RISK MANAGEMENT AND PROFESSIONAL INDEMNITY

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Photographs DANIEL THISTLETHWAITE

UNINTENDED CONSEQUENCES

Our annual *Legal Business*/Marsh risk round table saw law firm risk specialists share their views on the effect that greater scrutiny on financial stability is having on the market

MARK McATEER

The ghosts of Halliwells, Dewey & LeBoeuf and Cobbetts still loom large. Our 2014 risk management report, published in March, showed that a significant number of the UK's top 100 law firms have received more than one visit from the Solicitors Regulation Authority (SRA) in the last couple of years and financial stability has rapidly moved to the top of its agenda. In June 2013, the regulator announced that 160 firms across England and Wales were under intensive supervision due to the state of their finances and of those, 20% were so-called 'high-impact' firms – those in the top 200.

Respondents to our survey also observed more scrutiny from insurers over financial prudence when they were negotiating the renewal of their cover in 2013. With this in mind, our annual risk round table gathered some of the industry's leading risk management specialists to discuss the effects that this heightened awareness towards financial stability is having on firms' behaviours, as well as other agenda-setting issues in risk management. The impact, in many cases, is at times unintended, but nonetheless significant for both risk management teams and the industry as a whole.

Mark McAteer, Legal Business: What is your experience of the level of scrutiny being placed on firms by insurers and the SRA over financial stability?

Sandra Neilson-Moore, Marsh: All of our client firms are being asked questions by the regulator around financial stability, borrowings and partner compensation. The SRA is, of course, trying to accomplish two key things: one, to preserve the reputation of the profession and two, to secure protection for clients. In my view however, (and notwithstanding its best intentions) the SRA will probably be no more able to spot a struggling firm about to go under than the insurers are. On the other hand, the insurers in the space we deal in – ie the top 100 UK-based law firms – got on this 'bandwagon' not so much because of Halliwells or Cobbetts, but because of Dewey & LeBoeuf. They thought it was something nobody saw coming.

The insurers have a little bit more to worry about also, because the minimum terms and conditions (MTC) say that if a firm cannot pay its excess and the claimant has a valid claim, the insurers have to pay the claim from the ground up, ie pay the excess. It is reasonably well known that at least one insurer is going after the partners of failed firms personally, in an attempt to get the excess paid by the partners individually. I imagine that will wind up in court, because the MTC say one thing, while the laws applicable to LLPs say quite another.

Nicole Bigby, Berwin Leighton Paisner: A lot of it is to be seen to be regulating what the SRA feels is a public interest issue. If there was another significant collapse, it would be criticised for not having asked these questions, or not, at least, demonstrating that it was taking an active interest, so there is a measure of self-interest and self-protection about it. Perhaps the efforts will also have some measure of risk avoidance for the profession, at least, by virtue of ensuring that people's minds are focused on that; the partners and the firms know that they are going to be subject to a level of scrutiny. I'm not convinced whether or not the SRA's efforts are proportionate, targeted or relevant, or even really force the SRA to take more balanced risk decisions, but at least the board and the firm are aware there is somebody asking questions.

Emma Dowden, Burges Salmon: Even if you touched on an area [during the SRA visits] that was entirely irrelevant to your firm, it was still explored. There wasn't that customised approach. It was very standardised and structured.

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▶ **Andrew Carpenter, Marsh:** From what I hear, the questions are getting more informed, though; the SRA is learning and becoming more knowledgeable. The insurers, by asking for information that could be six or seven months out of date, do not get an up-to-date picture of the firm's financial position.

David Whitney, Bird & Bird: The latest risk update from the SRA talks about financial stability, but in a different sense. It seems as though the SRA is moving on from looking at financial stability as a subject on its own and is now looking at the link between financial instability and other characteristics. The update talks about the incidence of fraud and other wrongdoing. I just wonder if the SRA feels as though it has sent the message – it probably understands there is only so far it can go repeating the same warning – and it is now looking for other connections.

Amber Matthews, DLA Piper: Knowing that firms have an additional reporting obligation to the regulator may cause some firms to reflect on the way that they address financial stability issues. That is good for the profession as a whole. It doesn't make a big difference for large firms, who already concentrate on this heavily, but it's right that we provide this information along with everyone else. The changes to tax treatment of LLP members is driving some law firms – not DLA Piper – to put more partner capital into a business. If a large group of partners want to move at one time, then depending on the size of the firm, it could result in destabilising the firm financially. The government has now increased this risk to the profession.

Mark McAteer: Mark [Jones], as a former managing partner who is now a partnership consultant, are the new HMRC rules [governing fixed share partners in LLPs] the most risky area in terms of financial management for law firms at the moment?

Mark Jones, Addleshaw Goddard: I do not see the HMRC proposals as a risk management initiative. It is a revenue generation initiative; it is about tax. As I understand it, HMRC's estimate is that it will generate £3bn to £4bn in year one and, in terms of budget allocation, that has already been 'spent'.

A number of aspects of the LLP legislation have not yet been tested in the courts. Take LLP insolvency. As a result of recent insolvencies, we now understand that, while losses lie with the LLP, terminal loss relief goes back to the individual partners, not to the LLP. For the creditors of the business in liquidation, there is a mismatch there. That, to me, is more of a risk management issue than the HMRC's 'disguised employment' proposals, but it is driven by the law of unintended consequences, because, at the time, the legislation was brought in in a hurry and no one thought it through.

There are parallels with the evolution of the role of the SRA over the last few years. Whether we like it or not, we are in a regulated environment. Whether we like it or not, we have a regulator. There are tensions

Mark Jones, Addleshaw Goddard: LLP insolvency legislation of more significance than HMRC's proposals

that had not been thought through and the SRA and law firms are wrestling with the appropriate resolution of them.

The one aspect of the HMRC guidance that I still cannot get my head around is the statement that, when firms receive all of this new capital, they will not be allowed to use it to pay down the firm's borrowings. Why? It is, to me, unarguably commercial behaviour to do so.

Mark McAteer: What about external capital coming into firms via the alternative business structure (ABS) route? Our research shows a softening of attitudes towards this, but for most of the large firms represented around this table, generally the answer over the years has been: 'It is not an issue that affects us.' Has PwC entering the fray changed things?

Sandra Neilson-Moore: I will watch with great interest to see whether the big accountants succeed this time, because they have tried it before. Let's see if ABS changes things. I'm not sure how it could change things though.

Mark Jones: Look back ten years to the introduction of the LLP act. Since then, the LLP has become 'the norm' as the trading vehicle for a large law firm. Look forward ten years. In ten years' time I do not think that an ABS funded by external capital will be the norm for a large law firm. Part of the reason for that, even over a period as long as a decade, is that lawyers are personally risk-averse and cautious when it comes to behavioural change affecting them, such that the thought of operating in a demanding private equity-backed environment is something that they will not all rush to embrace.

Mark Hick, Wragge & Co: It is an issue of what you might call 'selling the family silver'. Among the large law firms, you want to retain the best people coming up the tracks. If you have already sold 50% of the business to private equity, the partners share only the remaining 50% between themselves. The best people coming up the tracks will want a share of 100%, not a share of 50%. In the large law firms, it is not a sustainable thing to do if you want to recruit and retain the best people. Today's partners do well when they sell 50% of the equity to private equity, but that is a big disincentive to the partners of tomorrow.

David Whitney: We were talking about unintended consequences earlier. I sense that one consequence (unintended or not) of the ABS revolution is that law firms are looking for other ways of delivering services even if they do not intend to embrace an ABS itself. So the focus on ABS licensing has changed the playing field and the mindset of the market. Against the background of the service and delivery developments we have seen in the last two to three years (eg nearshoring, virtual chambers of solicitors and new contract lawyering services), I suspect that many firms are feeling the pressure to evolve through innovation. I see that as the real winning result of the ABS revolution, not the actual creation of the ABS structure itself.

Emma Dowden: That is market-driven. It is about pricing innovation, client demands and client service. PwC will be an interesting entrant, because it has the scalable infrastructure, systems, knowledge and power to do that on a big scale. That is where it could be more interesting than the predominantly niche ABSs that have been licensed so far.

Sandra Neilson-Moore: It will be interesting if a law firm, and the partners inside a law firm, invest in a business that shares its brand, which is non-regulated. What happens if that part of the organisation brings the firm into disrepute or drags it down into insolvency?

Nicole Bigby: That is already on the SRA's agenda in terms of group contagion. At a business level, there needs to be strategic and commercial integration across the brand portfolio, the service delivery mechanisms. To the extent you are then managing different brands within a group portfolio. There needs to be coherence.

Emma Dowden: The challenge for lawyers there, is understanding what marketplace they are in for a particular client and recognising which end of the spectrum of the scale they are at, and then gearing the service and the product, effectively, towards that in order to meet the particular clients' needs ▶

Emma Dowden, Burges Salmon: New fining powers for SRA a step in the right direction

Nicole Bigby, Berwin Leighton Paisner: Law firms need to learn risk management lessons from working through the recession

and expectations. There is some way for the legal sector to go on that.

▶ **Sandra Neilson-Moore:** I am surprised there are not more claims coming from large firms subcontracting to smaller firms. It is amazing to me, in the 20 years I have been in this country, that while I have heard of lots and lots of these things happening, I have not yet seen more than two claims, probably, coming from that. This is a really fertile area. In these days, you really have to 'farm some stuff out' to a smaller or 'niche' firm, particularly in a local jurisdiction. If they mess up, you are 'prime', as far as the client is concerned.

Nicole Bigby: In certain jurisdictions, you are obliged to work within the local constraints and uncertainties, so even if the issue does arise, you manage to find a way through it. That is more relevant when you are working in a frontier or emerging market where, perhaps, the legislative regime or the market is not that mature; there is a lack of clarity in terms of the interpretation of the law.

Mark McAteer: What about the SRA's proposal to take on more responsibility for direct fining of law firms, upping the limit from a maximum of £2,000 to £100,000. Has this been properly thought through?

Sandra Neilson-Moore: If the SRA's power to fine was going up to £20m, then one would be concerned, but £100,000 is really not a lot of money.

Andrew Carpenter: Do you think it will generate more inquiries or cases, because there is a higher fine at the end of it?

Mark Jones: I suspect that part of the thinking is that, at the moment, its powers to fine are so limited that it feels it has to refer matters to the Solicitors Disciplinary Tribunal (SDT), because the conduct of the respondent justifies a more severe penalty. One of the consequences of that – and we are back to unintended consequences – is that the SDT is overworked. Should it really be necessary to go to the SDT simply because the SRA, probably quite rightly, believes that the appropriate outcome could be agreed with the respondent, but it cannot be in the context of the constraints it faces at the moment?

Amber Matthews: To have some teeth in being able to fine law firms is not the wrong approach per se, but there is the concern that the SRA exercises this power in the right way and proportionately to the actions of the solicitor or firm involved. Some of the examples provided in their consultation paper suggested they haven't got this right.

Emma Dowden: It is about there being transparency and having a due process in place, along with accountability, which should drive proportionality of application. Clarity around what that application would be is also needed, which goes to the heart of what is a

Mark Hick, Wragge & Co: Selling off large stakes to private equity makes firms unattractive to future partners

Clare Jaycock, RPC: Risk management at the fore, but should not determine strategic decisions

material breach and what the circumstances are when it is appropriate to levy that fine. Broadly, it is right. It gives the SRA some teeth and is a step in the right direction.

Clare Jaycock, RPC: That chimes entirely with the SRA's push on anti-money laundering. It is saying: 'We are going to come in and inspect firms, and look at their procedures and documentation. On a particular matter, we will look at the documentation. How have you documented your [anti-money laundering] decisions? If that is not up to scratch, we will fine you,' even if there is no hint of money laundering or anything actually being untoward.

Emma Dowden: The financial services sector has had that application for some years. You have seen banks being fined over the last ten to 15 years for not having adequate client due diligence procedures in place, for example. It seems to be mirroring that financial services sector approach.

David Whitney: There is an issue about this dual track approach. If there is a conduct element to a complaint or when there is another issue that affects an individual's continuing professional career, then the individual(s) and the firm concerned ought to have the choice to go to the SDT, rather than having to deal with the SRA acting as policeman, judge and jury.

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***Mark McAteer:** How involved is the risk management function of a law firm at an early stage in strategic planning on an international level? Is it simply a case that you are delivered a* **fait accompli** *and you have to deal with it reactively?*

Amber Matthews: There is good awareness of risk issues at board level in the large law firms. The challenge for all risk managers in professional services firms is getting the fee-earners to concentrate more on risk management issues. I am less concerned about risk awareness at board level. We need to raise better awareness of risk issues at the frontline level.

Clare Jaycock: It also depends how the firm plans its strategy. At RPC we like to be nimble so that we can take advantage of every business opportunity that may ▶

Andrew Carpenter, Marsh: Asking for information that could be out of date means insurers don't get accurate picture of firms

Amber Matthews, DLA Piper: Government has increased the risk to certain firms when several partners leave at once

▶ present itself to us. We'd had our eye on Asia for some time and when the right team came along, we wanted to move very quickly because they were a good fit. Clearly, risk management is, almost by definition, going to be trailing. We had an opportunity and we wanted to follow it. Risk management is always at the fore of our decisions, but it would be wrong if firm's strategy was governed by it.

Nicole Bigby: There is a role for a fully mature risk management function to support that strategic risk identification process with the board and say: 'In terms of the strategy that you want to execute, there are these risks associated with it,' be it to open in Hong Kong or set up a partnership with a local vehicle in Myanmar. I have just relocated a member of my team out to Singapore, so we are a little closer to the staff on the ground, spread across the globe.

Mark McAteer: As risk specialists, how much do you fear there will be reversion to the bad habits, now the economy is picking up again?

Amber Matthews: We are now in the 'new normal' and businesses are much more risk-aware. The business evolves so the risk departments need to evolve too. You have to be constantly evolving your teams and your approach so you remain relevant. We have great systems, processes, policies etc, but if people do not follow them, or they glaze over the minute they hear something has come through from risk management, you are not doing your job. We need to evolve as the business evolves, to try to be more practical in our guidance.

Mark Hick: The risk management bar we are setting is going up consistently. We are getting better at risk management.

Nicole Bigby: The challenge is to continue that level of sophistication. We probably spent the recession building the relationships, trust and confidence in us as advisers and in being able to deliver value. Now, we need to work at helping the business keep converting that value. That value may evolve in different ways, because we are looking now at capitalising on more opportunities, rather than just value preservation, which was just keeping the business compliant and intact. Now, we have some more oxygen to fuel growth.

Sandra Neilson-Moore: The firm's fee-earners aren't blind to that reality. Yes, they will come along and say, 'I want to do something' and the firm's risk management team will say, 'No, you can't do that'. It is part of the evolution of the risk management team's relationship with the fee-earners to say, 'yes, you can do that, but let's think of how you can do that in a way that makes sense for all of us – you, the clients, everything,' and very seldom do you say: 'Absolutely not; you can't do that.'

THE PANELLISTS

■ **Nicole Bigby** Partner and director of risk, Berwin Leighton Paisner

■ **Andrew Carpenter** Managing director, Marsh

■ **Emma Dowden** Director of operations and best practice, Burges Salmon

■ **Mark Hick** Partner, Wragge & Co

■ **Clare Jaycock** Director of risk and compliance, RPC

■ **Mark Jones** Partner, Addleshaw Goddard

■ **Amber Matthews** Partner and general counsel, DLA Piper

■ **Mark McAteer** Managing editor, *Legal Business*

■ **Sandra Neilson-Moore** European practice leader for law firms' professional indemnity, Marsh

■ **David Whitney** Senior risk and compliance manager, Bird & Bird

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David Whitney, Bird & Bird

Nicole Bigby: There is also a longitudinal memory for the people who rode out the heyday in 2007-08 and saw some of the mistakes that then came to light in the recession. We saw some of the impact of it, which we have tried to either manage or remediate going forward – limited supervision of deals being run by juniors; people working excessive hours in a day. That was a certain risk environment. Let's learn from that if the economy starts to pick up, because we have now come through a recession and we should have learned a lot of lessons as a result of seeing these issues being revealed.

David Whitney: Downturn or upturn, if you are operating in an environment that is regulated or in which the courts are becoming more proactive in commenting about conduct issues, then the relevance of risk management isn't going to go away. There is a value that risk teams add, and I believe that the management and partners in most large firms will continue to buy into that, as long as we adapt with the business. **LB**

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