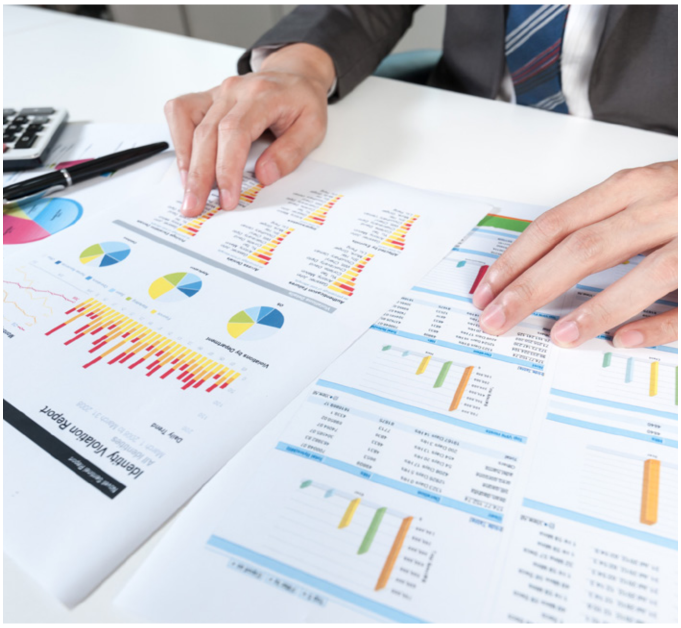
QBE European Operations

Managing risk when merging

Guidance note

There are undoubtedly many benefits to be gained from increasing the size of your firm through mergers, acquisitions – of whole practices or discrete teams, and lateral hires, but lack of forward planning, particularly in relation to risk, can lead to problems which far outweigh the benefits.



Increasing the size of your firm can lead to benefits including raising the firm's profile, increased geographical reach, expansion into new areas of work, costs savings and economies of scale, to name a few. This may involve a full-scale merger with another firm; acquiring all or part of another firm; taking on ready-made partners through lateral hires, or even whole teams, from other firms. But without proper planning, particularly in relation to risk, this can lead to problems which far outweigh the benefits. Does bigger really mean better? Balancing growth and regional / global expansion with client-focus is important to ensure the proposed merge supports your business objectives. So first just check: what are your values and purpose, and will the proposed merge actually support this, or could it put it in jeopardy?

Merging in any guise will undoubtedly sap time, money and lead to distraction, hassle, and possibly future claims so the end-goal needs to be worth it. If you still wish to proceed, some focussed risk management assessments will help keep it on track. Commercial due diligence, which will probably be carried out by an accountant, will of course, be essential. However, it is also important to carry out your own checks, even though there may be overlaps. You will want to obtain a clear picture of the risks you may be taking on and how you might deal with them, before you decide to go ahead. Even after the merge, in whatever shape or size, risk management will need to be ongoing process and is a professional obligation.

Assessing your target – attitude to risk

Risk management and quality assurance inevitably go hand in hand. Early discussions around your target firm's approach to risk management and the use of the core quality principles as a foundation for risk management will quickly indicate whether it's a match made in heaven... or not. If questions on these key issues are met with a blank stare, this might be the time to walk away:

- Where does risk management appear in the firm's list of priorities? Is it a regular management/board agenda item and do they appear genuinely interested in risk at the top of the tree?
- Are there trained people in the roles of compliance, risk, and quality, and if there are separate functions, is it evident that they work on a united front for continual improvement?
- Have they articulated risk appetite for work types, clients and wider business risks? Do any of these conflict with yours?
- What policies and procedures does the firm have in place and how is their effectiveness monitored? Has the firm achieved any recognised quality standards such as Lexcel or ISO 9001?
- Are all levels of personnel trained in the firm's risk and quality policies and procedures?
- Do the reward and recognition structures, KPIs and KRIs reflect the same values as yours?
- Is relevant MI used to drive continual improvement and is it checked regularly? Or is the approach more static or even complacent?
- What measures have been put in place to prevent recurrence of problems encountered? Does the ethos reflect a genuine desire to prevent repeat through practice-wide training and document updates to embed change permanently?

Taking all the above together, can the approach to risk be aligned to make the merge successful or will any special measures be needed to address any tricky issues? Often if a risk is too complex, can't be articulated clearly, or involves difficult people management issues, it will just be ignored, hoping that it will work out - clearly not the best strategy and some open and honest dialogue will be needed, with both parties articulating what their concerns are. There will often be power imbalances but if the aim of the merge is for mutual benefit, then working with that in mind should help to limit resistance to change and political struggles later. From there, control measures can be agreed, and whilst that may involve some difficult decisions in terms of management hierarchies, supervision and process controls, and the status of some individuals in the revised structure, a clear plan bought in to on both sides will more likely result in a successful outcome.

Looking in more detail – assessing the risks

The effect of an increase in claims should not only be measured in the cost of the impact on your premiums; it can also have an impact in terms of wasted fee earner and partner time; staff morale; the firm's reputation; loss of fees and loss of client confidence. It is therefore crucial that you take steps to avoid or mitigate the risk of future claims, by looking closely at the claims record and risk management procedures of your target and carry out your own risk assessment of the case load you will be taking on.

Ask about the firm's current claims record and whether they have any potential claims in the pipeline (especially any that have not yet been notified to their insurer). The firm should be able to obtain a claims statement from their insurer, which should provide an accurate record of claims against them. These records may reveal, for example, problems with particular areas of work or particular fee earners.

Also ask about complaints. Some types of work may attract more complaints than others, but the way the firm handles them can tell you a lot about their approach to client care and providing a good service. Are there more complaints about some departments than others? If so, are these a result of the type of work being carried out or do they suggest problems with supervision or the individuals involved. Don't assume that you will not be responsible for dealing with complaints (which can be costly, time consuming and lead to claims on your indemnity policy) relating to matters dealt with before your firm took over. The High Court has recently confirmed that the Legal Ombudsman can require a "successor" firm to deal with complaints about matters dealt with by their predecessors.

Ask if there are any regulatory issues outstanding, such as allegations of misconduct or cases considered by the SDT These could be evidence of a systemic or underlying problem. Is there any evidence that the SRA considers the firm to be high risk, such as appointing a regulatory manager to the firm? (This is not necessarily evidence of any wrongdoing, but it may lead you to ask further questions about the firm's relationship with the SRA and any issues that the SRA may have identified.)

Anyone can make a mistake, but not everyone learns from them. Look for evidence that where problems have arisen, whether claims, complaints, compliance issues or 'near misses', the firm has taken time to discover all contributory factors to the problem and has taken measures to prevent its recurrence. Does this involve training across a wide range of people and departments or is it limited to a chat with those immediately involved? Are operational changes captured in written policies, procedures, precedents or guidance / training notes documents to ensure the necessary changes are permanently embedded? The answers to these questions will enable you to gain a rapid insight into to the target firm's approach to combining quality management principles with risk management controls and perhaps how they will respond

Caseload review

A review of a selection of files of the target firm will undoubtedly help to give a clearer picture of the standard of work being carried out and any possible weaknesses. This though is a tricky area given the SRA's recent guidance on confidentiality (www.sra.org.uk/confidentiality) which suggests that unless the client gives their informed consent to their file being looked at by someone from outside the firm, this is likely to breach client confidentiality. The SRA states in its guidance: "In our view, it cannot be argued that no merger or acquisition can be completed without disclosure of client files. A merger or acquisition can take place without making any disclosure that results in a breach of the requirements set out in Chapter 4 of the Code."

However many firms include provision within their business terms to use independent file reviews to ensure quality standards are upheld, for instance for ISO 9001 and/or Lexcel certification, thus informing clients and allowing them to opt-out should they wish. There could therefore be scope to use this as the basis for independent review pre-merger to obtain a greater degree of understanding of the caseload risk being taken on. If deciding to proceed on such a basis, there should also be consideration of the use of confidentiality agreements, targeted review, and exclusion of own-interest/conflicted matters to further minimise the likelihood of a confidentiality breach.

The whole issue may only be clarified if M&A confidentiality breach cases make it to Court, so many firms will choose the safe option of not utilising file review to assess acquired caseload risk. In such cases, the quality of the target firm's risk assessment process comes into play: without accessing the individual files, are you able to assess the caseload risk to any extent?

For instance, can you see:

- the risk criteria against which new matters are assessed, and are they robust enough for your liking, covering both work and client risk, and can anonymised examples be seen in support of this?
- whether matter listings clearly show higher risk matters so these can be evaluated and later targeted for supervision and file review?
- whether matter descriptions on listings are sufficient to easily see if individuals or teams are acting outside their usual work type areas and/or agreed risk appetite levels?
- if the target firm has adequate understanding of what high risk matters are in hand and has applied suitable controls?

Scenario 1: Unknown unknowns

A £Million+ claim highlighting the importance of risk assessment of caseloads as part of the M&A process and the need to define and align risk assessment criteria from the different businesses.

One practice acquired a smaller firm with offices in a different location to help spread their geographical footprint. The acquired firm was a personal injury specialist dealing with the usual mix of work place accidents, road traffic accidents, local council claims plus some clinical negligence. The target firm did not have a defined risk assessment process for new work or clients taken on, and the acquiring firm did not have its own risk assessment criteria for this field of work either, resulting in an acquired caseload that was not fully understood. Within the acquired caseload was a slightly more unusual matter with much higher financial and personal value than the norm coupled with unusual limitation factors. Key dates on this were missed resulting in a significant claim as neither side in the deal had adequate controls aimed at identifying higher risk matters either before or after the acquisition stage.

Conflicts and confidentiality

As well as the risk of claims, you will need to consider any risks to your ability to comply with the regulatory requirements set out in the SRA Handbook. Conflicts and confidentiality are two major areas of professional conduct that can also have a financial impact. It is important to analyse the client profile of the firms involved for the likelihood of any conflict and the impact this might have. For example if both firms are involved in litigation do they have clients on the opposite sides of a matter? Do any potential conflicts involve major clients whose loss could have a significant impact on the firm? Do both firms work in the same niche area, meaning both could end up losing a significant number of clients? Even if there is not direct conflict, do you act for clients who are major rivals and who would object to you acting for the other?

You will also need to consider "own interest conflicts" i.e. whether any of the firm's partners or its fee earners' own business or other interests could conflict with the interests of any clients of the merged firm.

It's not just conflicts of interests between client and between clients and the firm that can arise as a result of expansion: there may also be conflicts of duties, in particular between the duties of disclosure and confidentiality. The rules in this area are complicated – the duty of disclosure applies to information of which the individual dealing with a client's matter is personally aware. Whilst in some cases there may be scope for "information barriers", these should be used with extreme caution, in exceptional circumstances and only where sophisticated clients are involved. In the majority of circumstances, where there is such a conflict the firm will need to stop acting for one or both clients. Having clear risk assessment criteria for clients, based on your experience or knowledge of their behaviours and working with them, not just compliance requirements, might also help when faced with difficult decision about which clients to keep for the long-term.

Insurance strategy

Once you have considered the potential risks, particularly the risk of future claims, you will need to decide how the merged firm will be insured going forward. This is where early discussions with your broker are essential. Depending on the circumstances, your firm may become a successor practice to all or part of the acquired firm and your broker or the SRA should be able to advise you on this (although the SRA will not make a ruling). In that case, claims arising from the work of the target firm, will be covered by the policy of the new firm, unless the target firm elects to take out run-off cover in respect of future claims. This is a crucial decision which needs careful thought and forward planning. Even where steps are taken to avoid succession, care needs to be taken to avoid succession without intent through 'holding out' whereby even the meekest of promotions might lead to unexpected claims (see Scenario 2).

Scenario 2: Succession without the planning

Pinpointing the dangers of including reference to acquired entities within promotional media.

Firm A had two offices in neighbouring towns when it was acquired by Firm B, but as part of the acquisition, the smaller office with some personnel and selected matters was sold off separately to Firm C. The acquisition by B looked in all senses to be a succession; taking all partners and the vast majority of the employees, occupying the principal office of A, and changing its name to B-A. Sometime later, when a significant claim arose relating to work conducted by the team that had been absorbed into B-A, investigations found that Firm C was proudly promoting on its website: "incorporating the ~ town office of Firm A". This was judged to be 'holding out' under the succession rules, and whilst legal liability remained with the 'ghost' of Firm A, C's policy was required to indemnify A and so C's insurer, most unexpectedly, had to pay for the claim of some £100k.

Post merger/acquisition integration

Whatever form the expansion of your firm takes, whether a full scale merger or taking on a couple of new partners, it is crucial that the different components are fully integrated. Taking over a much smaller firm and simply letting it operate as before, but as a branch office as your firm, is a highly risky strategy. Smaller-scale mergers are often referred to as 'bolt-ons' and where this is taken literally without effective integration it can lead to severe problems. Scenarios 3 (to the right) and 4 (overleaf) provide testament to this. The principles of the firm will be responsible both in law and conduct for the work carried out by that office and so it needs to be managed in the same way as the rest of the firm. If a merger on a larger scale is taking place, it may be necessary to review all of your policies and procedures to ensure they meet the needs of the new firm. This may be an opportunity to improve your processes by using the best of both. This is essentially just another aspect of risk and business management, although it may be new territory for some firms. The starting point is to have a detailed integration plan, including tasks, responsibilities and timing, which covers all aspects of operations and risk management, as well as its structure and organisation. Acquiring firms may wish to use QBE's Integration Checklist which is available in our Guidance Notes (link at the end of this article).

This detailed list includes various considerations under the subheads of:

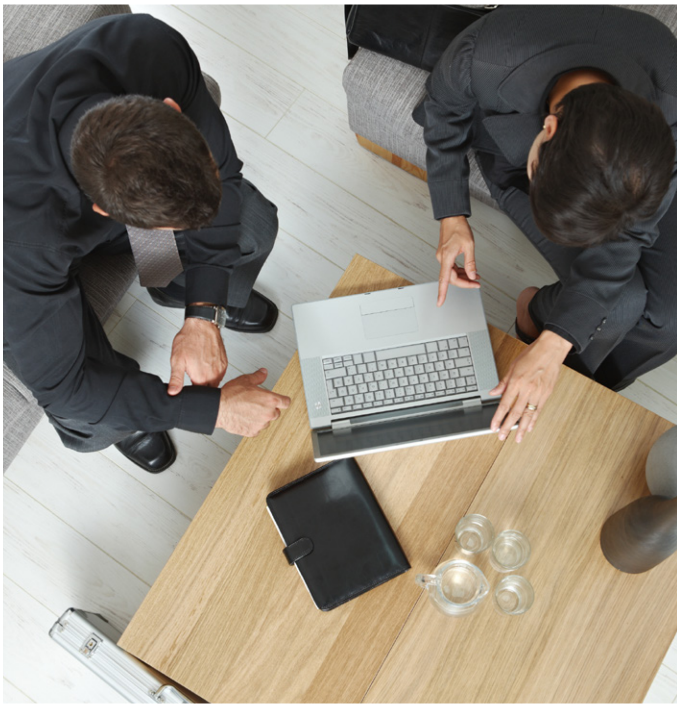
- Supervision
- Complaints handling
- HR Policies
- Confidentiality and disclosure
- Case management
- Joint Ventures
- Structures & Management
- Client care
- Conflict checks
- IT & Data control
- File management
- Outsourced Services
- Insurance
- Planning & Budgeting

Finally, should a merger or acquisition go ahead, or for any other reason you are taking over a file from another firm, don't just try to pick it up and carry on where the previous fee earner left off. Imagine you have been asked for a second opinion - are the client requirements adequately defined and achievable? Go right back to Heads of Terms, and ensure you are clear on objectives and are comfortable with the work and client risk as assed under your own criteria. If not, articulate your concerns and discuss them with a partner, supervisor, or peer as a sounding board — after all, a problem shared...

Scenario 3 : Managing the maverick

A Multi-Million GBP claim highlighting the importance of applying the agreed checks and balances across processes, services, and teams to avoid 'black holes' in risk understanding, and of balancing performance assessment so that reward and recognition are not based solely on fee-income.

A firm made a lateral hire to its Corporate Team – seen as a bit of a coup given that the new Partner brought with her some high profile clients and cases. Whilst considered a bit brash, and blasé about admin and systems generally, financial performance of the new recruit far exceeded plans and she became popular with her humorous tales of stars and celebrities. The new Partner was left to her own devices and 'wilful blindness' crept in as the errant admin was overlooked – or the gaps plugged for her by support staff. But when undertakings from a number of investors failed to be managed effectively in a complex financial arrangement, and the deal eventually fell through, the practice was left high and dry and had to pay out some very large sums to reimburse the investors for lost monies that had not been securely ring-fenced. Investigation of the claim was hampered by the absence of supporting records to defend the claim as it was found that many records were on her personal devices rather than held centrally on the firm's systems. Further, no formal risk assessment or peer review had been applied as was mandated by the firm's protocols, and no complex case plan or financing structure had been documented.



Scenario 4: Team tactics

Demonstrating the importance of integrating acquired teams into the practice post-acquisition, providing leadership rather than management in relation to company policies, and applying robust file review controls – generally, but especially to new areas.

A practice acquired a specialist team to provide clients with a niche service offered by its competitors. The small team moved across en masse bringing with them their client base and matter files. Things went well at first - billing increased in line with forecast and client feedback was positive. After several months though, complaints about the Partner in charge began to roll in from clients complaining about being billed for work not undertaken and never being able to contact the person concerned. The Partner involved eventually resigned but after investigation it emerged that other team members were aware of personal issues impacting upon his work but did and said nothing about this as loyalty to their Manager overrode commitment to the new practice. Key issues this case study illustrates are:

- The firm had failed to integrate the new team, effectively letting them operate as an isolated business without involvement of other personnel in the practice;
- Induction of the team had been commercially and technically focused and whilst support systems were available on the intranet, they were not positively promoted;
- The Whistleblowing policy was known about but viewed in such a negative light by the whole firm that no-one was inclined to promote it never mind use it;
- File reviews were based on personal rather than independent selection so these files could be hidden.

Authors

Deborah O'Riordan, QBE FSM Risk Solutions
(Enquiries to: Deborah.O'Riordan@uk.qbe.com)

Richard Robinson, Legal Compliance Services
(www.legalcomplianceservices.co.uk)

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QBE European Operations Plantation Place 30 Fenchurch Street London EC3M 3BD
tel +44 (0)20 7105 4000 www.QBEeurope.com

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