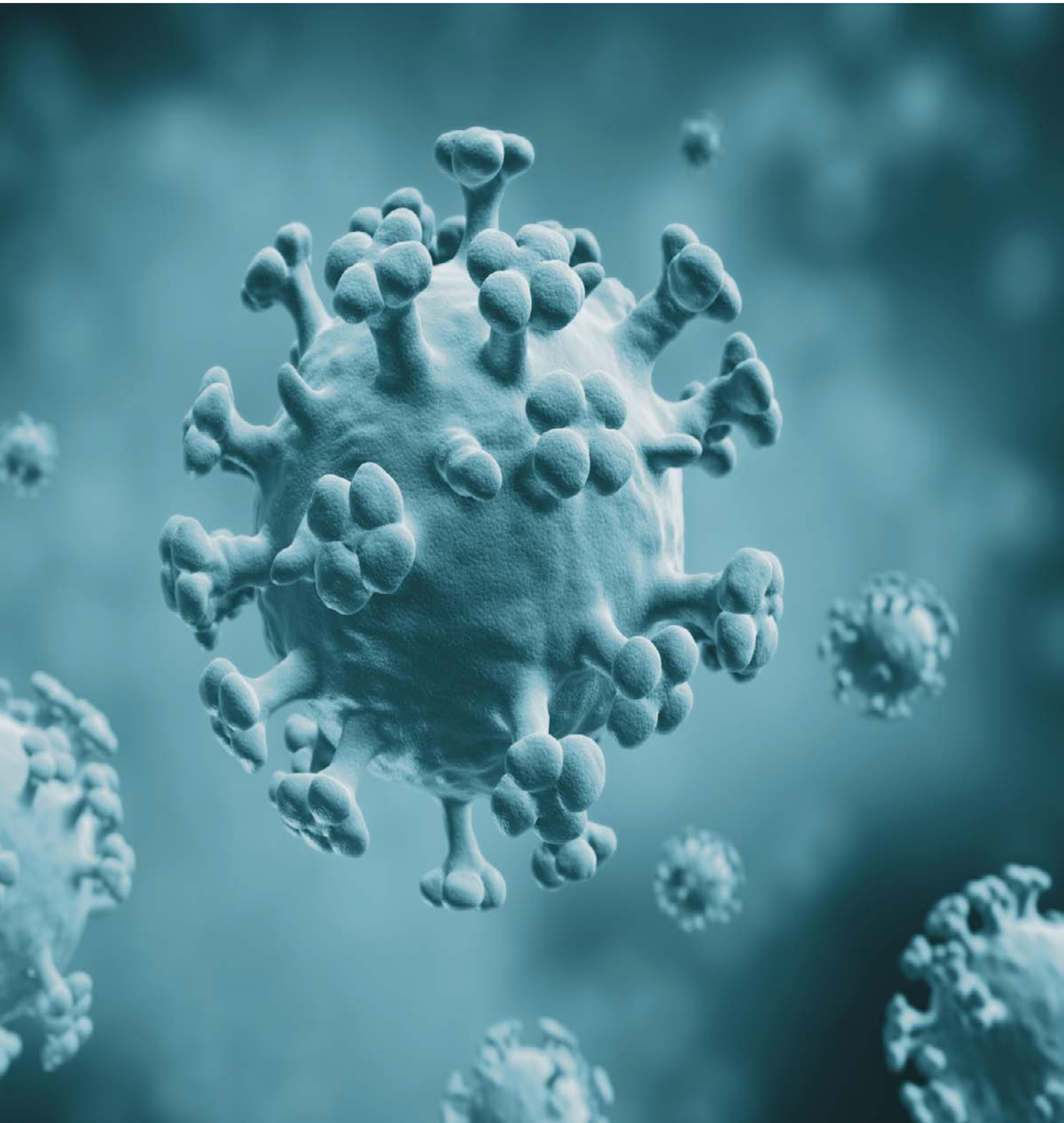
Catching a chill:
law firms and risks of group contagion

November 2013



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Executive summary

Group contagion is a risk that is relatively new to the legal services market, but is one that is well-known from other markets. Our definition of group contagion is:

> ***'The risk that liabilities, losses or events affecting one part of a group, then affect a regulated legal firm within that group, which impacts on the regulatory objectives. The impact on the legal firm may range from reputational damage to financial failure.'***

Group contagion is included as a 'potential' risk in the Outlook . Group contagion is particularly relevant to large conglomerate structures that contain several firms and entities within a single group. However, this risk may be relevant to any firm in a group structure.

Group contagion occurs in two broad forms:

Direct contagion involves a financial shock to one firm in the group spreading through the rest of the structure through direct financial links. It is best controlled by firewalling.

Indirect contagion involves outsiders reacting to an event at one firm in the group, with impacts on the rest of the structure. The most common manifestation of this is reputational harm. This is hard to control without giving up the benefits of a single brand.

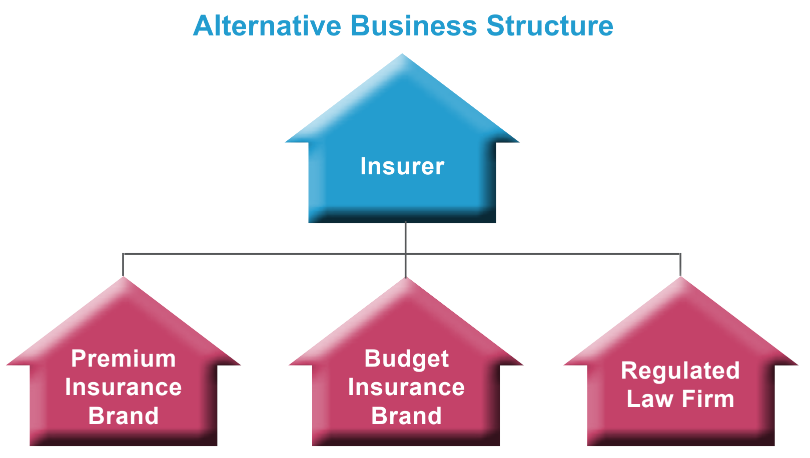
Firms that are part of a group will need to control their exposure to this risk. The primary defence against contagion is for individual firms within a group to have adequate financial and reputational risk management processes so as to prevent or mitigate shocks that could spread through the overall business. The creation of 'firewalls' between firms in a group is a common control for this risk, particularly where the contagion is direct. However,where branding is common throughout the group, a firewall will not be effective against indirect contagion.

Group contagion as a risk

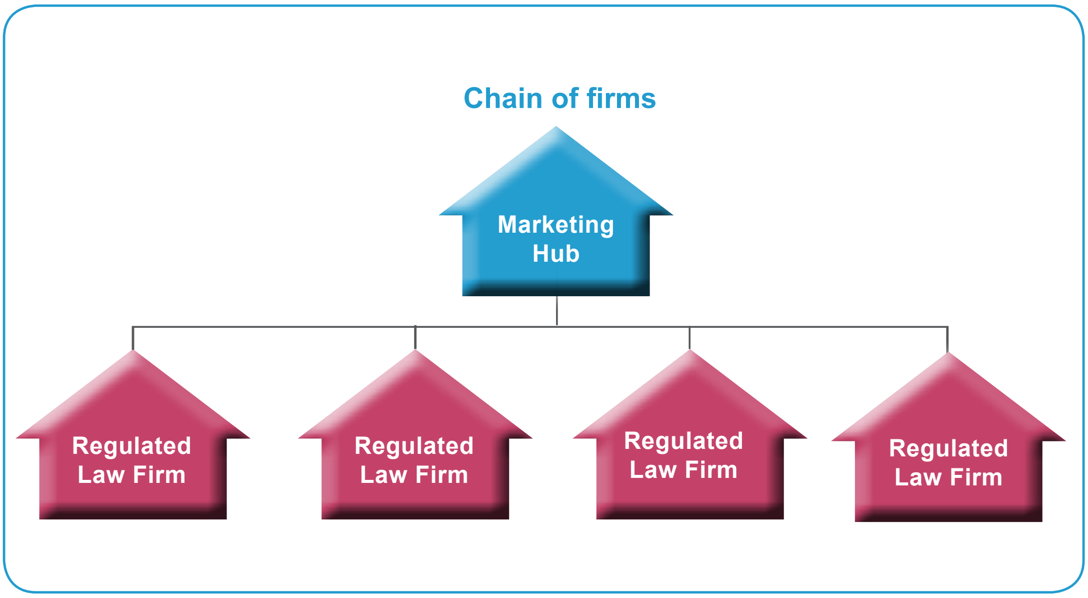
What is a group?

There are many structures in the legal services market that could be described as a 'group'. These range from international firms to franchised brands. The following are examples of the types of structure where the group may be at risk of group contagion.

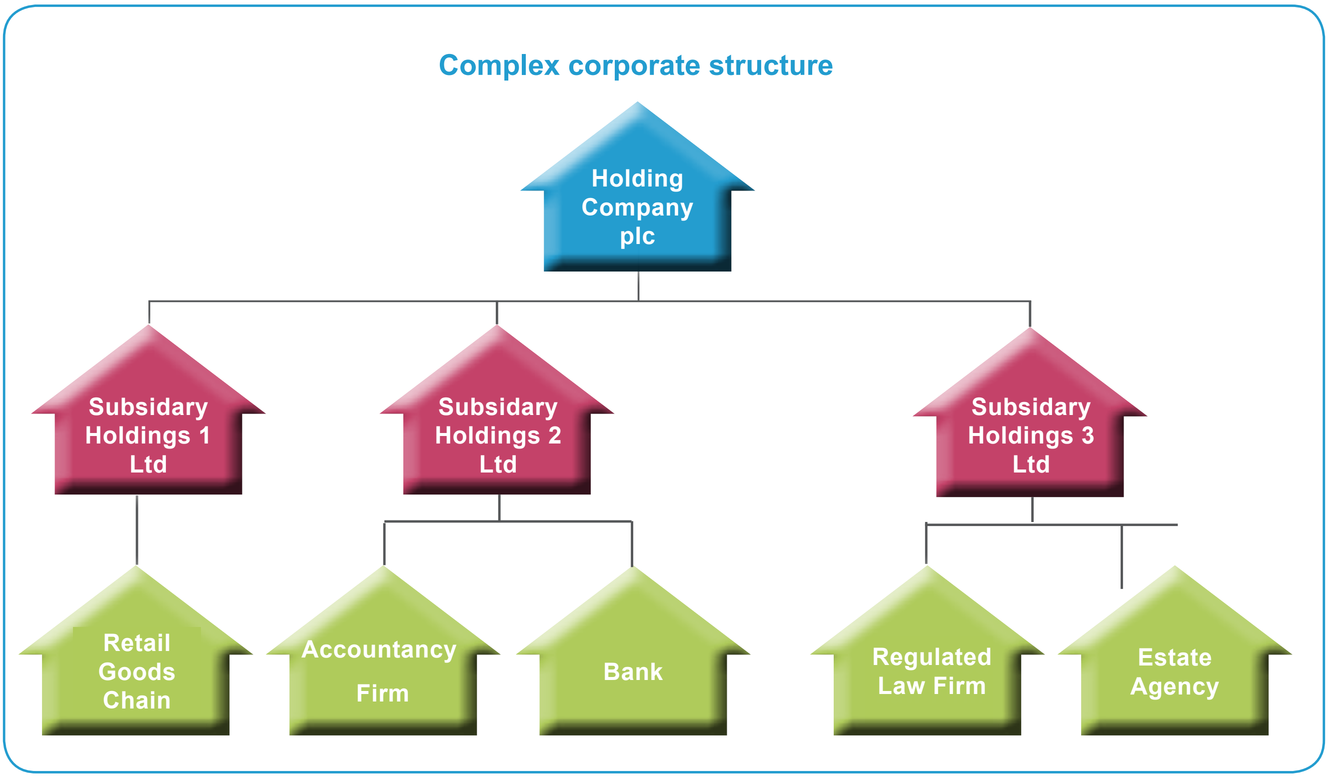
We are most concerned about the potential for group contagion with conglomerate and larger corporate structures. However, this paper will be relevant to any firm that shares characteristics with any of the structures highlighted.



Alternative Business Structure (ABS) providing legal services but forming one division of a larger group offering different services.



Chain of firms operating under a marketing collective or as a formal franchise. Where a marketing hub is present, this may not be a regulated law firm, and may or may not have direct investments in the member firms.



Complex corporate structure or conglomerates, which may involve holding companies, subsidiaries and different client facing firms, including non-legal services firms.

What causes group contagion?

Contagion is the process by which an impact in one group subsidiary affects the other members in the group

Direct contagion involves financial harm spreading through the structure. There are a number of possible causes, of which the most notable are:

- financial difficulties in one arm of the group
- financial crime within the group
- business interruption within the group

All of these start in one firm within the group. Financial interconnections within the conglomerate then transmit the shock across the group structure. This process can happen very rapidly[1].

Indirect contagion does not depend on financial links, but is caused by the reactions of others. It usually arises from a reputational impact on another subsidiary within the structure. Examples of potential impacts may include:

- a scandal involving unethical conduct in one arm of the group, such as involvement in corrupt practices
- widely-publicised poor service, or a major product safety scandal, in one arm of the group

Although the direct reputational impact is on the relevant subsidiary, the damage quickly spreads to the whole brand.

What are the consequences of group contagion?

Ultimately, both forms of contagion cause financial loss. Such losses can be heavy and can lead to other associated risks, such as financial difficulty, disorderly closure or misuse of client money.

Although it is slower to make a financial impact, indirect contagion also carries the threat of harm to reputation and public image. Given the value of the brand to most commercial firms' operations, this is a significant impact. After a severe scandal in part of a group, addressing the contagion can require drastic remedies. This was most recently exemplified by the actions of the News International group, after the phone hacking scandal at the News of the World triggered indirect contagion throughout the group. Nothing short of closing the newspaper was required to address the immediate risk to other parts of the News International group [2].

In the context of the legal services market, group contagion is a real risk to the regulatory objectives, including:

- damage the interests of consumers
- damage the trust that the public places in the provision of legal services
- the independence of legal service providers, which may be compromised by group contagion

1. Ito, T and Hashimoto, Y (2002), 'High Frequency Contagion of Currency Crises in Asia', *National Bureau of Economic Research*, Working Paper 9376, p.7. http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan014350.pdf

2. Tayburn Ltd (2011), 'Red Tops and Reputation—Containing a Disaster of Biblical Proportions', *Tayburn* September 2011. http://www.tayburn.co.uk/2011/09/red-tops-and-reputation-containing-a-disaster-of-biblical-proportions/

Controlling the risk

The first line of defence against group contagion is to control or prevent the initial shock. All members in the group should have adequate risk management systems to control risks to their operations.

It is not possible to predict or prevent all shocks. As such, firms in a group will need the ability to control risks arising from elsewhere in the group.

The creation of 'firewalls' is a common control for direct contagion[3]. Systems of this kind can ensure:

- individual entities within a group have separate management boards or structures with limits on common membership
- corporate policy stops financial linkages becoming too closely coupled
- individual group entities do not guarantee one another's finances

Strict adoption of these controls may hinder the efficiency of the group by preventing unified operations. The balance between controls and efficiency is a question that firms must decide for themselves in line with their risk tolerances.

Controls that can be implemented for indirect contagion include:

- reputational risk management in individual firms and across the structure
- prompt and effective remedial action after a scandal to control wider damage
- the use of a holding company without a single brand

If firms wish to gain the benefits of a single identifiable brand, then the possibility of indirect contagion through that brand is a risk that must be controlled. As was seen in the News International example, more drastic action is sometimes required in the event of a severe scandal.

3. Madsen, B (2006), 'Financial Groups and Conglomerates', *Monetary Review* 1st Quarter 2006, p141. Freshfields Bruckhaus Deringer (2003), 'Study on Financial Conglomerates and Legal Firewalls', *Council of Financial Supervisors in the Netherlands*. http://www.kgl-moent.net/DNUK/Publications.nsf/d8a9f2b39990e07880256a3e004157b5/d1cc2d1c86780f71c12571400032ebf9/$FILE/mon_1qtr_06_web.pdf#page=65

Conclusion

There are many benefits of group structures, both to businesses themselves and to their clients. These benefits may take the form of economies of scale, a strong and trusted brand or the potential for cross selling to better meet the needs of a client. We do not wish to discourage group structures or limit the benefits they may lead to. The aim of this paper is to highlight the risk of group contagion and the need for good controls to be put in place.

As with all risks, it is for individual firms to decide how to control their exposure. In doing this, they need to consider their own risk tolerances and to decide what controls are practical given their own circumstances. This paper aims to provide a guide, and does not seek to prescribe any specific course of conduct.

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