

INSURANCE ISSUES: *Risk Management*

A publication of the Law Society of British Columbia



*Lawyers
Insurance
Fund*

Hard Times: Managing risk in a troubled economy

"MELTDOWN OF HISTORIC PROPORTIONS"

"SERIOUS FINANCIAL TURMOIL"

"MOST WRENCHING FINANCIAL CRISIS SINCE THE GREAT DEPRESSION"

THE NEWS HEADLINES are provocative. By all accounts we've entered a period of prolonged economic instability. For lawyers, difficult economic times increase certain risks. This risk management issue highlights the risks and offers suggestions — and resources — to manage or avoid them. (see *List of Resources p.4*)

Financial distress

"Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery."

In a weak economy, incomes decline as deals collapse, financing dries up and businesses fail. And the misery that results from insufficient means may well lead to negligence claims. Lawyers practising in the areas of commercial law, including business purchases and sales and commercial leases, commercial lending, commercial real estate and securities are particularly vulnerable.

Over the past five years, these areas have generated 18 per cent of the reports to LIF and accounted for over 30 per cent of payments made or expected. With 25 years of program experience through various economic cycles, we know that both the number of reports and their cost will increase when economic conditions worsen.

What can you do?

- Awareness is the first requirement of managing any risk. If you practise in any one of these commercial areas, your services are a necessary component of your client's commercial venture. As the economy works against the success of that venture, you are first on the firing line in the event of failure. Even if you practise in a non-commercial area of law, appreciate that financial distress will cause clients — and others — to re-examine every step taken.
- Make the quality of your services unsailable. Take the time you need to think through the legal issues and strategies

necessary to achieve your client's ends. Be sure to get clear, specific instructions. Ask, don't make assumptions, about your client's intentions or the factual matrix. Review documents and file materials carefully to avoid missing a critical fact or issue. Remind yourself and your staff to take a thorough second (or third) look for inadvertent clerical errors before any document you draft is finalized. Use the Law Society's practice checklists and keep your personal and firm-wide systems in good working order to avoid "dropping the ball."

- Confirm your advice and instructions in writing. Not only does writing help avoid misunderstandings, but it can give you the necessary evidence to defend your position.

Devalued assets

"The education of Mr. Jonas had been conducted from his cradle on the strictest principles of the main chance. The very first word he learnt to spell was 'gain' and the second (when he got into two syllables), 'money.'"

Because shrinking stock portfolios and falling asset values work against the "gain money" goal, they create new risks for lawyers. Real estate practitioners may be dealing with the

fallout from a purchaser trying to avoid completing a deal struck in better times, or a lender refusing to fund. For all lawyers, delays of little consequence in the past may now result in real losses. For example, failing to timely liquidate stocks in an estate, sell a former matrimonial home, execute on a judgment or litigate ownership of a business may dramatically reduce the amount ultimately realized, and those affected will hold you responsible. You may also be targeted if better management of an investment or business might have avoided or reduced a loss, or if you provide independent legal advice on a matter in which the client realizes less than anticipated.

What can you do?

- Avoid taking on more than you can handle. Our claim files show that your ability to act competently — and in a timely manner — is affected by stresses in both your personal and work life. And if you are concerned about your staff's ability to manage their file load or any particular file — for any reason — intervene before delay leads to a real loss.
- Get organized. Incorporate into your practice the systems, practice checklists and best practices that will help you get things done in time.
- If you practise real estate, read the risk management material available in the insurance section of the Law Society's website. Publications such as "Curbing risk in real estate practice" and "Avoiding claims in real estate conveyancing practice" give you concrete tips to help you avoid the mistakes that might benefit a party seeking to escape a contract. Bullet-proof service is your best protection when prices are falling.
- Recognize your client's need for other professional advice. Business, investment and accounting advice and services may become more critical to your client in risky times. This step will ensure that your client's needs are met, and allow you to effectively pass the risk of any poor results to another party. As always, be sure to clarify in writing the division of responsibilities between you and other professionals.
- If retained to provide independent legal advice, use the independent legal advice checklist, available in the "Practice

Support" section of the Law Society's website. It will help remind you to ask the questions necessary to make sure that the client understands the consequences of the matter, while also serving as a record of your meeting.

Great expectations

Even lawyers who provide sound legal services and advice can find themselves targeted in a claim. The following are examples from our claim files:

Lawyer advised a client about the legal consequences of terminating a service contract. The client decided to follow a different course and, when adverse consequences resulted, alleged negligent advice by the lawyer. The lawyer's advice was sound, but she had not papered her concerns about the risks of the strategy that the client had followed.

Lawyer commenced a Small Claims action to recover fees for acting on a share purchase. The client counterclaimed, alleging negligent provision of legal services.

Lawyer reviewed purchase documents in order to provide a fee quote. The claimant decided not to retain the lawyer, but the lawyer didn't send a non-engagement letter. The claimant now alleges the lawyer was retained and failed to advise on an essential term of the purchase contract.

Lawyer for a company met with investors. When the investments are lost, the investors sue the company and its promoters. The investors now seek to add the lawyer to the action, alleging that the lawyer provided them with legal advice and failed to warn them of material risks to their investments.

What happened? In hindsight, it's apparent that the lawyers involved did not appreciate that a client or third-party had greater expectations than they could or would meet: the client's expectations about what the legal process could accomplish, or at what cost, were out of line with reality; the lawyer's understanding of the existence or scope of his or her retainer was not shared by a prospective client; a third-party (non-client) thought that the lawyer was somehow protecting his interests.

In the best of times, failure to manage expectations causes around 15 per cent of all reports to LIF. We expect these claims to increase as people find themselves in the worst of times financially, given that the lawyer's insurance policy holds the promise of a personal "bail out." Lawyers practising in the commercial sphere are at particular risk, as failing to manage expectations causes almost 30 per cent of all reports by these lawyers.

What can you do?

- Send letters that clarify your role. Retainer letters clarify what you will and will not do and pass the risk of what you won't do back to the client. Non-engagement letters for prospective clients for whom you have provided some preliminary advice confirm that you are not taking any steps until you are properly retained. Disengagement letters, including warnings on deadlines and any outstanding matters that may affect the client, confirm that you have withdrawn from an ongoing legal matter. If you're retained on a new matter for an existing client, send an abbreviated letter that still outlines what you will and will not do, and any other critical aspects of the retainer. If another professional or specialist is involved, such as an accountant in a tax-driven scheme, confirm in writing to both the client and the other professional the separate obligations and responsibilities of each party. Sample letters are available on the Law Society website.
- Build positive connections. Good rapport may be your best "insurance" against claims by an unhappy client. Establish it from the outset and nurture the relationship.
- Be up front with your client about legal fees. Explain at the beginning of the retainer how you will keep time and how you will bill your client. Send fee accounts as frequently as your comfort level allows or your retainer agreement permits. If the matter is proving more expensive than expected, discuss that with your client. Do not let unpaid fees continue to accrue.
- Manage risky clients. Prospective clients desperate for a miracle or who have been through several lawyers may have

expectations that simply cannot be met. Clients who are needy, controlling or unreasonably demanding of your time without reward may blame you for an unsuccessful outcome. Practise defensive lawyering, even if a client may not seem risky. Advise the client about the potential downside of any decision, and provide enough information to allow your client to make an informed decision. Don't be afraid to give bad news, and put it in writing. Document everything — your advice, your client's instructions, phone calls and voice mails. Retain e-mails. Copy your client on all correspondence — yours, and letters received by others. And if the relationship breaks down, it may be advisable to end the retainer.

- Make yourself third-party bullet-proof. Be aware of the risk inherent in third-parties who are involved with your client's transaction but have no separate representation. If the investment or commercial venture fails, third-parties who suffer may target you. Be alive to this risk and take protective steps, such as confirming in writing that you do not act for anyone but your client and recommending independent legal advice, as needed. Your actions may create a duty when none had existed, so be sure to act in a manner consistent with your position that you represent only your client. If you do receive funds in trust, be crystal clear about the terms upon which those funds are held and make sure they are met before the funds are paid out.

Conflicts

"Any man may be in good spirits and good temper when he's well dressed. There ain't much credit in that."

Lawyers who have acted in a conflict know how quickly positive relationships can sour when a client loses funds, and suddenly views the legal services provided far less favourably. The following are examples from our claim files in which lawyers experienced this dramatic shift in perception:

Lawyer acted for two couples purchasing a revenue property. The property sold at a loss, and the couples argued with

each other over whom has to bear what portion of the loss.

Lawyer acted for the parties to a shareholders agreement. One shareholder alleged that the lawyer acted in a conflict and failed to obtain a guarantee of the debt of the other shareholder.

Clients about to embark on a new venture often want to move quickly and incur as little start-up cost as possible. Lawyers swept up by the parties' urgency, conviction that nothing will go wrong and desire to save money may not appreciate that they are in a conflict until it's too late. And as the economic climate chills, this risk increases. Clients with diminished resources want to try and cut their legal costs. As viable business opportunities are scarce, those that do exist may be seized on by clients who want you to act quickly — and cheaply — before conditions change. Prospective clients may threaten to take their business elsewhere if you refuse to act for all parties or if you insist that additional terms are needed to protect their position.

What can you do?

- Carefully consider the situation and your ethical obligations. Appendix 3 of the *Professional Conduct Handbook* sets out the situations in which a lawyer can act in a conflict, but these exceptions are quite narrow. If you cannot act, explain why.
- Resist the temptation to either save the parties money by simply "papering the deal" or compromise your ethical duty in order to keep a client who is threatening to leave if you will not act for everyone. Individual interests are compromised when a lawyer attempts to serve more than one master, and you risk a claim once the individuals involved lose money and are able to argue that you were not focused exclusively on their interests.
- Help the party for whom you will not act find a new lawyer, then look for ways that you can control the overall costs and avoid unnecessary duplication without compromising your client's interests.

Frauds

"I have known a vast quantity of nonsense talked about bad men not looking you in

the face. Don't trust that conventional idea. Dishonesty will stare honesty out of countenance, any day in the week, if there is anything to be got by it."

The ability of con artists to present as honest folk creates the risk to lawyers finding themselves the tool, dupe, or even victim, of an unscrupulous client. It's almost certain that the current economic downturn will create opportunities for new scams and schemes that will use or prey on lawyers. And as the economy dampens the demand for legal services, scam artists may seize the opportunity created by your need for new work. Further, as victims have little hope of recovery from the fraudsters, you — and your insurance policy — are the deep pocket that promises financial redemption.

What can you do?

- Get smart. Fraudsters present themselves as legitimate clients in need of legitimate services, so keep your antennae up, especially if the matter involves a transfer of funds from a third party — or from you — to an unfamiliar client. Ask questions. Use critical thinking in examining all aspects of the transaction. Learn the "red flags" of potential frauds and the fraud prevention steps that you can take by reviewing the extensive material produced by the Law Society and the Lawyers Insurance Fund.
- Avoid putting your insurance coverage at risk. If you are allowing use of your trust account simply as a conduit for funds, you are engaging in a highly risky activity. As you are not providing legal services, there is no defence or indemnity coverage available to you under the insurance policy for any losses.
- Remember your ethical duty to be on guard against becoming the tool or dupe of an unscrupulous client, reinforced in 2005 through amendments to Chapter 4, Rule 6 of the *Professional Conduct Handbook*. The amendments expressly highlight a lawyer's duty to refrain from any activity the lawyer "knows or ought to know" assists a fraudulent enterprise. In addition, a new footnote to Rule 6 explicitly warns a lawyer to be wary of clients who promise third parties unrealistic returns on investments placed in trust with the lawyer.

- Sign up for e-mail receipt of Notices to the Profession from the Law Society. These Notices help to alert lawyers to new frauds as they're discovered, and e-mail means timely receipt. Read and share them with your staff.

Theft

"So now, as an infallible way of making little ease great ease, I began to contract a quantity of debt."

In lean times, law businesses suffer. And in those times, the temptation of using the firm's trust funds to pay personal debts – or avoid incurring them at all – might prove very difficult to resist. The following stories made headlines earlier this year:

A trusts and estate lawyer in Maine, USA was sent to prison after stealing more than \$300,000 from his clients and law firm. Despite earning an annual income of \$269,000 and family assets in excess of \$1 million. Insecurity about money triggered his actions — he felt he needed greater savings.

A legal assistant at an Alberta law firm apparently defrauded the firm of more than \$1.4 million through various means, including forging lawyers' signatures on trust cheques. A pre-sentence report by a forensic psychologist stated that she stole the money initially "because she could" and it "gave her a rush."

If these situations can happen when the economy is healthy and business is brisk, it does not bode well for the risk when the economy is faltering and personal financial circumstances worsen. Moreover, dire economic times may exacerbate the underlying causes of many thefts by law firm partners and employees – substance abuse, gambling addictions, or depression.

What can you do?

- It's wonderful if your book-keeper is a grandmother whom you've employed for thirty years or your partner is held in the highest regard in the legal community. However, you cannot abdicate your own personal responsibilities in relation to trust funds on the premise that you trust that each will always do what is right. Remember your own duties and make sure that only you discharge them. Complete information on your

professional obligations relating to trust accounting is available on the Law Society's website.

- Separate duties to eliminate the ability of one person to gain complete control over your firm's financial records. Implement appropriate checks and balances, including internal audits. Use the sample checklist of internal controls available on the Law Society's website, and contact the Trust Assurance department for more information, as well as best practices relating to trust assurance.
- Do not practice in isolation — silos work best for wheat, not people. Pay attention to your colleagues and staff, including their mental well-being. If you think someone needs help, contact the Lawyers' Assistance Program. (604-685-2171 or toll-free 1-888-685-2171)

Inadequate insurance

"...accidents will occur in the best-regulated families..."

Regardless of how well you provide legal services and run your practice, even in an expanding economy the limits and scope of coverage provided by the compulsory insurance program may not be enough to protect you from the potential liability risks inherent in practice. As noted earlier, we know that a shrinking economy increases both the number and cost of claims, particularly for lawyers practising in the commercial areas of law. Personal liability for defence costs and damages that are ultimately uninsured can be financially devastating.

What can you do?

- Assess your own exposure to claims that exceed the limits of the compulsory policy, or fall outside coverage. For example, what is the potential financial fall-out from your biggest file — the client with the most to win, or lose, as a result of your services? The adequacy of insurance depends, in part, on the nature of a lawyer's own activities, as well as those of partners, associates and employees and the potential impact of those activities, in a worst case scenario, on clients and third parties. Remember that the compulsory policy provides a limit of \$1 million for all claims arising out of either a single error or numerous

related errors, and this limit is eroded by defence costs.

- Buy excess insurance if you may be at risk. Excess insurance extends the limits of coverage offered by the compulsory policy, and may pick up risks not covered by it. It is available on the private market. Consult a broker experienced in lawyers liability insurance to help assess your own needs, and determine if excess insurance is appropriate for your firm.

List of Resources

Practice support

- Download sample letters (retainer, non-engagement and closing), practice checklists and the independent legal advice checklist (currently in "Confidentiality/Privacy/Conflict of Interest") from the "Practice Support" section of the Law Society's website.
- Contact the Law Society's Practice Advisors for information on best practices (Barbara Buchanan at 604-697-5816 or bbuchanan@lsbc.org) and setting up and using systems (Dave Bilinsky at 604-605-5331 or dbilinsky@lsbc.org).
- Visit the Law Society's online learning centre (sign in through the Law Society website) for resources to help you improve communication and other skills.

Fraud prevention and other risk management material

- Information on fraud prevention, as well as other risk management materials for lawyers, is available at Regulation & Insurance/Insurance/Risk Management on the Law Society's website.

Trust assurance and accounting

- Find information on your professional obligations relating to trust accounting, as well as the sample checklist of internal controls (in "Trust Accounting"), under "Trust Assurance & Reporting" in "Regulation & Insurance" on the Law Society's website.
- Call the Law Society's Trust Assurance line at 604-697-5810 or e-mail trustassurance@lsbc.org for more information, as well as best practices relating to trust assurance.

Excerpts from Charles Dickens