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Recent Developments in Risk Management

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Limiting the Scope of Engagements — Duty to Provide Advice on Transactional (Business) Risks

Peterson v. Katten Muchin Rosenman LLP, 792 F.3d 789 (7th Cir. 2015)

Risk Management Issue: Do transactional lawyers have a duty to provide business advice to their clients?

The Case: The trustee of the bankruptcy estates of insolvent investor funds (Funds) sued the Funds' lawyers, Katten Muchin Rosenman LLP for legal malpractice. During a six-year period, the firm advised the Funds how to structure their transactions with entities controlled by Thomas Petters.

The transactions consisted of the Funds loaning money to Petters' entities, which purportedly used the loans to finance some of warehouse club Costco's inventory. The security for the Funds' investment consisted of: (1) paperwork showing the inventory that Petters supplied, and Costco's agreement to pay; and (2) a lockbox bank account for Costco to deposit its payments for the Funds to withdraw.

The payments to be made by Costco were instead made by another Petters entity. Petters told the Funds' manager, Gregory Bell that Costco insisted on paying one of Petters' entities, which then deposited the money into the lockbox account. Instead of providing the Funds' investors this information, Bell and the Funds lied and told them that Costco deposited the money directly into the lockbox. As a result, Petters controlled the alleged payments made on the investments.

Costco never had any relationship with Petters. The entire relationship was just a Ponzi scheme run by Petters. As a result of the arrangement, the Funds were left with no recourse and no ability to recover their loans when Petters' scheme eventually collapsed.

The Funds' bankruptcy trustee sued the firm, alleging that it breached its duties to the Funds by failing to advise Bell that having no direct contact with Costco, and receiving no money directly from Costco, suggested that Petters' business was fraudulent. The trustee alleged that the firm was engaged to structure the transactions, which included advising the Funds on what contractual devices were appropriate to protect the Funds. Specifically, the trustee faulted the firm for failing to recognize, when negotiating the contracts, the risk raised by the lack of contracts and direct payments, plus the potential that the purported Costco transaction documents were forged. The trustee also alleged that after Petters fell behind in lockbox payments, the Funds consulted the firm, which failed to counsel the Funds to obtain better security, and merely advised them to defer the due dates on the late payments.

Finding that the complaint failed to state a claim on which relief might be granted, the U.S. District Court for the Northern District of Illinois dismissed the complaint. The district court accepted the firm's argument that it had no liability for failing to provide business advice where the client knowingly bypassed verification with Costco to obtain higher interest rates from Petters.

On review, the U.S. Court of Appeals for the Seventh Circuit questioned the district court's failure to consider the complaint on its own terms, and the lower court's reliance on events from the firm's perspective in reaching its opinion. The court noted that while the complaint alleged that Bell attributed the high returns in part to lack of direct verification with Costco, it did not allege that Bell was apathetic to legal advice to reduce risk raised by lack of direct contact with Costco.

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The court of appeals also questioned the district court's failure to consider the complaint's primary allegation, that the firm failed to recognize the increased risk caused by allowing repayments to be routed through Petters, and not to come directly from Costco, and its failure to suggest additional security to reduce the risk.

In reversing the district court's ruling, the appellate court rejected a "bright line" between business advice and legal advice, recognizing that a transactional lawyer must counsel the client on the level of risk inherent in different legal structures, and draft and negotiate contracts that protect the client's interests. In general, it is the role of the transactional attorney to provide legal advice on the best security for a transaction, to inform the client's business decision based on that legal advice. Where the lawyer fails to recognize the need for the advice, the representation is inadequate; however, where the advice is provided, but the client rejects the advice, in general, the attorney has met the standard of care and need not badger the client.

Notably, the appellate court recognized that "the scope of engagement" in the engagement letter establishes the lawyer's role and duties. Where retained to provide advice on how to structure transactions, the attorney has a duty to advise the client on the relevant legal forms available, and the risk associated with the various forms. However, the transactional lawyer has no duty to question either the client's business objective or the client's business relationships.

Lastly, the appellate court disagreed with the district court's dismissal of the matter at the pleading stage. Relying on *Conklin v. Hannoch Weisman, P.C.,* 145 N.J. 395, 413, 678 A.2d 1060 (1996), and *Lopez v. Clifford Law Offices, P.C.*, 362 Ill. App. 3d 969, 975, 299 Ill. Dec. 56, 803 N.E.2d 460 (2003), the appellate court noted that legal advice "must be . . . tailored to the needs and sophistication of the client." However, the client's "needs and sophistication" are factual issues, precluding a motion to dismiss. Moreover, the appellate court recognized that the complaint did not allege the scope of the firm's retention, the advice the Funds sought, the advice the firm promised to provide, or Bell and the Funds' level of sophistication about commercial factoring and the legal devices available. Therefore, the court found that it was not possible to determine whether the firm had performed its services negligently at the pleading stage, making the matter better suited for summary judgment or trial.

Risk Management Solution: This opinion emphasizes the need to include a carefully drafted and detailed scope of engagement in every written engagement letter. Where retained to provide legal advice related to business transactions, the lawyer must ensure that the client acknowledges, and is in agreement with, the scope of the engagement. Transactional attorneys are not retained to provide business advice. However, lacking an appropriately described scope of retention, a transactional lawyer will be held to the standard generally applied, including the need to recognize and counsel on the risk associated with various legal structures.

Rules of Professional Conduct — Law Firm Dissolution and Lawyer Mobility — Procedures for Notifying Clients

Risk Management Issue: How should lawyers and their law firms give notice to clients when the attorney leaves the law firm or the law firm dissolves?

The New Rule: On February 27, 2015, the Virginia Supreme Court approved new Rule 5.8 of the Virginia Rules of Professional Conduct, requiring a departing lawyer and his or her law firm to adhere to specific notification requirements regarding his or her departure or the law firm's dissolution. This rule, which went into effect on May 1, 2015, specifically provides:

> **Rule 5.8 Procedures For Notification to Clients When a Lawyer Leaves a Law Firm or When a Law Firm Dissolves.**
>
> (a) Absent a specific agreement otherwise:
>
> (1) Neither a lawyer who is leaving a law firm nor other lawyers in the firm shall unilaterally contact clients of the law firm for purposes of notifying them about the anticipated departure or to solicit

representation of the clients unless the lawyer and an authorized representative of the law firm have conferred or attempted to confer and have been unable to agree on a joint communication to the clients concerning the lawyer leaving the law firm; and

(2) A lawyer in a dissolving law firm shall not unilaterally contact clients of the law firm unless authorized members of the law firm have conferred or attempted to confer and have been unable to agree on a method to provide notice to clients.

(b) When no procedure for contacting clients has been agreed upon:

(1) Unilateral contact by a lawyer who is leaving a law firm or the law firm shall not contain false or misleading statements, and shall give notice to the clients that the lawyer is leaving the law firm and provide options to the clients to choose to remain a client of the law firm, to choose representation by the departing lawyer, or to choose representation by other lawyers or law firms; and

(2) Unilateral contact by members of a dissolving law firm shall not contain false or misleading statements, and shall give notice to clients that the firm is being dissolved and provide options to the clients to choose representation by any member of the dissolving law firm, or representation by other lawyers or law firms.

(c) Timely notice to the clients shall be given promptly either by agreement or unilaterally in accordance with Rule 5.8(a) or (b).

(d) In the event that a client of a departing lawyer fails to advise the lawyer and law firm of the client's intention with regard to who is to provide future legal services, the client shall be deemed a client of the law firm until the client advises otherwise or until the law firm terminates the engagement in writing.

(e) In the event that a client of a dissolving law firm fails to advise the lawyers of the client's intention with regard to who is to provide future legal services, the client shall be deemed to remain a client of the lawyer who is primarily responsible for the legal services to the client on behalf of the firm until the client advises otherwise.

Virginia's new rule is similar to Rule 4-5.8 of the Florida Rules of Professional Conduct. The main difference is that Florida restricts unilateral client communications only by the departing lawyer, whereas Virginia restricts unilateral client communications by both the departing attorney and the law firm.

Virginia's rule was designed to encourage law firms and departing lawyers to cooperate in notifying clients when these situations occur. Proponents of the Virginia rule believe that clients are best served by having the notification requirement apply to the attorney and the law firm alike.

Virginia's rule also requires the attorney and the law firm to provide timely notice of separation. While the definition of "timely" will vary by circumstance, no communication about the lawyer's departure may be made until the departing attorney and the law firm have first conferred, or attempted to confer and failed to agree on a joint communication to the clients. The notification must clearly notify the clients of their choices for their future legal representation.

Lawyers and firms alike should beware of the defaults applied in the event a client of a departing attorney fails to advise the lawyer and law firm of his or her intention with regard to who is to provide future legal services. Clients who fail to respond to the notification remain the responsibility of the firm when a lawyer departs and of the primarily responsible attorney in the event of a firm dissolution.

Some commentators are hopeful that this new rule signals a trend toward increased attention to the rules governing lateral mobility and the need for clear guidance on how to effectively comply with the duty of client communication in the context of such a transition.

Risk Management Lesson: The Virginia and Florida rules arise from the desire to create a "level playing field" applicable to both law firms and individual lawyers seeking to make lateral moves. Even absent such rules in other states, these rules underscore the benefits — including the avoidance of unnecessary (but presently all too common) disputes and allegations of unethical conduct — of incorporating explicit provisions to the same effect in law firms' partnership or other business documents.

Scope of the Relationship — Local Counsel Arrangements — Permissible (and Impermissible) Limitations on Duties

The Association of the Bar of the City of New York Committee on Professional Ethics, Formal Opinion 2015-4: Duties of Local Counsel

Risk Management Issue: To what extent may attorneys hired as local counsel circumscribe and limit their responsibilities and duties to the ultimate client?

The Opinion: In June 2015, the Association of the Bar of the City of New York Committee on Professional Ethics (Committee) issued a formal opinion discussing the duties of attorneys who serve as local counsel. Lawyers often use the designation "local counsel" to describe an attorney who provides assistance on a matter (typically litigation) in that attorney's jurisdiction, where the lead attorney on the case practices in a different jurisdiction. Lead counsel generally has the relationship with the client, and local counsel may not even communicate with the client directly in the ordinary course.

This common arrangement, however, poses potential ethical problems for the attorney acting as local counsel. Under the New York Rules of Professional Conduct (Rules), all lawyers are ethically obligated to provide competent and diligent representation to their clients and to keep the client reasonably informed about the status of the matter, among other obligations. As the Committee notes, simply designating oneself "local counsel" does not absolve an attorney of these obligations.

The Committee goes on to explain that there is a solution for attorneys wishing to serve as local counsel in the traditional, limited sense. Rule 1.2(c) permits attorneys to limit the scope of their representation. This does not absolve the lawyer from compliance with her ethical duties, but narrows the universe within which those ethical obligations apply. The client must give informed consent to the limited scope representation, and the limitations must be reasonable under the circumstances.

The Committee opines that, for example, a local counsel may limit his or her representation to reviewing lead counsel's legal arguments and exclude obligations to verify factual information provided by lead counsel. A local counsel may not, however, sign his or her name to a complaint if he or she believes the causes of action are not supported by the factual allegations, because the local counsel cannot reasonably limit the representation to exclude his or her ethical duty to avoid filing frivolous claims. The Committee recommends that the local counsel agreement be in writing.

Risk Management Solution: Communication, communication communication. An attorney retained as local counsel who wants to limit his or her role may do so if the representation complies with Rule 1.2(c). It is the lawyer's obligation to communicate to the client any limits on the scope of the representation, rather than to rely on undefined terms, such as "local counsel." Local counsel may reasonably rely on lead counsel to communicate with the client about the case. However, we are aware of some cases where local counsel learns of a settlement offer that lead counsel considers unacceptable, and is told that lead counsel will not communicate the offer to the client. In these circumstances, the local counsel's duty under Rule 1.4 is to inform the client, even against the express direction of lead counsel. That duty cannot be avoided by language limiting the scope of the engagement. The bottom line remains that the engagement as local counsel, including any proposed limitations, should be in writing and signed by the ultimate client, not just lead counsel.