



# Identifying and Managing the Increased Risks Law Firms Face in a Recession

By Anthony E. Davis and David J. Elkanich

Unique problems – and risks – can arise in an economic downturn, when lawyers have time on their hands and not enough to occupy them within their normal sphere of practice and competence. A recently reported case from Bronx County, *MC v. GC*,<sup>1</sup> exemplifies this. There, a lawyer, referred to as “Ms. Smith,” who at the time was an associate at a major New York law firm, was assigned to work on a pro bono matter, in this instance a divorce case, a practice area in which she had no prior experience.

As it turned out, after both parties signed a settlement agreement, Ms. Smith’s client moved to vacate the settlement, alleging that she did not understand key terms and the agreement did not contain terms she had discussed with Ms. Smith. The judge vacated the settlement and restored the case to her calendar, finding that the lawyer made “careless and inaccurate” statements to her client and was inadequately supervised by her firm. The court

added that the lawyer did not have the “appropriate training and supervision” to know whether her statements to the client were correct.

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What is important about this case, which involves an otherwise-experienced lawyer, is that the risks inherent in every lawyer's and law firm's practices are amplified during an economic downturn. Even in the best of times, lawyers face risk every day as an inevitable part of their practices. But in a down economy lawyers also face the likelihood of a reduced amount of business, which creates both income and overhead – particularly headcount – concerns. At the same time, lawyers and law firms are likely to face an increase in the number of malpractice claims, as well as claims brought by third parties alleging breaches of a fiduciary duty and fraud, and, possibly, claims by partners for management liability. Lawyers and law firms are often viewed as the last “deep pockets” when deals fail or formerly “good” clients go bankrupt.

This article will focus on a number of areas of risk that merit special attention during an economic downturn and will suggest ways in which lawyers and their firms can prepare for and manage these heightened risks. Specifically the article will address the following critical topics:

1. Client Selection and Client Intake Management
2. Practice Management and Troubled Clients
3. Maintaining Appropriate Financial Controls
4. Due Diligence in Lateral Hiring
5. Firm Management During an Economic Downturn

### Develop and Maintain Appropriate Client Intake Procedures

Client selection and intake are two related areas with the potential either to increase risk, or, if properly managed, to enhance profitability. Careful consideration of which clients are appropriate for the firm is enormously important in determining whether a law firm: (1) has the ability to handle a particular client matter effectively and to the client's satisfaction; (2) will be paid for the services rendered; or (3) will possibly face litigation at the conclusion of the matter. All of these factors assume heightened significance during an economic downturn. Choosing the right clients is never more important than when clients are scarce. Firms may feel tempted to take clients they would not otherwise accept, because new clients may be few and far between. But such thinking may lead to unfortunate outcomes if the firm is unable to represent such clients effectively. The intake process involves the preliminary information gathering that both lawyers and clients need to determine whether the representation should proceed. Law firms should therefore assess how well they are dealing with the following principles of effective client intake management.

#### Sufficient Information

Does the firm gather sufficient information *before* deciding whether to accept a prospective client? In particular, is the firm assessing whether (1) the client's matter falls

within one of the firm's areas of practice; (2) the client has realistic objectives that are obtainable; and (3) the client is both willing, and able, to pay appropriate fees? Taking the time to gather the information necessary to answer these questions significantly reduces the risk that firms will take on work that they are not qualified to handle, and also ensures that clients and their lawyers are on the same page with respect to strategy and analysis.

#### Appropriate Level of Expertise

Does the firm carefully allocate and assign work to lawyers with the appropriate level of expertise? In difficult economic times, many firms and, within firms, many individual lawyers face the question of whether to branch out into unfamiliar areas of practice to make up for the loss of business in other areas. “Dabbling” creates multiple risks, including the heightened danger of errors and omissions, the temptation to bill clients for the “learning curve,” which can lead to messy fee disputes, and the concomitant risk that the new work will be unprofitable.

Does the firm insist upon adequate retainers prior to accepting engagements from new clients?

#### Independent Partner-Level Review

Does the firm *require* independent partner-level review (*i.e.*, review by someone other than the lawyer seeking to introduce the client or matter) of the information assembled prior to acceptance of new clients? It is – or should be – axiomatic that individual partners should not be allowed to decide which clients or matters to accept without prior firm approval. With the exception of solo practitioners, all lawyers have and should use the opportunity to have someone other than themselves conduct this sort of review.

#### Adequate Retainers

Does the firm *insist* upon adequate retainers prior to accepting engagements from new clients? A prospective client's objection to paying a retainer is a red flag that this client is likely to be unwilling (or unable) to pay appropriate fees. Lawyers should affirmatively choose their pro bono cases rather than having them forced upon them.

A firm that addresses these four fundamental issues before undertaking a client representation is much more likely to prevent disputes with clients that could lead to liability claims. In economic terms, the cost of implementing these procedures is minimal in light of the risk that may be avoided.

## Practice Management and Troubled Clients

A firm's obligation to review and analyze the appropriateness of its clients does not end once it accepts a new client. Firms need to establish a system of practice oversight

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that evaluates the status of all open matters, and clients' payment history, as an ongoing process. Good practice management ensures that every client is receiving high-quality service at all times. On the other hand, permitting individual lawyers – however experienced – to manage “their” clients entirely unsupervised ensures only that if or when a problem develops, the firm will have been unaware of the warning signs of impending trouble.

During economic downturns there is a greater risk that a formerly “good” client will become a “bad” client. When this happens, disputes may arise between the firm and the client regarding the quality of, and the amount to be paid for, legal services. In addition, these situations may also generate claims by non-client third parties, such as investors and trustees in bankruptcy. For example, a client whose business fails may file for bankruptcy or otherwise cause its creditors and investors to lose money. In consequence, the client's investors and creditors may assert that the lawyers failed to properly advise the client so as to prevent or mitigate losses or that the lawyers actively assisted the directors/principals to commit fraud and/or a breach of fiduciary duty.

Good practice management can help individual attorneys identify these problems and deal with them, starting with documenting the advice being given, thereby establishing the necessary record to refute such claims. Among the indicators that a hitherto good client may be evolving into a high-risk client are the following:

1. the client is having financial difficulties;
2. the client, who has historically paid its bill on a regular basis, is now slow to pay or stops paying fees altogether;
3. any sign of improper or unlawful activity by the client or its management; and
4. client complaints regarding the quality of services being provided or increasing hostility from a client who has previously complained.

Accordingly, practice group leaders need to monitor all client matters systematically and regularly in order

to help lawyers identify warning signs as soon as they appear. Firm leaders must be ready to intervene to ensure the firm is giving and documenting appropriate advice, or even, when necessary, requiring that the firm withdraw from engagements. In smaller firms, the leadership should take time at regular case meetings to address these issues; solos should monitor clients for the warning signs in order to take appropriate, timely action.

## Maintain Appropriate Financial Controls

Law firms and their individual partners are responsible for ensuring that their firms' financial controls are adequate to enable their firms to weather the economic downturn. To that end, law firms should:

1. Arrange for their outside accountants to review the firm's internal controls to determine whether those controls are adequate.
2. Require, at a minimum, that two lawyers sign *all* checks and withdrawals from client and escrow accounts. No non-lawyer should ever be allowed to have signatory authority over client or escrow accounts.
3. Ensure that client funds are deposited in designated client accounts that are federally insured. Although the FDIC has, for now, agreed to insure all client funds held in law firms' client or trust accounts, it will be important going forward to monitor the continuation of this unlimited insurance and, should the policy change, for firms to spread client funds in accounts at different banks limited to the amounts that are covered by FDIC insurance.
4. Require regular, monthly reviews of client and escrow account bank statements by firm management to ensure that (a) all client funds are being appropriately managed; (b) clients are provided an accounting for trust account receipts and disbursements; and (c) the client and escrow account ledgers balance at all times. These safeguards are important in times of prosperity, but they take on extra significance in times of economic hardship. While law firms themselves and their individual employees may both be experiencing financial pressure, it is vital that firms designate senior lawyers to oversee all of these elements of account management in order to avoid both deliberate and inadvertent violations of the duties owed to clients and to the firm itself.
5. Actively manage deteriorating receivables, which may be the first warning sign of a “good client turning bad,” described above.

As in the other areas discussed, solo practitioners and very small firms face particular problems when it comes to financial controls. There may be fewer employees and it may be easier to keep an eye on things, but in smaller organizations people may work more independently

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with less oversight, thereby raising the risks described above. In a solo practice there is no one to look over the solo's shoulder. Whether a firm is small or large, however, the message is the same: When the economy is tight, it is critical to maintain rigorous financial controls within the law firm.

### **Due Diligence in Lateral Hiring**

In an economic downturn, the lateral hiring of lawyers may appear especially attractive. However, lateral hires are often risky investments. While the firm seeking to hire a particular prospective lateral may view the attorney's book of business and experience as a short-term investment for a potentially significant long-term return, the lawyer seeking to join the firm may be a potential "Trojan horse," importing serious problems into the unsuspecting firm. Among the due diligence steps firms should consider are the following.

#### **Review the Client List**

Thoroughly review the lateral's client list for potential conflicts of interest with the firm's current and former clients.

#### **Investigate and Verify Credentials**

Investigate and verify the lateral's credentials. Even where the prospective lateral is "known" to others within the firm, the firm should check the veracity of the lateral's qualifications, bar memberships, and criminal record, and should conduct a bankruptcy and credit check (with permission, of course).

#### **Avoid Ongoing Disputes**

Identify – and avoid hiring – laterals who are likely to have ongoing disputes with their former firms, because these will detract from the lawyers' attention to serving clients. Similarly, to the extent possible (and subject to confidentiality obligations) seek to establish whether the prospective lateral hires will be leaving their former firm in a weakened financial condition. If a new hire's prior firm fails or dissolves following the lawyer's departure, the lawyer may be faced with potential significant personal liability or with significant claims for unpaid compensation or return of capital. Again, to the extent that those loose ends are unresolved before the lawyer leaves the prior firm, there is an increased risk that the lateral's time and energy will be diverted from serving clients after the lateral joins the firm.

#### **Set Realistic Compensation**

Set compensation in relation to actual collected dollars with no (or minimal) guarantees, other than a draw to cover the lateral's initial period of time with the firm. Guaranteeing earnings to new laterals can put a strain on a firm's working capital, and end up causing the firm to

experience a loss if the lateral's promised billings do not materialize.

#### **Establish the Infrastructure**

Establish the necessary infrastructure to integrate the lateral's practice and clients into the firm, and to oversee the work of the lateral. It is not sufficient simply to give a laterally hired lawyer an office, a computer and a secretary, and leave the lawyer to meet (often inflated) billing targets. For every lateral hire, the firm needs to develop a plan that continues to be carefully managed after the lateral arrives. This should be a whole-firm commitment – the firm's existing lawyers, practice group leaders and support staff must be willing to give their time and energy to accomplish the integration of the lateral and his or her clients into the firm. The need for these efforts is every bit as important, and may be significantly more burdensome, when firms bring on entire specialty or practice groups.

#### **Firm Management in an Economic Downturn**

Lawyers and their firms can take a number of management steps to assure their continued strength when confronting economically difficult times. These include the following.

#### **Partnership Agreement**

Review the firm's partnership agreement. An inadequate or unclear partnership agreement can pose a significant problem in the event of lawyer departures (whether voluntary or involuntary). If it becomes necessary to terminate partners, the agreement should define the terms of separation. In an economic slump a departing partner's buyout could easily produce a dispute with the remaining partners. A firm that dissolves should have partnership terms prescribing the dissolution process, and partners should be familiar with these arrangements. If the agreement is not adequate in these areas, it may make sense to amend the agreement before a crisis erupts, when it may be difficult or impossible for partners to come to terms.

#### **Capital**

Make sure that the firm is adequately capitalized, and reduce debt, in order to ensure the firm is properly funded.

#### **Budget**

Engage in a thorough, effective and continuing budgeting process that addresses both costs and revenues.

#### **Compensation**

Review and, if necessary, adjust the firm's compensation structure so that it is appropriately focused on collegial goals, rather than encouraging individuals to develop their own practices. An "eat what you kill" culture does

little to foster collective goals, and a system that puts the interests of individual lawyers over the interests of the firm creates significant risk that lower-quality clients may be accepted.

Law firms are business organizations, created not only to deliver legal services, but also to provide compensation to the partners, as well as firm employees. Economic hardship may undermine the sustainability of the institution. A management structure that worked in good financial times may be ineffective or even counterproductive in more difficult times. By regularly reconsidering the relationship among partners and addressing ambiguities or policies that threaten the long-term viability of the firm, law firms can reduce the risk that they will experience serious disputes or collapse.

## Conclusion

Law firms, like every other economic enterprise, are confronting the realities of economic recession. In such times, firms need to be diligent in resisting the temptation to “cut corners” in the ways in which they operate and practice. Firms intent on practicing law over the long haul need, instead, to take extra care to identify the increased risks of practicing during hard economic times and to take the necessary steps to manage those risks. ■

1. 76148/07, N.Y.L.J. (June 18, 2006); 76148/07, 2009 Slip Op. 29260 (Sup. Ct., Bronx Co. May 22, 2009).

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