



# A systematic approach

## to law firm risk management

by Malcolm M. Mercer



*Risk is an inevitable reality of law practice. The only way to eliminate risk is to stop practising law – an option most readers of this article are not yet contemplating. A more realistic option is to actively mitigate risk through structured, systematic risk management. This approach is particularly helpful at the law firm level, where risk management can sometimes be seen to be contrary to the perceived self-interest of individual lawyers in the firm. A systematic approach – that begins with a risk analysis and includes strategies to mitigate identified sources of risk – not only helps overcome this issue of self-interest, but also contributes to the prospects of success of the firm.*

*For law firms, the two principal sources of risk are also its principal assets – its clients and its lawyers.*

### Client risk

Client-related risks fall into four, overlapping categories; claims risk, departure risk, credit risk and conflicts risk.

**Claims risk:** The most obvious risk facing law firms is that their clients will seek compensation through professional negligence or fiduciary duty claims. Lawyers also face the risk of complaints

by clients to their regulators. The consequences may be direct – e.g., the law firm is obliged to pay an award of damages or is faced with litigation costs or insurance costs. Indirect consequences include damage to the firm's reputation and morale.

"Dangerous clients" present another major claims risk. In fact, analysis of major claims against law firms indicates a significant

association between major claims and situations in which “dangerous clients” face legal scrutiny on matters where their lawyers assisted. Such claims often fall in the high severity category – uncommon but ugly when they arise.

**Departure risk:** The risk that a good client leaves the firm not only has major implications in terms of revenue, reputation and the professional cohesion of the firm, but is also tightly connected with claims risk. Clients who are dissatisfied are more likely to leave and are more likely to make claims. Clients for whom work is not properly performed may fire their lawyers whether or not they also assert claims.

**Credit risk:** Related to the first two client risks is credit risk. Unhappy clients don’t always pay their bills. Some also depart and/or make claims against their lawyers. But payment risk has another aspect. Just as dangerous clients are a greater source of claims risk, the risk of non-payment is also a risk associated with taking on dangerous clients.

**Conflicts risk:** Whether a matter of legal conflicts or simply business reality, every client carries the risk that acting for that client means another prospective retainer is not available.

### Lawyer risk

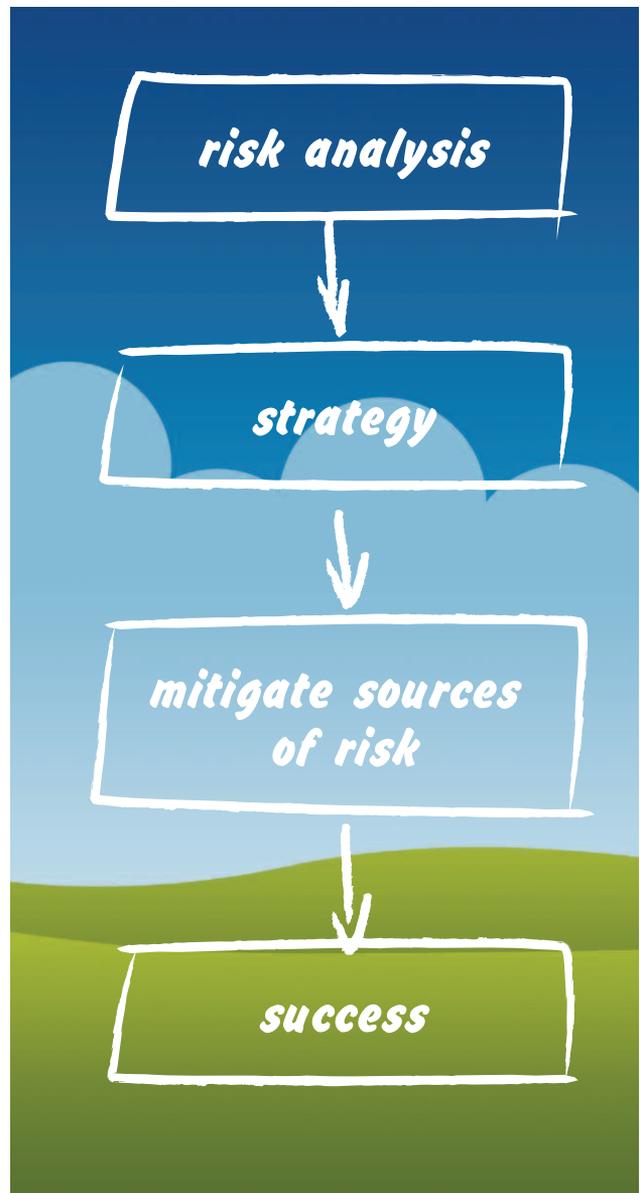
Current, new and departing lawyers are all sources of risk for the law firm. Not surprisingly, lawyer risk and client risk are closely connected, as they are essentially flip sides of the same coin.

**Current lawyers:** Lawyers in the firm are the source of several different kinds of risk. First is performance risk. Everyone at some time fails to practise at the level required. Sometimes we are too busy. Sometimes we are not well organized. Other times we act outside of our area of expertise or experience. Some lawyers prefer to do everything themselves rather than delegate or refer matters to other more appropriate lawyers.

Misconduct risk is another possible concern. Some lawyers do act improperly, perhaps as a result of stress or the opportunity of “the moment.” Other times misconduct is a matter of character. It is not uncommon for the risk associated with a dangerous client to be magnified by the involvement of a lawyer who does not have the strength of character to “do the right thing.”

Conflicts risk arising out of the personal activities of current lawyers is another significant source of risk – but also one that firms often are not as well equipped to identify and prevent as client-client conflicts. Lawyers who wear multiple hats such as trustee, executor or other fiduciary or who have a direct or indirect personal interest in the matter at hand are a good example of this risk.

**Arriving lawyers:** Two risk issues arise with new lawyers. The first is that the new lawyer may not be what he or she appears to be in terms of character or expertise. Why the lawyer left a firm may not be self-evident – but the reason for the departure may have consequences for the new firm. As well, arriving lawyers bear conflicts risks – especially the risk that the presence of the arriving lawyer may interfere with the ability of the law firm to continue to act for an existing client or on an existing matter.



**Lawyer departures:** The loss of a valuable lawyer, including the potential gaps in expertise that may be created by the departure, is an obvious risk. Departing lawyers also potentially compromise client and firm confidential information and property.

### Strategies for mitigating risk

Law firms can mitigate the client and lawyer-related risk factors a number of ways.

**Client-focused mitigation:** Strategic client management that is firm-based – i.e., in which the firm rather than individual lawyers decides on whether to take on clients and matters – is one way to reduce client risk.

Client intake that is firm-based has many advantages:

- Acting as a firm permits deliberate choice as to the best retainer to take on rather than just taking the first retainer that walks through the door – the usual result of individual choice.

- Acting as a firm permits more dispassionate consideration of the legal conflicts which may arise and of the type and character of client that the firm wants to take on. For whatever reason, individual lawyers find it harder to say no to new work and sometimes saying no is the best answer.
- Firm-oriented client and matter intake also helps firms ensure that proper retainer letters are required for new clients and new matters. Client conflicts, an important client risk, can be better managed with proper disclosure and agreement at the outset. Clear identification of the scope of the retainer at the outset and over the course of the retainer mitigates performance risk.

Of course, acting as a firm can be difficult. People making the decisions must be properly informed and motivated, and trusted by others to act in the interests of the firm as a whole. But the alternative is simply sharing space.

Client teams are more effective at risk management because the firm then acts as a firm rather than as a collection of sole practitioners. Client teams reduce performance risk by delivering breadth of experience and expertise to the client. Client teams reduce the risk that individual lawyers will be beholden to or “captured” by the difficult client. Use of client teams increases the chance that client concerns will surface to be dealt with positively before it is too late. Client teams decrease the risk arising from the departure of any one lawyer from the firm.

Firm-based client communication also can help mitigate risk more effectively. Client audits by the firm permit client concerns and complaints to surface which may not be raised with the lawyers concerned. They also permit clients to advise what the law firm is doing right and, if asked, what else the law firm may do to assist the client.

As well, firm-based financial management can mitigate risk. Vigilance with respect to accounts receivable and work-in-progress can help identify client dissatisfaction before it is too late, as well as identify a client under financial stress, which can lead to “dangerous client” behaviour.

**Lawyer-focused mitigation:** Providing lawyers with continuing education and training are important ways in which a firm can mitigate performance risk. Effective continuing education involves more than keeping lawyers up-to-date with legal developments: It also includes practice management and professional responsibility. Encouraging legal excellence and intellectual interest in the law mitigates performance risk, as well as reducing the risk that lawyers will leave by increasing collegiality and professional satisfaction.

To reduce the risk associated with incoming lawyers and staff, firms need to have systems that ensure diligence in interviewing, reference and background checking, and proper decision-making. This is more important than it sometimes appears, as the risk of an unsuccessful lateral transfer is significant and comes with significant direct and indirect costs.

Reducing the risk associated with departing lawyers requires proper procedures and protocols for protecting client and firm confidential information and property and proper client file transfer. Diligent and thoughtful exit interviews that help the firm better understand internal problems also can mitigate the risk of subsequent departures.

## Systems and policies

**Claims management:** Having proper errors and omission insurance is a very important aspect of risk management. Coverage needs to be properly assessed in terms of the scope and amount of coverage.

As well, proper internal reporting of claims and potential claims preserves coverage, and enables the firm to be proactive about addressing potential risks and to ensure proper disclosure to the client when a potential problem is identified. The internal cultural mindset should be that the greater sin is in failing to report and seek help.

**Firm policies and systems:** The following are some important policies and procedures that firms should consider as part of their risk management toolbox:

- Standard policies with respect to audit enquiries, client confidentiality, conflicts, opinions and retainer letters help mitigate risk by better educating lawyers within the firm and by encouraging a law firm culture in which risk management is understood in the context of day-to-day practice
- The risk of current and former client conflicts requires a proper conflict database and proper conflicts searching. Adding the new entities which become involved during the course of a retainer, whether as clients or adverse parties, to the conflicts database is very important and a frequent omission.
- Sophisticated electronic screening of confidential client information is increasing important. Equally, the ability to open matters and clear conflicts on a confidential basis is crucial.
- The involvement of “un-conflicted” experienced lawyers to manage and clear conflicts mitigates conflicts risk and mitigates the risk of “tainting” the lawyer doing the client work.

## Conclusion

The most effective risk management starts with a structured and methodical approach to identifying sources of risk. It includes appropriate mitigation strategies. Moreover, proper risk mitigation requires that lawyers act together as a firm and not as a collection of sole practitioners. The result is not only better risk management, but also a firm that is ultimately more productive and profitable.

---

*Malcolm M. Mercer is a partner and general counsel at McCarthy Tétrault in Toronto. He can be reached at [mmercer@mccarthy.ca](mailto:mmercer@mccarthy.ca)*