Recession and recovery: The impact on lawyers’ professional liability exposures

The credit crisis and recession was tough on the legal profession. Some law firms saw revenue fall as commercial transactions dwindled, many clients demanded lower prices and some client companies padlocked their doors. Other law firms fared better as credit crisis litigation surged, but even those that did well were subject to a sharp uptick in lawsuits brought by disgruntled clients. In an economy where a lot of people were unhappy, lawyers were often convenient targets for their frustration.

As the economy recovers, it seems reasonable to anticipate that the number of lawyers’ professional liability claims will drop. Thus far that has not been the case. In fact the number of new claims related to the credit crisis and recession continued to grow in 2012, and the number of large claims increased sharply. Economists declared the recession over in 2009, but its effects linger on.

Residential real estate and bankruptcy are two areas that continue to generate a large number of claims, but almost no practice area is immune. The challenges are exacerbated by law firm mergers, layoffs and bankruptcies, which can result in administrative glitches, confidentiality and conflict of interest issues, and general client dissatisfaction.

Economic recovery may signal better days ahead, but for now lawyers should be aware that they remain at an elevated risk for lawsuits. Some firms – especially those that are shrinking or merging – may find it difficult to maintain a focus on risk management, but a heightened emphasis on risk management is especially important for them.

The impact of the credit crisis and recession

Legal malpractice claims typically surge during economic downturns. An analysis of claim activity by Mendes & Mount concluded that during the 25 years preceding the recent recession, spikes in claims coincide with two of the most troubling economic periods. The most recent economic crisis, the worst since the Great Depression, affirmed that trend.

Lawyer professional liability claims tend to be trailing indicator of the economy, so the full impact of the credit crisis and ensuing recession did not register immediately on claim frequency.

Heightened exposure to lawsuits is attributable to several factors. Some lawyers were at the center of the storm, providing counsel to the brokerages, banks and real estate firms that were significant players in the credit crisis. At the other end of the spectrum, new law school graduates launched their careers with less support and guidance, often as sole practitioners. More generally, companies and individuals who lost money during the downturn were motivated to recover their losses, and lawyers involved in failed deals and other money-losing transactions, or who are perceived as having failed to protect their clients’ interests in a no-win economic and business environment, were highly visible targets.

Compounding this troubled scenario, law firms also were attempting to reduce costs and increase income. Like other businesses under pressure they often assumed risks they would avoid in a more stable climate. Cost-cutting measures also may have weakened risk management practices.
During and immediately following the credit crisis and recession, many malpractice suits stemmed from commercial and residential real estate transactions, collections and bankruptcy work, financial institution representation, and various other business transactions and merger and acquisition matters. A study of insurance claims by the American Bar Association found that, during the period 2008-2011, real estate matters overtook personal injury matters as the most-frequent subject of malpractice claims (20 percent versus 16 percent of all claims). Common allegations in recession-related real estate claims include:

- Diverting escrow money.
- Fraud associated with “flipping” transactions.
- Title search failures
- Negligent advice as regards backing out of a real estate deal.

An increase in collections and bankruptcy claims may be attributable largely to collections claims arising out of the Fair Debt Collection Practices Act. A cottage industry in collection protection emerged, adding to the claims activity.

According to the ABA study, the activity most likely to generate claims was “preparation, filing, and transmittal of documents,” followed by “Advice.” The study found that almost 70 percent of all claims are made against firms with fewer than five lawyers; of that 70 percent, almost half are made against sole practitioners (though the authors of the report caution that the largest firms are underrepresented in the survey). The volume of claims against sole practitioners is attributable in part to the fact that sole practitioners represent a significant percentage of total small law firms.

The ABA study also found that there was a general decline in the number of paid claims of $5,000 or less, but an increase in higher-dollar claims.

### The recovery: not out of the woods yet

Economists declared the Great Recession over in June 2009, but the recovery has been agonizingly slow. In fact, the economic expansion following the 2008 recession has been the weakest of the post–World War II era. Nonetheless, things are getting better, which might imply a drop in the frequency of lawyer professional liability claims. This has not yet proved to be the case, however. A survey of LPL insurers by broker Ames & Gough found that 71 percent of participants had a year-over-year increase in new claims in 2012, with 40 percent experiencing an increase of 21 percent or more.

The Ames & Gough survey also disclosed an increase in claims greater than $50 million. The brokerage firm attributes the increase in severity to “the growing complexity and sheer size of the underlying matters being handled by law firms, as well as the higher defense costs associated with complex malpractice suits.”

One reason that claims activity continues to grow is simply because lawyer professional liability claims activity lags changes in the economy. Many suits being settled today have their roots in activities occurring during 2007-2009. Mendes & Mount found that on average there is a two year or more lag between the date of an involved act and the date that a major lawyers’ professional liability claim is made.

Continuing turmoil in the legal sector also potentially contributes to an increase in LPL claims. According to legal consulting firm Altman Weil, as of mid-year there were 39 law firm mergers, putting 2013 on a potentially record-setting pace. Law firm dissolutions, bankruptcies and mergers can increase exposures since, as new firms take over accounts, they may look to blame the old firms for any errors. Distressed firms, looking to cut costs, may have cut corners and are therefore vulnerable to allegations that they mismanaged a case.
Layoffs at large law firms have surged, while at the same time the pursuit of top-line revenue growth by acquiring partners with portable books of business has created what Northwestern University professor Steven J. Harper terms a “lateral hiring frenzy,” at big firms. Some analysts observe that these business strategies — rapid growth through mergers and aggressive poaching of lawyers from rivals, combined with a growing spread between the salaries of a firm’s top partners and its most junior ones — contributed to the 2012 bankruptcy of blue chip law firm Dewey & LeBoeuf.

A majority of respondents to the Ames & Gough survey saw a correlation between the rise in claims to mergers and lateral hires. “Conflict of interest” was the first- or second- most frequent cause of malpractice claims for most survey participants.

Some analysts see the disruptions sparked by the Great Recession not as temporary blips that will disappear as the economy improves, but as fundamental changes in the legal profession’s business environment. Some foresee a sustained period of intensified competition, resulting in lower margins and a shakeout of weaker competitors. Among the factors that are contributing to this state of affairs are the rise of a new breed of legal services vendors combined with the globalization of legal services, more sophisticated corporate clients who are better able to leverage the vast amount of knowledge available with the click of a mouse, and technology that results in fewer billable hours. According to one analysis, “the price of continued prosperity for lawyers is going to be innovation and doing more with less.” Continued pressure on the legal profession suggests that heightened legal malpractice claim frequency and severity may be the new normal.

**Risk management and insurance**

Law firms should be diligent in their risk management practices and resist the temptation to cut corners when under increasing competitive pressure. Firms should take extra care in identifying and addressing the risks of practicing law during challenging economic times, and recognize that the environment in which they operate is likely to remain challenging even as the economy improves. The steps law firms can take to lower the possibility of being sued include:

- **Stick with what you know.** Although the economy is improving, many firms may still feel pressured to retain work they would otherwise refer out to someone with more specific knowledge. Taking on work outside one’s area of expertise is an invitation for unsatisfactory outcomes and an unhappy client.

- **Avoid problematic clients.** Proper client screening is always important, but especially so in a litigious environment. Law firms should research potential new clients to make sure they are not involved in questionable activities, they don’t have a history of suing their lawyers and they are able to pay their bills. Additionally, non-paying clients should be promptly terminated. Delay in seeking payment may result in collection activity which rarely results in payment, however often spurs law suits against the firm.

- **Communicate frequently with clients.** Responsive client service goes a long way to keep clients satisfied, especially during difficult times. This includes quickly returning phone calls and keeping clients updated on their matters. A thorough and accurate paper trail of client communications also is important to the effective defense of malpractice claims.

- **Conduct appropriate due diligence in lateral hiring.** It is critical to thoroughly review the lateral hire’s client list for potential conflicts of interest. Additionally, the candidate’s credentials should be thoroughly reviewed, even if he or she is well known. Potential disputes with former firms that might be triggered by the move also should be taken into consideration.
• **Don’t neglect basic risk management.** When law firms are under stress, or are undergoing mergers or are downsizing, risk management may suffer. Basic risk management steps that need to be in place at all times include systems to track deadlines, procedures to avoid overbooking lawyers, an effective conflicts check system and processes to assure engagement letters are drafted that clearly define the scope and limits of each client representation. Law firms also should develop a culture that encourages lawyers to report potential problems to the firm’s management or general counsel before they spin out of control. They should also communicate with their insurance broker and carrier who often have greater resources to draw from.

Law firms also should review their professional liability insurance program with their broker to assure that it is adequate for the current threat landscape characterized by both heightened frequency and severity of claims.

### Conclusion

The economy is recovering, but law firms still are exposed to the residual effects of the credit crisis and recession. Malpractice claims typically increase during an economic downturn, but in the case of the recent recession, claims have continued to mount even as economic conditions improve. The increase is attributable substantially to a sluggish recovery and the continued effects of the recession on clients, who may blame their lawyers for adverse outcomes. This especially has been the case for real-estate related claims. The increase in claim frequency has been exacerbated by turmoil in the legal profession: mergers, layoffs and lateral hires all contribute to heightened risk.

Increased competition is likely to characterize the legal profession for the foreseeable future, meaning that claim frequency will probably remain elevated. The number of very large settlements also has been growing. Law firms can take steps to reduce the likelihood of being sued by following proven risk management practices.

A keen focus on risk management is especially important for firms that are merging or are otherwise undergoing significant changes. Internal turmoil and disruptions may make it more difficult to sustain current risk management practices or to implement new procedures to address areas of heightened risk. Law firms also should reassess the amount of professional liability insurance purchased, taking into consideration the increased probability of a large settlement.

### NOTES:

7. Ibid
8. Anthony P. Spain, Possible Impact of the Current Economic Downturn on Lawyers’ Professional Liability Claims, Mendes & Mount
11. “Survey: Legal Malpractice Claims Spiking Due to Recession,”