



Addressing Potential Management Liability Risks Facing Law Firms Today

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Managing a law firm has always presented challenges. However, in today's sophisticated business environment, directing a regional, national or multinational law firm places significant demands on even the most experienced partners. Most large law firms are managed as businesses, and this management structure imposes significant potential liability risks on firm leadership similar to the risks encountered by executives and directors of a public company. As a firm's size increases, so does the potential liability of its leaders.

The demands of firm management and its associated risks can at times seem overwhelming, particularly for an attorney who wishes to maintain an active practice while shouldering leadership responsibilities. However, there are several steps that firm management can take to address these potential liability exposures. This article explores several of these risk management techniques.

Up front, it is important to recognize the increased risks that may result from the current economic downturn. For example, as firms attempt to respond rapidly to the downturn by laying off attorneys and support staff, decreasing or modifying associate and partner compensation, and revising business models, allegations of mismanagement may arise more frequently. Similarly, the recent rapid demise of several prominent firms underscores the need for management to address proactively potential risks arising out the decision-making process. Bankruptcy is, in fact, a textbook scenario in which various claims may be made against a firm's leadership for mismanagement. On the positive side, however, the following steps provide guidance on addressing these risks.

Step #1: Recognize Common Management Liability Risks

As a first step in an effective risk management program, a law firm should recognize some of the common fact scenarios that result in disputes over management decisions. This will allow management to anticipate where problems might arise and actively work to address these issues before they result in a lawsuit or claim.

Management liability claims may be classified into three groups: *partnership disputes*; *third party disputes*; and *employment disputes*.

Partnership disputes, where one or more partners or former partners bring claims against a firm and its management, are a frequent source of management liability claims. These disputes often focus on compensation, employment decisions, and overall management of the firm. Common claim scenarios may include:

- Partnership compensation claims by individual partners against firm management, usually after a partner has left a firm.
- Wrongful partner termination or de-equitization claims. For instance, one large multinational firm was sued by the Equal Employment Opportunity Commission after a group of the firm's partners alleged that, due to their age, they were "forced out" by demotion to counsel status. According to public reports, the firm eventually settled the age discrimination suit for \$27.5 million.

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- Claims by individual partners for failure of management to support their practice with adequate resources and staff.
- Claims by individual partners against the firm's general counsel or ethics counsel for erroneous advice. This may include, for example, negligent advice in addressing conflicts or with regard to a malpractice claim.
- Any other claims by individual partners against firm management concerning the business of the firm, where the firm or partners suffer a loss. Examples include:
 - Mismanagement ("wasting") of firm or partner assets, such as bad investments or poor accounting;
 - Imprudent expansion by opening an unsuccessful branch office or hiring a lateral attorney or group that results in loss to firm, such as from a malpractice claim against such attorneys from a client they brought from their prior firm;
 - Entering into a bad lease or bad ownership of office space;
 - Bad procurement decisions;
 - Insufficient insurance for a catastrophic loss;
 - Self-dealing, criminal or professional misconduct of senior management.

Third party disputes, where a party unaffiliated with a firm brings a claim against the firm and its management, probably arise less frequently than partnership disputes but may include claims by other law firms, claims by clients that do not involve malpractice, and any claim against firm management for failure to fulfill an obligation of duty to a third party other than a client. Such claims may include:

- Claims by unrelated law firms for wrongdoing in hiring lateral attorneys or practice groups, including poaching clients, other attorneys and staff, and tortious interference with business relationships. In one prominent case, a law firm in bankruptcy sued another firm that had acquired a group of its partners, alleging, among other things, that the acquiring firm had interfered with its business relations and aided and abetted the departing partners in breaching their fiduciary duty by obtaining from the departing partners confidential information about the firm.
- Claims for vicarious liability of firm management in malpractice claims. For example, in one suit by a client against a prominent law firm, the client alleged that the firm had negligently supervised a partner who defrauded the client.

Employment disputes, where a current or former employee brings a claim against firm management arising out of an employment decision, would most often be brought in the context of a lawsuit for unlawful discrimination. Such claims may include:

- Claims that a law firm's management encouraged or failed to properly address discriminatory employment practices.
- Claims for failure to promote an associate to partner. For example, a former senior associate at a large law firm sued the firm and several of its partners, including the head of the firm's IP practice, alleging that the firm and the partners had failed to honor a promise to him that he would be promoted to partner.

Step #2: Reduce Current Management Liability Risks

After recognizing common management liability risks, a second step a law firm may take as part of an effective risk management program is to work to reduce its current risks. This step may include a detailed review and revision of a firm's management policies and procedures. In particular, law firms should focus on the firm's partnership, finances, and employment.

First, firm management should establish definite plans to address partnership issues before they arise. The partnership agreement plays a crucial role here, so firm management should ensure that the agreement provides appropriate guidance in the kinds of fact scenarios discussed above. On the other hand, last-minute or secretive amendments to the partnership agreement aimed to target specific partners create a greater risk for conflict. Firms should also be sensitive in handling

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partner departures and terminations. In general, firms should refrain from negative press releases or statements regarding former partners. At least one large firm has faced a lawsuit from a former lawyer for allegedly disparaging statements made after the lawyer departed the firm.

Second, management should make sure they are able to understand and make sound financial decisions on behalf of the firm. Nevertheless, many lawyers admittedly have no training to run a business and must learn "on the job." Therefore, a law firm should seek sound and independent advice from business professionals concerning its major financial decisions. In the current tough economy, management should be particularly sensitive to the following issues:

- Controlling major expenses. One publication has estimated that large firms devote 85% of their expenditures to salaries and rent. Careful consideration should be made before entering into a long-term real estate lease.
- Ensuring adequate cash flow. With tightening in credit markets, even a temporary loss of cash flow can lead to significant difficulties for a law firm. Large firms have been handling this issue in several ways. Some firms have requested capital contributions from partners to help weather the financial storm. Other firms have increasingly relied on their available credit lines. For instance, according to one banking official, in 2008, firms accessed 25 percent more of their available credit lines.
- Maintaining loan covenants. Two large law firms recently entered insolvency due in part to breaches of their loan covenants. For instance, according to press reports, at one of the firms, the departure of fourteen intellectual property litigators with \$80 million in business triggered a notice requirement in the firm's lending agreement. The firm's lenders then called certain of its loans, eventually leading the firm to declare insolvency.

Third, law firms should be sensitive to certain employment issues that may arise more frequently in the context of recent widespread layoffs in the legal industry. Whenever an associate or other employee is laid off, fired, dismissed, or "forced out," there is a possibility he or she may allege discrimination. When unemployment levels are higher in the work force in general, more individuals are likely to sue their former employers alleging discrimination. Consultants are advising law firms to ensure that associate and staff layoffs or firings are not motivated by or implemented through a discriminatory practice (e.g., by laying off a disproportionate number of associates of a particular race or gender without an adequate, non-discriminatory reason).

Step #3: Evaluate Insurance Coverage Needs

A final, obvious step a firm can take as part of its efforts to address potential management liability is to consider investing in management liability insurance. No lawyer in his or her right mind would consider practicing law without professional liability insurance. Yet, many lawyers forget that many decisions they make on a day-to-day basis in managing their law practices fall outside their professional liability insurance. Therefore, a firm should evaluate whether its current insurance program affords adequate protection for management decisions.

Following these three risk management steps should provide a good start to addressing potential management liability risks facing law firms today. As law firms grow in size and complexity, the risks facing firm leadership will also continue to increase. However, following these steps will help to ensure that the risks are far outweighed by the rewards of a fulfilling law practice.

