Law Firm Management Liability Update

What Your Firm Needs to Know About Management Liability
Over the past five years, one in four private companies experienced a lawsuit against its officers and directors for negligent acts or omissions. The number of director and officer (D&O) suits is even more prevalent among larger firms, where one in three companies with 50+ employees has experienced a D&O lawsuit.

Unlike most American companies, law firms used to be somewhat immune to suits against their management. There was a sense that a law firm partner would never sue his firm; that the profession of law had an unspoken code of “lawyers do not sue other lawyers.”

Times are changing. Geographical expansion, mergers and acquisitions, new practice areas, and organic growth -- as well as the need to be both proactive and reactive to competitive pressures within the legal industry -- have led firms to “corporatize.” As lawyers and law firms begin to emulate corporations, there has been a de-emphasis in law firm allegiance and law firm recruitment is no longer akin to a marriage commitment, lasting forever. In 2007 alone, lateral hires were up over 20% from the previous year, with many lawyers leaving their current firm for relatively small amounts of money.

This lack of firm loyalty is exposing the day-to-day management decisions of law firm leaders to many of the same liability risks faced by directors and officers in corporate settings. Underscoring this fact is the alarming increase in lawyers bringing claims against their former partners and associates. A quick Internet search turned up several accounts of partners and associates suing their former firms. Consider these recent headlines:

- Ex- Coudert partners should pay $11.8M
- Spurned Orrick Associate Sues Firm
- Law Firm Fight Escalates to Criminal Charges Against Former Partner
- Former Partner Suing Dorsey & Whitney Law Firm
- Ex-Partners Sue Townsend for Cut of Fees
- Hunton & Williams in Flap With Former Partners
- Pay Dispute Trial Reveals Salaries at Sonnenschein, Nath, & Rosenthal Law Firm
- Law Firm’s Brawl Over $1 Million Bonus

The steady drumbeat of claims by attorneys -- against the firms that once recruited them -- is drawing increased concern from law firm managers that are anxious to avoid the costly D&O lawsuits that have plagued the private sector for so many years. This concern has spawned an increased demand for Management Liability insurance intended to cover claims against the directors and officers of a law firm.

In this edition of Information Alert we will discuss ways in which firms might be exposed to claims against its management; the value of Management Liability insurance to protect law firms from these types of losses; and risk management guidelines to help safeguard against Management Liability claims.

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1 2005 Chubb Private Company Risk Survey
How Your Firm Might Be Exposed to Management Liability Claims

Although there is a broad spectrum of management liability risks that can lead to a claim (see the box to the right), there are three exposures that should be highlighted as key causes of claims against the directors and officers of a law firm. First, is “lateral liability,” or the risk associated with having a heightened number of lateral hires. Although any law firm that wants to be successful needs to be open to lawyers coming into the fold from other firms -- and likewise free to go “shopping” for other lawyers -- increased mobility has produced a new breed of attorneys that are not hesitant to sue their employer.

The risk of Management Liability claims is also particularly high during a merger or acquisition of another firm. When the unification of two firms is not managed properly, the result can be multiple claims. Incidentally, five-year figures from Hildebrant International and Altman Weil, Inc. indicate that law firm mergers have increased more than 50% in the last five years, from 35 mergers in 2003 to over 50 in 2007.

The third exposure involves the marginalization of law firm associates or partners. This can occur in a variety of ways, including: reducing attorney compensation; not giving associates the opportunity to become partner; and/or having a mandatory retirement plan which forces older attorneys to leave the firm. In fact, retirement plans are one of the biggest issues law firms face today. Most large firms have a mandatory retirement age (when lawyers either retire or de-equitize, thereby forfeiting their financial stake in the firm). However, mandatory retirement is creating discord among baby boom-era partners -- many of whom are healthy; vibrant; and often still the rain-makers of the firm. In the fall of 2007, the international law firm of Sidley Austin, LLP settled for $27.5 million with 32 former partners who were forced out of the partnership because of their age. The following year, the consulting firm Altman Weil published a survey reporting that 57 percent of firms in the United States with 100 lawyers or more still had a mandatory retirement program in place.

Recent Management Liability Cases

Although there are many ways a firm’s management can and has been exposed to suits against its directors and officers, the below three cases underscore some of the key reasons for management liability claims:

**Brobeck** — There have been a spate of lawsuits following the collapse of San Francisco’s Brobeck, Phleger, & Harrison. In 2003, Brobeck collapsed when former chairman Tower Snow led more than a dozen partners laterally to establish the San Francisco office of London-based Clifford Chance. The remaining partners not only blamed the collapse on the large number of departing partners, but also on Snow for locking fast-growing Brobeck into expensive office leases that created crushing debt.

Some of the lawsuits that followed the collapse of Brobeck are described below:

- The Brobeck bankruptcy trustee and retired Brobeck partners pursued claims against Clifford Chance and the departed Brobeck partners alleging that partners' departure, induced by Clifford Chance, precipitated Brobeck’s demise. In 2004, Clifford Chance agreed to a $5.5 million claims settlement for profits received from the unfinished business the Brobeck partners had brought with them to Clifford Chance.
Subsequently, Clifford Chance sought to have its management liability insurer, Indian Harbor Insurance Company, pay the full amount of the settlement plus $2.3 million in legal fees. The Manhattan Supreme Court ruled, however, that the insurer should only have to pay 40 percent of the settlement. The court decided that the remaining 60 percent balance should be allocated to the former Brobeck partners, who were not covered under the Clifford Chance management liability policy. (Clifford Chance Ltd. Liab. P’ship v. Indian Harbor Ins. Co., 2006 WL 3821841 (N.Y. Sup. Ct. Dec. 27, 2006). The court’s position was largely based on the fact that the Management Liability policy purchased by Clifford Chance stated that the parties would take into account the "relative legal and financial exposures of, and relative benefits obtained in connection with the defense and/or settlement of the Claim by the Insured and others."

- The Brobeck bankruptcy trustee also pursued claims against Morgan, Lewis & Bockius. This Philadelphia based firm acquired 100 lateral hires from Brobeck, and ultimately paid Brobeck's estate $10.2 million in 2004 to settle claims for profits it received on a case once handled by Brobeck.

- In early 2005, 207 of the former Brobeck partners reached individual settlements totaling more than $23 million, to recover distributions and bonuses the partners should have received, but did not because of the firm’s insolvency.

- In the Spring of 2008, the trustee in the Brobeck bankruptcy case sued 10 former partners, as well as the two firms those partners joined, for work the partners took to their new firms (Orrick, Herrington & Sutcliffe and Dorsey & Whitney) after Brobeck dissolved. This case has not yet been resolved.

Coudert – On the heels of Brobeck is the case of Coudert Brothers. The Coudert Brothers firm once had 28 offices across the globe and employed 600 lawyers. It was recognized as a pioneer in international law.

The firm, which shut down in August 2005, has since declared bankruptcy; is drenched in debt; and was recently handed down a pair of adverse judgments which total $2.8 million. Even though the firm has paid off the $23 million owed to bank creditors Citigroup and JPMorgan Chase, it still registers $18 million in liabilities; five of the firm’s creditors are owed more than $1 million apiece; and Coudert still faces malpractice claims in Connecticut and California. This is just the beginning.

Following Coudert’s bankruptcy, a group of retired partners filed a lawsuit. Now in the U.S. District Court for the Southern District of New York, the lawsuit alleges, among other claims, that members of the firm’s executive committee breached their fiduciary duty to retired partners by stripping the firm of its assets, as it began to falter, thereby avoiding their obligation to pay pension benefits. Bankruptcy filings show that there is a $5 million management liability policy as an asset of the estate (arguably not nearly enough coverage for a firm of this size and geographic scope). Interestingly, however, the court has suggested that in devising its plan of liquidation, the law firm should consider not using the remaining management liability policy to release the former management partners from liability for potential claims from third parties. Instead the court has suggested saving it for possible internal claims. Among those other claims made by retired partners relate to the sale of certain Coudert practice groups to Baker & McKenzie; Dechert; Orrick, Herrington & Sutcliff; and DLA Piper.

Doe v. Doe - In yet a third example of claims against a law firm’s directors and officers, is the case of Doe v. Doe. In the instant case, a law firm’s new management committee implemented a plan to significantly reduce the compensation of a certain group of partners. The plan was created in an effort to induce some partners to leave the firm and enable the remaining partners to increase their own compensation. The “marginalized” partners noted that the firm’s partnership agreement had no provision for partner termination and, in turn, filed a suit. The claim brought against the firm’s management committee alleged that the committee had acted outside of its authority to constructively terminate the partners’ employment. The case settled for approximately $2 million.2

Law Firm Management Liability Insurance
In response to the growing exposure identified above, the insurance market developed Management Liability insurance, in 1999, to protect professional firms and their managers. It is an extension of the more-widely known "directors and officers liability insurance," modified and tailored to

2 Chubb Promotional Material
provide specialized coverage for the day-to-day management decisions that expose law firm partners, managers, and shareholders to many of the same liability risks faced by the directors and officers in corporate settings.

Today, almost no one sitting on a board of directors for either a for-profit or a not-for-profit organization will serve without ensuring that there is Directors and Officers Liability insurance to protect them. Yet, many law firm partners/shareholders and executive directors sit on management or executive committees without any such insurance protection.

It could be that many firms are unaware of this coverage. Up until recently, Management Liability insurance was only written by a handful of insurance companies and was a somewhat costly coverage. However, as the availability and competition for this coverage have increased with demand, the rates for Management Liability insurance have come down significantly. It is now possible to add this coverage to your firm’s insurance portfolio while staying within your law firm’s budget.

Coverage Highlights
Management Liability insurance is customarily written as a claims-made policy form, which means that coverage is triggered by the assertion of a claim during a policy period. A claim is generally defined as a written demand for monetary damages, civil proceeding commenced by a lawsuit, criminal proceeding, administrative or regulatory proceeding/investigation, or arbitration against the firm or partners for a wrongful act (as defined above).

Management Liability insurance is designed to cover claims involving:

- Partner vs. partner claims or claims brought by partners not involved in the firm’s management, against those tasked with making management decisions. This might include claims for negligence in the day-to-day business decisions made by the firm’s management committee or executive officers (e.g., excessive borrowings/expenditures, unreasonable lease terms, questionable lateral hiring, closure of unsuccessful branch offices, etc.);

- Partnership agreements or compensation disputes;

- De-Equitization issues;

- Interference with contractual relations;

- Merger & acquisition disputes (e.g., increased capital expenditures, poor results, increased conflicts, and claims of misuse of confidential information received during the discussions).

Which Firms Should Purchase Management Liability Insurance?
Management Liability Insurance should be considered by law firms large and small.

Smaller Firms - For small firms, any claim against the firm’s management would affect the bottom line much faster than a larger firm. It is easy to quickly accumulate half a million to a million dollars in defense expenses. By purchasing Management Liability insurance, smaller firms can protect themselves from partnership disputes by larger firms that want to cherry pick their partners. Also, any law firm with an eye toward expansion may also want the protection the insurance provides their ability to grow, with the potential issues that arise from lateral hiring and mergers.

Larger Firms - Large firms with an international presence may face conflict of law issues, and are therefore more likely to need coverage for intra-office disputes. The other big issue that comes up is whether or not non-attorneys, such as when a large firm hires a CFO or a COO as an employee, are indemnified under the partnership agreement. The firm may want coverage for the business decisions that these employees are making on a day-to-day basis that affect the overall management of the firm.

Recommendations for Securing Adequate Protection from Management Liability Claims
Complete a Thorough Management Liability Risk Assessment – The best starting point is for firms to contemplate this risk and analyze potential causes of Management Liability claims. While there is no silver bullet to prevent claims from being made, firms should recognize the existence of Management Liability losses and determine whether the risk for their firm should translate into a difference in the way they document compensation, complete performance reviews, or make other decisions that might end up being the subject of discovery years later.

Purchase Adequate Management Liability Insurance Limits – In order to protect your firm against potential claims, ensure that your firm has
adequate limits of Management Liability insurance. Typical limits purchased range from $1.0 million to $5.0 million for small to mid-size firms, but limits up to $25 million or more are available for larger firms.

**Seek Advice and Guidance Prior to a Firm Merger** - As stated previously, Management Liability losses are arguably at their highest when the merger of two firms is not managed properly. In order to reduce the likelihood of claims resulting from the merger process, it is important to not only focus on the synergies of the merging firms, but also the difficulties that may arise where the firms overlap and/or what it will take to achieve identified goals. Bring your broker/adviser in on the early side. They will have some good queries for firms thinking of a merger, such as: Has there been a merging clients’ conflict check? Have the merging firms discussed partner and associate compensation? Have the firms discussed their retirement policies?

In summary, firm stewardship can change a firm’s course by the way in which it responds to the globalization; competitive pressures; and economic realities of the legal market. However, while the corporatization of firms may be inevitable and may even translate into greater opportunities for some, change may also foreclose opportunities for others. When the latter occurs, management is often held liable and the firm should be adequately insured and prepared when that time comes.

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