations matters. Additionally, many states have rules limiting the amount of contingent fees that can be earned by lawyers in certain matters.

Whether a contingent fee is appropriate for a particular engagement depends upon the circumstances of each representation. Generally, it is only appropriate when the services to be performed support an intended economic recovery or savings for the client from which the lawyer's fee will be deducted, and when there is a risk that this will not be obtained. Even where a contingent fee is appropriate, it is a good idea to make other fee options available to clients. Because some jurisdictions prohibit mandatory contingency fee arrangements, lawyers are generally obligated to offer the client alternative fee structures and explain the implications of each. This is necessary to ensure that the client has provided informed consent to the terms of the representation in accordance with the rules. Absent this explanation, a client's decision to accept a contingent fee arrangement might not be treated as informed consent.

Is the Fee Reasonable?

Once it has been established that a contingent fee is permissible and appropriate, the next question is whether the fee is reasonable. Although contingent fees are subject to special rules, they are governed by the same ethical standard of reasonableness that applies to other types of legal fees. In order for a contingent fee to be proper, it must be reasonable. A contingent fee is not reasonable merely because it has been agreed upon by the attorney and client. The fee charged by a lawyer for services must be reasonable under the particular circumstances notwithstanding the client's agreement to pay it. Because circumstances can fluctuate over the course of a given engagement, what sounds reasonable at the outset of the representation might appear unreasonable later.

In order for a contingent fee to be reasonable it must be earned. A contingent fee becomes unreasonable when it bears no relation to the time and effort expended, or to the level or duration of risk experienced in handling the matter. It is necessary for lawyers working on a contingency basis to keep detailed records of the work performed on their clients' behalf. This includes tracking time spent and expenses incurred, even where such amounts are not billable to the client under the fee agreement. This allows the lawyer to determine whether changed circumstances warrant a fee adjustment to align the fee with the value of services provided. In the event the fee is questioned, it also allows the lawyer to demonstrate how the contingent fee was earned.

Is the Agreement Valid and Complete?

According to ABA Model Rule of Professional Conduct 1.5(c), a contingency fee agreement must be in writing to be valid. While it is advisable for lawyers to put all of their fee arrangements in writing, most state ethics rules and codes follow the Model Rules in this requirement, even if the attorney has previously represented the client in other matters. Many courts have taken the position that failure to comply with this ethical requirement renders an oral contract unenforceable. In addition to providing the client with a written agreement for his review and signature, Rule 1.5(c) also requires lawyers to specify the size or proportion of the lawyer's fee, the expenses for which the client will be responsible, and the effect that deduction of expenses will have on the fee. At the conclusion of each representation, the lawyer must provide a disbursement statement to the client, describing the outcome of the matter and the amount of fees to which the lawyer is entitled, along with an explanation of the services rendered for these fees.

Key Points For A Contingency Fee Agreement

How expenses will be paid

Rule 1.5(c) establishes only minimum requirements for contingency fee agreements. There are numerous other considerations, both ethical and professional, that should be taken into account to avoid the risks associated with such arrangements. First, the written contingency agreement should specify whether the lawyer's share of the recovery will be taken from the gross amount recovered before expenses or from the net amount after expenses are deducted. Because it is up to the parties to decide whether expenses will be contingent upon recovery, it is important for this issue to be spelled out clearly. Lawyers should be particularly careful about delineating the client's obligation to pay for expenses incurred during the engagement. A contingent fee agreement should set forth both who is responsible for expenses and the estimated amount of those expenses, as well as how and when they are to be remitted.

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Contingency Fee

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Timing and method of fee payment

The timing and method of payment of fees also must be addressed. When and how the attorney is to be paid is especially relevant in litigation matters and other disputes that might result in a settlement. Because settlements are often structured to provide the client with installment payments rather than a lump sum payment, how and when lawyer fees are to be paid can become complicated. Fee agreements that are silent on this issue for the most part have been interpreted unfavorably to lawyers, and the failure to specify the timing and method of payment could result in disputes and lengthy fee payment delays.

Scope of the engagement

Contingency fee contracts should specifically describe the services to be provided. Do the fees owed to the lawyer include the cost of pursuing an appeal? What happens if the case needs to be retried? In anticipation of these problems, some lawyers charge incremental shares that increase at various stages of the representation. In such instances, the written agreement should specify when such increases will take effect.

Payment in the event of early termination of representation

The contingent fee agreement should address how the attorney will be paid if the engagement is terminated before the contingency arises. The rule in nearly every jurisdiction is that a lawyer who is discharged before the contingency occurs loses the right to recover under the contingent fee contract. Instead, the lawyer is entitled to the reasonable value of the pre-termination services under principles of *quantum meruit*. A lawyer is also entitled to *quantum meruit* if the circumstances of the representation warrant his withdrawal.

Clients should be alerted up front that counsel will still seek their fee or a reasonable substitute if the lawyer is discharged or needs to withdraw from the representation before the contingency occurs. The most effective way to do this is through a conversion clause. Generally, a conversion clause converts the fee due under a contingent fee contract to an alternate fee if the contract is terminated before the contingency occurs. Such an alternate fee is often based on the amount recoverable under *quantum meruit*, a percentage of the highest settlement amount offered prior to the termination, or some other formulation. Some states require a conversion clause in the contingency agreement for an attorney to seek payment after withdrawing from the representation.

Any conversion clause should limit the recovery to the lawyer's reasonable fee and out-of-pocket costs. Any other application could be viewed as hindering the client's rights. A contingency fee agreement cannot interfere with a client's right to choose whether or not to settle his case. For example, a provision that automatically converts the fee to an alternate fee if the client rejects the attorney's settlement advice or settles his own claim is void. It is also improper for a conversion clause to operate as a penalty upon termination, thereby chilling a client's exercise of his right to terminate the engagement. Although lawyers can and should protect themselves in such a relationship, they must remember at all times that they are hired by clients and subject to termination at any time with or without cause.

Is the Fee Agreement Understood?

The detail and clarity of the written contingency fee agreement is critical. In the event of a dispute, ambiguities will be resolved against the lawyer. Additionally, for the agreement to be valid, lawyers must make certain that their clients fully understand its terms and agree to them. Because misunderstandings over fees can give rise to client dissatisfaction, lawyers using contingency fee agreements must candidly discuss the terms of the fee agreement and ensure that clients understand the terms.

In examining whether a contingent fee charged to a client is reasonable, courts will consider whether the lawyer adequately advised the client of the likelihood of recovery and the likely amount of such recovery. It is important to remember that informed consent by the client is a requirement no matter what type of fee agreement is employed. Lawyers can safely take advantage of the contingent fee option, but only by being aware of the ethical rules and pitfalls common to such arrangements and by exercising caution in memorializing and communicating the agreement.

By Michael Vahey, J.D., Risk Control Attorney, CNA Insurance Co., Chicago, IL. Mr. Vahey is an attorney for CNA's Lawyers Professional Liability insurance program, providing risk management training and consulting services to the company's policyholders, and regularly addressing practicing lawyers and law firms throughout the country on ethics and practice management related topics.

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