Talk for Professional Indemnity Forum Conference 2005

Law Firms – Combating the threats

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Introduction

Law firms are constantly beset by risks and threats from a number of directions. These risks and threats are becoming greater rather than diminishing. For example, firms have to cope with increasing demands from clients who require ever quicker responses 24/7 as a result of electronic communication. They have to cope with legislation giving them a policing role in the fight against commercial fraud and the profession will soon be subject to regulation of a kind never seen before. Some say that they anticipate an FSA-style of regulatory regime involving massive administrative requirements and interference in their practices. This is all in addition to the age-old problem of simply getting their advice wrong.

I want to dwell in this talk on three areas which can have a big impact on law firm risk, which if well enshrined in the firm's culture can make firms fit to meet the ever increasing challenges facing them. These are:-

- choosing the right clients
- choosing the right work and
- limiting liability

Choosing the right clients

(a) Firms must avoid becoming implicated in clients' misdeeds.

Common law and statute are increasingly looking to professionals to assist in the fight against corporate fraud. See for example the Money Laundering Regulations in this country and the Sarbanes Oxley legislation in the United States which imposes "whistleblowing" obligations on UK lawyers acting for US corporations here. There is a whole armoury of common law and equitable remedies against professionals who are caught up in the corporate malpractice of their clients.

The perpetrators of this malpractice often use lawyers to help them in their transactions. History shows numerous solicitors becoming embroiled in the wrongdoings of clients and suffering the consequences. I came across a solicitor some years ago whose clients were pedalling a fraudulent bank instrument investment scheme to wealthy, retired German couples. The documentation was obscure but what was clear was that the investors were told that their money would be safe because it was going to be put in a "trust account" of an English solicitor and the solicitor's practicing certificate was waved around to give credibility to the scheme. They were told that their money would stay in the "trust account" until such time as it was to be replaced by a sum many times greater. The struggling young lawyer in a two partner firm did the clients' bidding notwithstanding the fact that he had been warned that one of the clients might have been previously implicated in a huge fraud against the Salvation Army. He transferred investors' money from the "trust account" on the instructions of his clients and it disappeared. Fortunately for him, the claims were never properly put but in fact the potential range of claims against him was large - from allegations of negligence, to breach of trust, to breach of fiduciary duty to knowing assistance in breach of trust, to fraud, conspiracy and possibly negligent misstatement.

The solicitor in the leading case of *Walker v Stones [2000] 4 All ER 412* was a trustee of a trust set up by George Walker of Brent Walker for the benefit of his children. The solicitor allowed himself to be persuaded to apply assets for the purpose of shoring up George Walker's crumbling empire. He swore an affidavit to the effect that he honestly believed that what he had done was in the best interests of the beneficiaries. However, the court didn't believe that any reasonable solicitor could have taken this view and he was found to have been dishonest.

The remedies against those guilty of these various wrongs are wide and various ranging from straightforward damages to a requirement to restore the trust fund in its entirety, to criminal sanctions such as fines and imprisonment. Some of the breaches of the law, for example breach of fiduciary duty carry equitable remedies which are not capable of having their severity mitigated by means of arguments of contributory negligence on the part of the Claimant (see *Nationwide v Balmer Radmore (a firm) 1999 (PNLR) 606.* Further, arguments of foreseeability and remoteness of damage are generally irrelevant to remedies for breach of trust and breach of fiduciary duty (*Swindle v Harrison [1997] 4 All ER 705).* Also, where an action is based on the fraud of the Defendant, the time within which an action must be begun does not start to run until the Claimant has discovered the fraud – section 32 Limitation Act 1980. So there is potentially a long time within which such claims can be brought. Further, it has been established in *Dubai Aluminium v Salaam [2002] 3 WLR 913* that "innocent" partners can be liable under section 10 Partnership Act 1890 for knowing assistance or other breaches of duty if what was done was done in the ordinary course of the firm's business so that these partners can be sued. It follows that their insurers have a liability under their professional liability policy.

Another way in which unscrupulous clients use solicitors is to get them to make a statement confirming some fact thereby inducing a third party to enter into a contract. The third party may then have a right to sue the solicitor for damages on the basis of negligent misstatement or deceit. A solicitor for whom I acted some years ago was asked by his client to confirm to a third party with whom the client was hoping to enter into a business contract, the existence of an agency agreement by which the client was entitled to supply a certain type of aeroplane to the Middle East. Although this agreement had at one time existed and the solicitor believed it still to be in operation, the agreement had, in fact expired and the third party sued the solicitor for negligent misstatement.

So what should insurers look for in a potential insured to see whether they have the potential for falling into this kind of trap?

First, there must be a good client vetting system in place. This is mandatory nowadays under the money laundering regulations. Proof of client identity as well as training, record keeping and internal reporting of knowledge or suspicion of money laundering are all necessary under these regulations. The regime set up under the Proceeds of Crime Act 2002 places additional burdens on solicitors to "know their clients" and to think about the sources of funds and the effects of particular transactions. (This increased obligation makes it easier to assert that the professional had the requisite knowledge to support an allegation of dishonest assistance in a breach of trust.)

In addition to ensuring that law firms are complying with their money laundering obligations, insurers need to look for evidence of a culture in which partners are alive to the danger of acting for clients with dubious reputations. It is all too easy to see the attraction and potential profit in acting for a high profile client with a bad reputation and all too difficult to resist the thought of good fees. However, a risk-averse partnership will recognise the danger and support a partner in turning away the wrong type of client.

Further, all the lawyers in the firm need to be properly trained so as to be aware of what can go wrong, how they can be used by clients and the need to decline to make statements to third parties unless they are absolutely sure that those statements are accurate.

(b) Firms must have a reliable and sophisticated conflict checking system.

The rules governing conflicts of interest have been the subject to a major overhaul by the Law Society recently. The new rules have been published and are due to receive authorisation by the Master of the Rolls soon. They are designed to prevent a situation where the solicitor's duty to one client is at odds with his duty to another or where his duty to a client conflicts with his own interests. Much is said and misunderstood about conflicts of interest. However, breach of duty in this respect can result not only in disciplinary action against the solicitor but also in a claim for breach of duty by a client although such claims are few and far between.

However, the recent case of *Hilton v Barker Booth & Eastwood* [2005] 1 WLR 567 is a powerful illustration of the dangers in a firm acting for two parties to a transaction. Here a firm of solicitors acted for a developer, Mr Hilton, who was going to buy a development site, build flats on it and sell the property to another client of the firm, Mr Bromage. The firm also agreed to act for Mr Bromage. Mr Bromage had a conviction for offences involving dishonesty. This was known to the relevant partner in the firm but he did not tell Mr Hilton of it. The transaction went disastrously wrong for Mr Hilton because Mr Bromage failed to complete on the sale to him. Mr Hilton sued the solicitors.

Both the Court of Appeal and the House of Lords pondered the firm's conflicting duties in these circumstances. The firm should never have agreed to act for Mr Hilton because by accepting the instruction, they put themselves in a position where their duty to disclose all relevant information to Mr Hilton conflicted with their duty to keep the information about Mr Bromage's conviction confidential. However, the Court of Appeal concluded that the breach of duty in taking on Mr Hilton as a client had not led to any loss because absent the breach, Mr Hilton would have gone to another firm and the transaction would have gone wrong in the same way. The House of Lords wanting to find against the firm which had behaved so badly would not exonerate the firm of liability to Mr Hilton by reason of their duty to keep Mr Bromage's conviction confidential. They held that the firm had a duty to inform Mr Hilton of the conviction and had they done do, the transaction would not have gone ahead. Accordingly, the firm was ordered to pay damages to Mr Hilton.

(c) Finally, financial controls and transparency regarding costs.

It is important for law firms to deal with clients who know and understand the costs involved in instructing solicitors and who can afford to pay those costs. Clients who find themselves with an unexpectedly large bill often look to find a way to avoid paying it. They frequently allege that the service which they have received is defective in some way or another and this sort of dispute often ends up in a claim.

The Solicitors' Costs Information and Client Care Code set out in Chapter 13 of the Law Society's Guide to the Professional Conduct of Solicitors and devised by the Law Society under Solicitors' Practice Rule 15 sets out in detail, among other things, the information which clients must be given about costs. The rules are detailed and should form part of any firm's training programme. For example, costs information must be clear, given at the outset of the retainer and at intervals throughout it. The solicitor must give an estimate of future costs and must for example discuss with the client whether the likely outcome in a matter will justify the expense or risk involved. The Code emphasises that it is good practice to take money on account and to agree with the client that regular bills will be rendered.

If the requirements of the Code are applied assiduously, it should be possible in most cases to identify the client who cannot afford the firm's services and who therefore should not be taken on as a client without special arrangements being put in place such as a conditional fee agreement (which many firms are not prepared to countenance). Credit assessments are good practice in the case of clients who are likely to be incurring over a certain level of fees.

Choosing the right work

As all underwriters are only too well aware, the area of law in which a solicitor practices will have a very substantial effect on his claims record. Statistics in the annual reports of SIF show that during the life of SIF that conveyancing consistently gave rise to the biggest number of claims and commercial work, the smallest.

Type of work	**1987 to 1999 (76,291 claims)**		**1999/2000 (5,855 claims)**	
	% number	**% value**	**% number**	**% value**
Conveyancing	46.6	49.5	36.9	29.3
Personal injury	16.2	14.3	17.9	16.6
Other litigation	12.0	9.9	15.7	17.3
Commercial	4.6	10.0	3.8	14.7
Other categories	20.6	16.3	25.7	22.1

In terms of the average value of a claim, the SIF statistics show that in the last year of SIF the average value of a conveyancing claim dropped while that of the other three main categories of claim increased, in particular commercial.

Type of work	**Average value £ 1987-1999**	**1999/2000**
Commercial	74,396	142,753
Conveyancing	35,921	29,463
Personal injury	29,899	24,472
Other litigation	28,045	41,272
Other categories	26,805	32,051

There are no comprehensive statistics available showing claims since the beginning of the open market in 2000. However, it appears that the number of conveyancing claims is decreasing both by number and value and the number and value of commercial claims is increasing.

An enormous threat encountered by law firms is the sheer breadth of the law in any particular field and the inability of solicitors with a wide practice to know the answer to every issue which arises in the course of their work and the temptation by those with a specialist practice to advise outside their own area of competence.

The much quoted case of *Hurlingham Estates v. Wilde & Partners [1997] 1 Lloyd's Rep 525* is a very good illustration of this problem. Here the solicitor took on a retainer for a client involving the sale of business premises. There was a tax aspect to the transaction. There was no engagement letter and the solicitor later said that he had made it clear to his client that he was not going to advise on the tax aspect. However, the court did not accept this evidence and Mr Justice Lightman delivered a particularly scathing attack on the solicitor:-

"Mr X, the solicitor, assumed the full role in the transaction and responsibilities to be expected of a solicitor having the conduct of it. I have no doubt that, if he had at the meeting of 29 May exposed his ignorance and unfitness to have the conduct of the matter as he should, the clients … would have immediately instructed someone competent instead. Mr X must have known and feared this. He entered the tax minefield armed only with a precedent book (as he frankly admitted) not knowing what to look for or the significance of anything he found …"

In the recent case of *Clarke v Iliffes Booth Bennett (a firm) [2004] EWHC 1731 (Ch)*, the court held that it was part of the duty of a commercial conveyancer to know of or to advise on the procedure for the removal of land from the Green Belt, an issue which one might have thought of as a matter of specialist planning law.

What insurers need to look out for in a potential insured firm is a robust and thorough training programme for lawyers in their chosen area or areas of practice and again, a culture in which work will only be done by those with the relevant expertise or who being capable of identifying a need for specialist advice can seek such advice from elsewhere in the firm or for example from counsel and not held onto by those who do not. It will be a culture in which if a piece of work is wholly outside the expertise of anyone in the firm it will be turned away, painful though that may be.

Limiting liability

There a are a number of ways in which firms can limit their liability.

- By carefully defining the scope of the retainer
- By imposing contractual limits on liability
- By converting to LLP status

Scoping the retainer

The Law Society's Guide to the Professional Conduct of Solicitors, 8th Edition, states the obvious at paragraph 12.08(1):-

"It is essential at the outset for a solicitor to agree clearly with the client the scope of the retainer and subsequently to refer any matter of doubt to the client. If a solicitor limits the scope of the retainer, it is good practice for the limits of the retainer to be precisely defined in writing to the client"

The importance of defining the scope of a solicitor's duty in writing in the engagement letter derives essentially from:-

(a) evidential issues – a clear letter of engagement is the best evidence of what the solicitor has agreed to do.

(b) The central role played by solicitors in many transactions which may lead a client to assume and a judge to rule that the solicitor is responsible for matters on which he did not believe he was required to give advice.

(c) The law as to what a solicitor's duty is.

(a) Evidential issues

Where the point has not been put beyond doubt, e.g. through an engagement letter stipulating that the solicitor is not advising on tax, there is scope for conflicting evidence from client and solicitor as to what was actually agreed.

Sadly, the court doesn't always believe the solicitor. As we have seen, the court in *Hurlingham Estates v Wilde & Partners [1997] I Lloyd's Rep 525* didn't believe the solicitor when he said that he had told his client that he would not be giving advice on the tax aspect of the commercial property transaction. The court said that if the solicitor was not proposing to advise on some aspect of the transaction, it was important that he record this in writing if the client was to be able to give fully informed consent.

It is often not so much a case of the solicitor's evidence being disbelieved as the client having a much clearer memory of what was said. The recent case of *Normans Bay Ltd v Coudert Brothers [2003] EWHC 191 (QB)* is very much in point. In that case the client was investing in a Russian state joint stock company which was to be privatised. It was proving very difficult for the solicitors to get hold of the privatisation documentation which had been produced by the Russian government. A key issue at first instance was whether the client or the solicitor had agreed to be responsible for trying to get hold of that documentation and carrying out due diligence on it. It was key because the client's investment in a Russian company was subsequently held invalid by the Moscow Arbitration Court because it was to be made over a period of 5 years rather than 3 as stipulated by the government in their documentation.

The court preferred the evidence of the client who said that the solicitor was to have obtained the relevant information. The judge concluded:-

"These issues concerning … instructions, their scope and whether they were varied, have only arisen because of the lack of contemporary documentary records that I would expect a conscientious solicitor to have made. Any uncertainty as to a solicitor's instructions, in particular their scope, ought to be resolved and the prime responsibility for that must rest with the solicitor."

(b) Role played by solicitor

To a Judge, the solicitor often appears to be playing the lead role in a commercial transaction by virtue of being responsible for communication with the other party's solicitor and, in particular, for revising the draft agreement to reflect changes required on his side of the transaction.

Where the solicitor is just one of the professionals involved on behalf of the clients – others being potentially accountants or tax advisers for example – the central role he plays is conducive to a judicial finding that he is responsible for certain advice (e.g. tax) if otherwise there is a danger of the matter falling between two stools: the courts "abhor a vacuum".

(c) The law

In order to see how a well written letter of engagement can help to limit the solicitor's liability, one needs to look at how the law will decide on the scope of the solicitor's duty. The law in this area is constantly being tested. The basic principle is that a solicitor is only required to do what the client asks him to do.

So in *Clarke Boyce v Mouat [1994] 1 AC 428* it was said that the solicitor had "no duty to go beyond instructions by offering unsought advice on the wisdom of a transaction":

In *Midland Bank Trust Co Ltd v Hett Stubbs & Kemp [1979] Ch. 384* it was said that "the Court must beware of imposing upon solicitors …. duties which go beyond the scope of what they are requested and undertake to do":

This principle was very recently confirmed in the Privy Council's 2004 decision in *Pickersgill v Riley* (Times Law Reports, 2 March 2004) which approved the following statement at para 10-160 in Jackson & Powell, 5th edition:-

"In the ordinary way a solicitor is not obliged to travel outside his instructions and make investigations which are not expressly or impliedly requested by the client."

But notice the words "in the ordinary way" and the word "impliedly". There are implied duties as well.

If the client is inexperienced the solicitor's duty broadens. As the Court of Appeal said in *Carradine Properties Ltd v D J Freeman [1999]Lloyd's Rep PN 43*:-

"An inexperienced client will need and will be entitled to expect the solicitor to take a much broader view of the scope of his retainer and other duties than would be the case with an experienced client."

It is worth noting that the question as to how experienced the client actually was can often become a disputed issue of evidence at trial where it has not been "flushed out" by appropriate wording in the engagement letter. In *Carradine* the solicitor successfully demonstrated at trial that his client did not need him to advise upon the importance of checking whether insurance was in place. But it is much better if there is no scope for argument because, unsurprisingly, the courts have sympathy in practice for the claimant who says that, having bought a dog, he was not intending to bark himself!

A further broadening of the solicitor's duty arises from the fact that often the solicitor comes across information when carrying out the assignment which needs to be brought to the client's attention. The previous authorities were summed up nicely in the *Pickersgill* case. There the court said that the solicitor had a duty to point out to his client "any legal obscurities of which Mr Riley might have been unaware" and of "drawing the attention of Mr Riley to any 'hidden pitfalls'". The solicitor in that case was held not to have had an obligation to tell his experienced businessman client that he ought to investigate the financial standing of a company from whom he was taking an indemnity which was to run for many years.

I hope that the above demonstrates that the scope of a solicitor's duty under the general law often goes beyond what has been said between client and solicitor and that the engagement letter or a subsequent revision of it offers an opportunity to the solicitor to peg this back.

Insurers should certainly investigate whether a potential insured has an invariable rule that every retainer is covered by an engagement letter.

<u>Contractual limitation</u>

Accountants have been routinely limiting their liability in relation to non-audit work for some years (although section 310 of the Companies Act 1985 currently prohibits the limitation of liability in relation to audit work). However, the position has been strikingly different so far as solicitors are concerned, perhaps because law firms have not seen many catastrophic claims of the kind faced by accountants over the past 30 years.

Historically law firms have been concerned that attempts to limit their liability would make them seem uncompetitive or even unprofessional. However, the harder professional indemnity market of several years ago and the consequent need for greater emphasis on risk management has led firms to re-evaluate the issue and recent surveys indicate that there is now a much greater interest amongst solicitors in the subject. Although the picture is still patchy, law firms finally now appear to be grasping the nettle of limitation of liability. The example of other professions, especially accountants, and a heightened concern, post-Enron, at the risk of "melt-down" have clearly been influential.

In a 1999 City of London Law Society survey, 33 of the 42 firms which responded did *not* limit their liability to clients. Five years later however, a 2004 survey by PricewaterhouseCoopers showed a significant decrease in partner resistance to capping liabilities. Almost a third (29%) of those surveyed "routinely" capped liability in contrast to only 12% in 2003. Three-quarters of those surveyed perceived a need to limit liability, in contrast to only 50% the year before. Of those firms not routinely limiting liability, PWC found that partner resistance was perceived as the main barrier (over 67% at the top 25 firms), followed by 50% perceiving client resistance to be a problem.

Even more recently, a Legal Week poll in February 2005 discovered that three-quarters of UK partners admit that their firm at least occasionally limited liability on individual transactions, while more than 10% of partners do so routinely. Legal Week reported that this represents a notable shift from the previous year when almost half of respondents said they did not cap liability, compared to 28% in the February 2005 survey.

Principle 12.11 of the current Law Society Guide to the Professional Conduct of Solicitors, (8th Edition), makes clear that it is acceptable for solicitors to restrict or exclude liability to third parties and/or to restrict liability to clients although not below the minimum level of obligatory insurance cover of £1m increasing to £2m as from 1st October 2005.

There are exceptions to this in the case of fraud and, importantly, "contentious business agreements" in respect of which section 60(5) Solicitors Act 1974 renders void any provision that a solicitor shall not be liable for negligence. However, in a recent talk arranged by my firm, the immediate past President of the Law Society, Peter Williamson, made it clear that he did not consider that there was any justification for this restriction and committed the Law Society to re-examining it. The current President of the Law Society has confirmed to us that the Law Society will be seeking the abolition of that restriction in the forthcoming Legal Services legislation.

Limitations of liability for negligence are subject to the test of reasonableness imposed under the Unfair Contract Terms Act 1977 and the test is applied at the time the contract is made. Where liability is capped at a specific sum, the Act requires the court to have specific regard to the financial resources available to the guilty party and to the extent to which insurance cover was available.

There are further guidelines, set out in Schedule 2 to the Act, which are strictly applicable only to sale of goods cases but are nonetheless also likely to be taken into account in other cases. These include the strength of the parties' bargaining positions and whether the client was offered an inducement to accept the term or could have contracted with another supplier without the term. However, there has been very little case law as to the reasonableness of limitation clauses in professional retainers and this is an area in which we will have to watch the law develop.

There are a number of different methods of contractual limitation of liability such as:-

- A financial cap

- A reduction in the period in which claims can brought below the standard limitation period

- Proportionate liability where other advisers are involved in the transaction

- An exclusion of liability for indirect or consequential loss

The first of these – the cap – seems by far the most popular.

I would suggest that the use of contractual limitations of liability by firms could be speeded up if insurers were to provide some financial incentive in terms of premium. I appreciate that there are difficulties with this in that given the claims made nature of the policies, the insurer may not be the one to benefit from the limitation. However, it is certainly the case that the accountancy profession was hugely encouraged to introduce such contractual limitations some years ago by a hard market and lack of capacity within it.

Limited liability partnerships

A third mechanism for limiting solicitors' liability - particularly of the catastrophic kind - is the limited liability partnership, which protects its members from the exposures created by the law of joint and several liability of partners. This is a big subject and there is not time to dwell on it in any detail today.

The latest statistics show that currently, 189 firms have converted to LLP status, a relatively small number given that there are around 5,000 firms in England and Wales which have more than one partner. At a recent conference for large law firms organised by St Paul International Limited, 82% of delegates expected the majority of law firms to be LLPs in 10 years time. More specifically, PWC's survey from 2004 (mentioned above) indicated that 41% of the top 25 firms have either already registered as an LLP or have decided to proceed. Only 18% have decided that it is not an appropriate strategy at the current time and the remaining 41% are actively considering the LLP option. However LLPs are not as popular when one considers law firms across England and Wales. Zurich Professional's recent survey showed that a greater percentage of such firms (37%) have ruled out LLP status, while over half (52%) are yet to decide and only 11% have converted or are committed to doing so.

Catastrophes such as Enron and WorldCom appear to be slowly persuading law firms of the advantage of LLP status in addressing a potential disaster scenario, in which the value of a claim exceeds the level of the firm's professional indemnity cover. This is so notwithstanding certain disadvantages such as the cost and administrative burden of conversion, the need to disclose profits and the tax issues associated with foreign offices.

Trading as an LLP does not necessarily, however, offer total protection in the event of disaster. If an individual partner has assumed personal responsibility towards the Claimant then he or she may be found to remain personally liable in tort. However, the 1998 decision of the House of Lords in *Williams v Natural Life Health Foods Limited* [1998] 1WLR 830 suggests that such assumption of personal responsibility will be rare – it is not a matter of what the solicitor is deemed to have done but what he or she in fact said or did in order to assume responsibility. LLPs can make it clear in their engagement letters that no personal liability is intended to be assumed by individual members of the firm.

Conclusion

Law firms are, quite rightly, facing up to the need to impose upon themselves more stringent risk management practices and procedures than ever before. Although the profession hasn't seen the scale of claims which the accountancy profession has seen in the last 20 years arising from such cataclysmic events as the collapse of Barings, Enron and Equitable Life, nevertheless, the solicitors profession does operate in an ever increasingly regulated world and can expect much more of an FSA-style regulation in the next 5 or so years than it has ever seen before. Insurers are entitled to expect that firms are preparing for these challenges and should scrutinise the steps which firms are taking towards risk management, in particular, their culture of risk awareness and best practice.

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