

Insurer Survey

LPLI 2018 Claims Survey: Legal Malpractice Claims Increase in Severity and Scope as Firms Adapt to Market Realities

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Introduction & Overview

Despite what continues to be a challenging environment for the legal industry, it appears that individual firms are continuing to adapt – and some are even thriving. This has required a strong focus on cutting expenses, adopting new work processes, expanding the use of technology, and in many cases, reducing headcount.

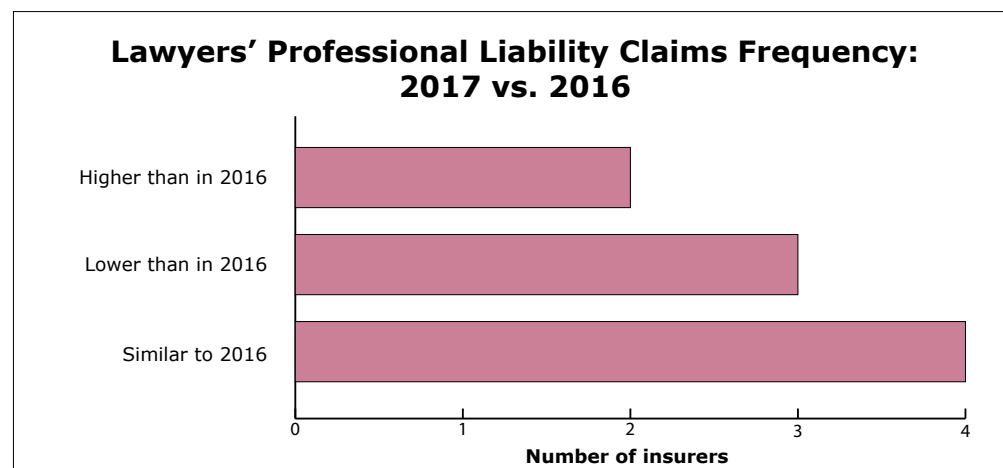
Many feel these dynamics may be contributing to an expansion of law firm professional liability exposures. Yet, despite this perceived heightened risk profile, the leading lawyers' professional liability insurers saw claim frequency stabilize in 2017. Nonetheless, claim severity, including the cost to defend legal malpractice claims, continues to increase year over year.

In the second quarter of 2018, Ames & Gough, a trusted risk and insurance advisor to law firms, conducted its eighth annual survey of Lawyers' Professional Liability Insurance ("LPLI") claims. As in our prior surveys, the current study looks at the volume of claims insurers are experiencing as well as specific trends with respect to larger claims. It identifies issues most likely to trigger malpractice claims; practice areas seeing the most significant claims activity; and takes a close look at several risks receiving greater scrutiny, such as those related to lateral hires, third parties, and cyber security. We also examine how insurers are managing claims, including their use of outside counsel and related legal defense costs.

Senior claim executives at nine leading insurance companies that write Lawyers' Professional Liability Insurance coverage participated in this year's survey. The insurers included: AXIS, CNA, Huntersure, Ironshore, Markel, Travelers, Swiss Re, QBE, and XL/Catlin. Together, they insurer approximately 80 percent of the Am Law 200 firms, as well as a host of mid-size and smaller firms. We are grateful for their participation in our study and are pleased to present the findings in this report.

Survey Findings

1) Legal malpractice claims frequency remains flat.



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Overall, the number of new malpractice claims brought against law firms in 2017 remained consistent on a year-over-year basis with prior years (despite being well above historical experience in the years preceding the 2007 - 2009 recession). Among the nine insurers surveyed, four indicated the number of claims filed in 2017 was similar to that in 2016; two reported frequency was higher, by 6 - 20 percent; and three indicated it was lower.

2) Legal malpractice claim severity continues to soar.

Claims with reserves over \$500,000: Despite the good news on claim frequency, insurers continue to grapple with claim severity. All the insurers surveyed had claims with reserves over \$500,000. Five had more than 21 matters with reserves over \$500,000 (combined indemnity and defense costs).

Claims paid over \$20 million: Eight of the nine insurers polled have participated in a claim payout of \$20 million or more.

Claims paid over \$50 million: More significantly, five insurers participated in a claim payout in excess of \$50 million, with one participating in a claim payout over \$150 million; another, exceeding \$100 million; and three had participated in a claim payout between \$50 million and \$100 million. Although some of these insurers likely were involved with the same claim(s) given quota-share coverage arrangements and excess limits, it's unmistakable that the number of claims resulting in larger multi-million dollar payouts – and the amount of those payouts – has increased year over year.

The continued increase in attorney's fees, along with rising e-discovery costs and longer tail claims, has fueled some of the increase in claim severity. The potentially substantial cost of malpractice claims underscores the need for law firms to give careful consideration to the limits they purchase. At the end of the day, "the rubber meets the road" when a large claim occurs and your firm needs to make sure it has adequate financial protection.

3) Largest number of claims stem from four key practice areas.

Business Transactions, Corporate & Securities, Real Estate, and Trust and Estate work trigger bulk of claims.

Practice Areas Generating Largest Number of LPL Claims*

| Area of Practice | Responses (by percentage) | | | | | | | |
|--------------------------------------|---------------------------|------|------|------|------|------|------|------|
| | 2017 | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 |
| Trust and Estate | 56 | 56 | 56 | 67 | 50 | 57 | 0 | 33 |
| Corporate & Securities | 56 | 56 | 33 | 56 | 63 | 57 | 67 | 33 |
| Business Transactions/Commercial Law | 56 | 67 | 67 | 56 | 50 | 43 | 67 | 50 |
| Real Estate | 67 | 44 | 56 | 44 | 63 | 86 | 67 | 67 |
| Collection & Bankruptcy | 22 | 11 | 0 | 11 | 0 | 14 | 33 | 33 |
| General Litigation | 11 | 11 | 11 | 11 | 0 | 0 | 17 | 0 |
| Taxation | 0 | 0 | 11 | 0 | 25 | 14 | 0 | 0 |
| Personal Injury Plaintiff | 11 | 22 | 22 | 0 | 13 | 14 | 33 | 17 |
| IP | 0 | 0 | 0 | 0 | 13 | 0 | 0 | 17 |
| Family Law | 0 | 0 | 0 | 0 | 0 | 0 | 17 | 0 |
| Litigation Defense | 0 | 11 | 11 | 0 | 0 | 0 | 0 | 17 |

**Note: Survey participants provided multiple responses, so the totals sum above 100 percent. The survey also inquired about LPL claim activity in several other practice areas but received no responses in each of the past seven years. These areas include: Labor & Employment, Insurance Defense, Criminal/White Collar, International Law, and Personal Injury Defense.*

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Business Transactions/Corporate & Securities. With the U.S. economy performing well, merger and acquisition activity is humming along. With this increased workload, it is no surprise that the corporate and securities and business transactions practices of law firms garnered a fairly equal number of responses as having the most claims. Both practice areas have been fairly consistent each year in terms of the percentage of insurers seeing claims generated from them.

When business deals go bad, clients inevitably start looking to their lawyers. Allegations in a legal malpractice claim involving a “deal gone bad” often include simple scrivener errors, inadequate representation, breach of fiduciary duty and conflicts of interest. These claims might include situations where the attorney overlooked a significant detail or issue in a transaction; didn’t raise the matter as significant with the client; failed to advise the client about the disadvantages of the transaction or issue; or failed to adequately outline from the beginning whom they did or didn’t represent.

Meanwhile, the cost to defend business transaction claims has been appreciably higher than for defending claims from other practice areas, largely due to the complexity of the representations. These claims typically involve multiple parties, extensive documentation, and the need to engage subject matter experts for the defense.

Whether a company is in the process of formation, protecting its intellectual property, raising capital, going public or private, or embarking on a cross-border acquisition, its hired corporate and securities and business transactions lawyers must have the experience and know-how to guide the company through these complex and high-stakes challenges.

By recognizing the most common risks associated with such corporate matters, attorneys can implement practices and procedures to minimize potential exposure to related legal malpractice claims. These, at the minimum, should include:

- Determine if the attorney and firm have the requisite expertise, time and tools to accept the matter.
- Conduct a thorough conflict check and be clear in the engagement letter whom the firm represents and whom it does not represent. As business transactions have gotten more complex and more parties are involved it has become particularly important to sort through these issues and remain alert to any potential conflicts. A key component of this step is to follow through with comprehensive, well-written and executed conflict waivers.
- Provide detailed documentation of the scope and specifics of the engagement including specificity on the specific aspects of the transaction the firm will and will not be handling.
- Ensure thorough handling of the documentation, including double-checking work to avoid scrivener errors.
- Maintain an ongoing and detailed dialogue throughout the representation to avoid and correct any misconceptions regarding whom the attorney represents; fiduciary obligations; and the pros and cons of any particular elements of the transaction.

Some insurers see rise in third-party claims: Not surprisingly, the insurers citing business transactions and corporate securities work as having the largest percentage of claims also report seeing an uptick in third-party claims.

Commercial Real Estate Claims on the Rise Again. The number of commercial real estate transactions has been on the rise and many commercial real estate lawyers are beginning to experience a related uptick in legal malpractice claims. In a recent multi-million dollar legal malpractice verdict, which involved an underlying commercial real estate deal, the plaintiff successfully argued that the law firm’s phrasing of a loan guaranty lease agreement wrongly applied not just to the intended transaction but also to all financial obligations between the bank and some of its clients, a drafting error that allegedly cost the bank \$60 million.

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Below are some of the more frequent legal malpractice claims filed by clients against their commercial real estate attorneys.

- **Inaccurate property description** – the lawyer made an error in the preparation or drafting of a deed or mortgage/financing document. Drafting errors are often due to the misuse of defined terms, dropping phrases between drafts, or even cannibalization of previous drafts or documents that go unchecked.
- **Vague lease or loan guarantee language** – the lawyer drafted an agreement that did not properly protect the client's interests. Again, this is often due either to misuse of defined terms or mistakes in formulas or payment provisions. It's important that the attorney reconcile documents as the real estate deal evolves and to then double-check the final draft for vague terms or calculations errors.
- **Inadvertent attorney-client relationship** – the attorney inadvertently created an attorney-client relationship by answering an unrepresented party's questions at closing and then gets sued for conflict of interest.
- **Attorney acting as escrow agent** – the attorney holding escrow funds lets a balance fall below full amount or releases funds without an agreement from both parties.

Trust and Estate still sees significant claim activity. *Trust and Estate* continues to see a large percentage of legal malpractice claims, largely due to two factors:

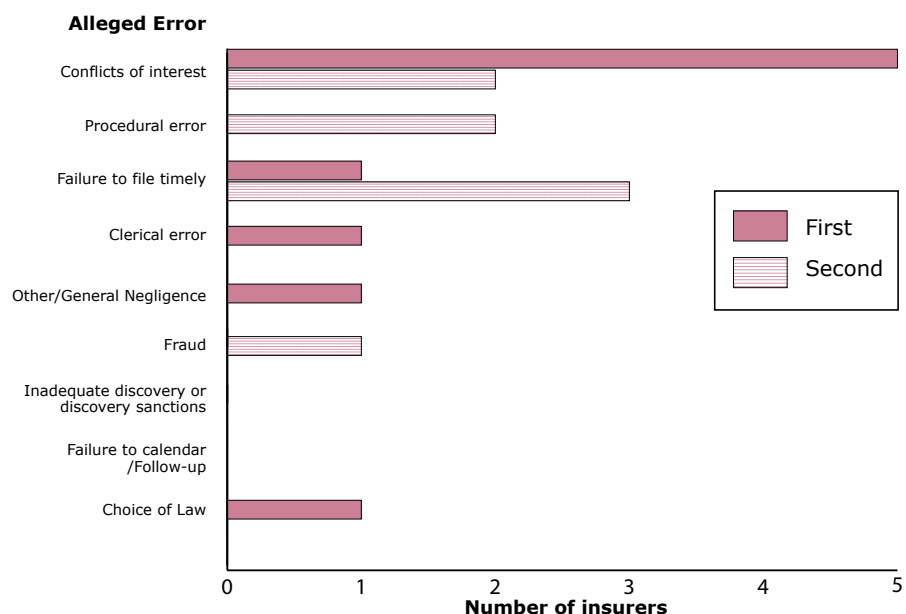
- The reality that *Trust and Estate* inherently involves personal and sensitive matters, making it uniquely susceptible to the potential for client dissatisfaction.
- The sheer volume of transactions, as we enter a period that will witness the largest transfer of wealth in U.S. history.

Trust, estate and probate lawyers provide a broad range of client services, from estate planning, to tax advice, to estate administration and other related services. In addition, it is not unusual for a third party, such as a relative or family friend, to initiate contact with a trust and estate attorney on behalf of an elderly potential client. Thus, this work requires clear and effective communication if a firm is to avoid conflict of interest claims.

Potential exposures arising from these circumstances can typically be addressed by using engagement letters that make it clear who the client is; whom the firm will or will not be representing; and which services the firm will and will not perform on behalf of the client.

4) Conflicts of Interest still biggest malpractice error.

First and second most frequently alleged malpractice errors



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Year after year, conflicts of interest continue to be the most common alleged malpractice error. Seven of the nine insurers surveyed this year cite conflicts as the leading or second leading cause of legal malpractice claims. A law firm's representation of a client in the face of an actual or alleged conflict of interest is taken seriously by clients and courts, mostly because such actions are viewed as a breach of the *duty of loyalty*.

This underscores the importance of conducting thorough conflict checks, including the need for law firms to have systems in place to flag situations where conflicts may arise, appropriate protocols for avoiding them, and established procedures to investigate such circumstances. Notably, during the course of an engagement or a law firm's handling of a matter, the potential for a conflict needs to be addressed at multiple times, including: before accepting a new case; each time new parties are added to a lawsuit (this is most often overlooked); and when new factual or legal issues arise that implicate potential conflicts.

In addition, lawyers need to periodically review and refresh themselves on the disciplinary rules that govern potential conflicts of interest. Be sure to review your own state's disciplinary rules, the *Model Rules of Professional Conduct* (which generally apply in the federal court system), and any practice-specific ethical rules (such as the USPTO *Rules of Professional Conduct*).

5) Cyber claims made under Lawyers' Professional Liability policies flatten, as more law firms purchase stand-alone cyber liability insurance.

This year, only four of the nine insurers surveyed saw an uptick in malpractice claims resulting from a data security breach, compared to five insurers in the 2017 survey. This is despite the fact that cybersecurity is arguably the single biggest risk law firms face. Of those in the current survey, Hacking and Employee Error were both cited equally as the number one reason for claims.

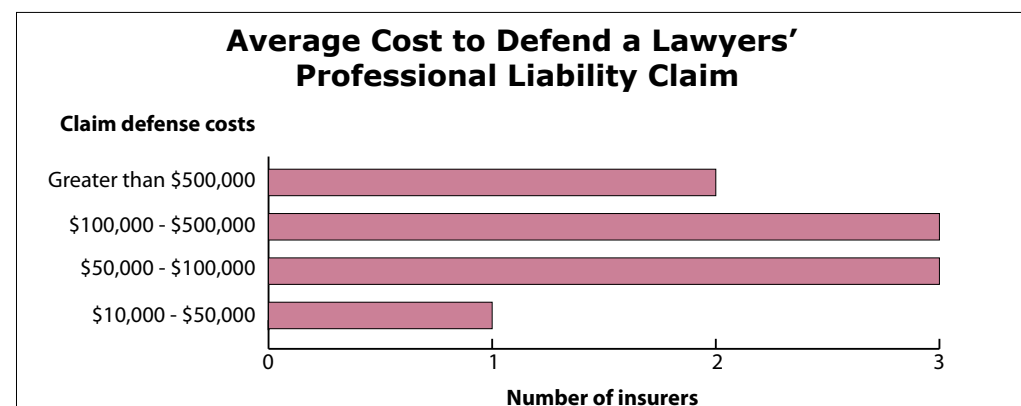
The flat number of cyber claims reported under the legal malpractice policy is most likely due to the fact that more law firms have purchased stand-alone cyber liability insurance policies, rather than to rely on finding coverage under their lawyers' professional liability policy.

Underlying the growing trend among law firms purchasing stand-alone cyber liability insurance may be pressure from clients to invest in the protection as a result of a heightened focus on cyber risk. Indeed, law firm clients have begun requiring firms both to upgrade their cybersecurity capabilities and to provide proof of cyber liability insurance coverage.

Together with the insurance, a "must have" for law firms is a detailed incident response plan. These plans lay out what the roles are within the firm, which external resources will be utilized, and what has to be done when a breach happens.

Whether the plan is two pages or dozens of pages, it needs to list specific actions to be taken and individual responsibilities for implementing them. To ensure any plan can be executed efficiently and seamlessly, those initiating the plan need to make sure they have complete cross-functional cooperation and knowledge and full acceptance of individual roles and responsibilities.

6) Legal malpractice defense costs up across the board.





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ABOUT AMES & GOUGH

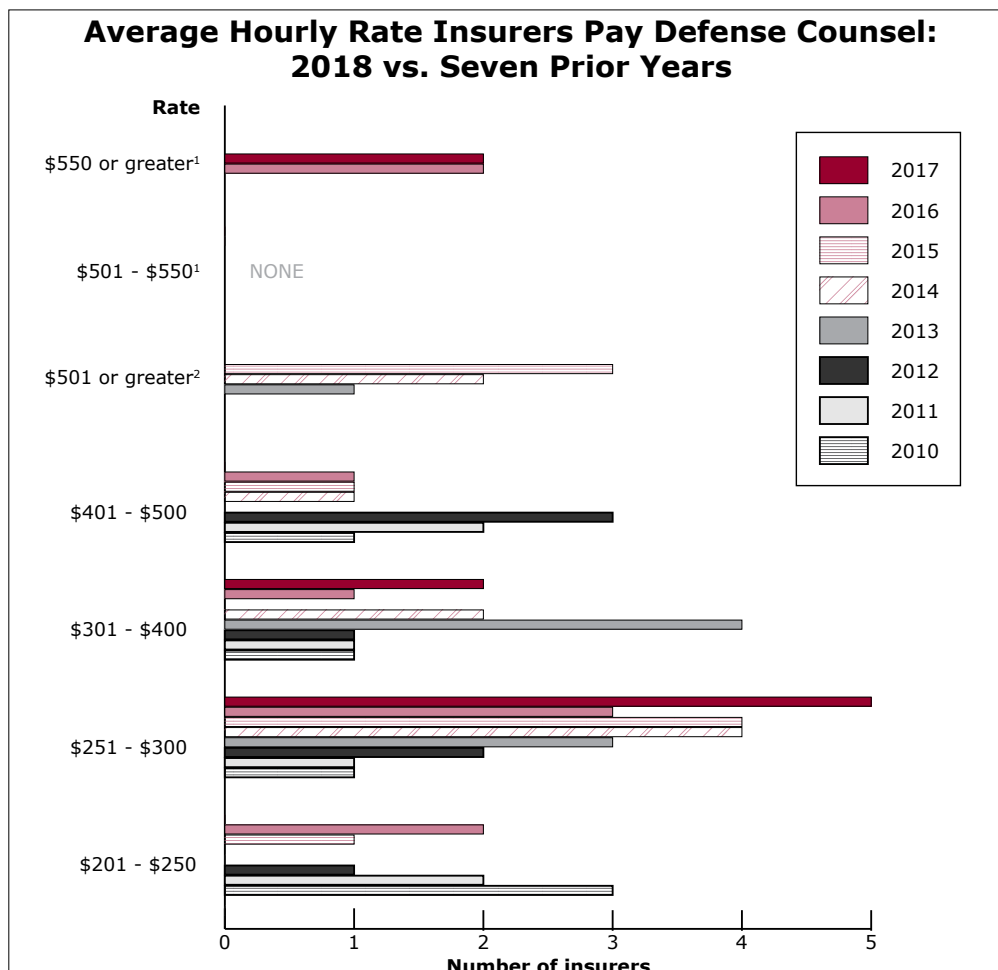
Ames & Gough, founded in 1992, has established itself as a committed, superior resource for law firms, design professionals, and other consulting firms and professional organizations in need of professional liability insurance and risk management assistance. In recent years, the firm has expanded its capabilities to include management liability, employment practices liability, kidnap & ransom and related insurances; as well as more typical property and casualty insurances. The firm has offices in Boston, New York, Philadelphia, and Washington, DC.

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All nine insurers surveyed indicated defense costs increased in 2017 over the prior year. Two indicated the average cost to defend a claim exceeded a half-million dollars; these insurers likely are insuring large law firms with retentions of \$1 million or more, so any thresholds below that amount would not apply to them. Meanwhile, three insurers stated their average defense costs were between \$100,000 and \$500,000. Claim complexity and e-discovery continue to drive this upswing.

The hourly rates insurers pay defense counsel also rose again in 2017, with 67 percent of the insurers polled seeing an increase. Of these insurers, six saw an increase of up to 2 percent, and one, an increase of 2 - 5 percent.



1. New category introduced in 2017 survey.

2. For 2013-2015, the category was defined as "greater than \$500."

Conclusion: As firms move to address challenges, risk management remains key.

Given the array of challenges facing their firms today – from shrinking demand for their services to the proliferation and increased use of alternative legal services, and the expansion of cyber risks – law firm leaders cannot afford to drop the ball on their risk management. Malpractice suits not only cost firms money, they also rob the firm's leadership of valuable time they need to spend with clients or to address other management issues. They can also inflict enduring damage to a firm's reputation. This reinforces the value of continuing sound risk management practices and active monitoring of claims as tools that support a firm's continued adaptation to an evolving marketplace.