Lawyers' Professional Liability UPDATE

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Duty

Duty to Disclose Financial Problems With Securitizations

Grant Thornton, LLP v. FDIC, 694 F. Supp. 2d 506 (S.D. W.Va.2010)

A 2010 West Virginia federal decision concerned how much credit Grant Thornton, LLP was entitled to receive on a judgment against it for $25,080,777 from a settling law firm. The Kutak law firm's settlement was based on an alleged failure to advise a bank's board of "red-flag" risks concerning securitizations, the transactions and the parties involved. The court listed nine red flags and other frauds against the bank, while Kutak continued to assist the bank's management in closing transactions, which the law firm knew were harmful to the bank. The Federal Deposit Insurance Corporation (FDIC) had contended, based on substantial evidence, that the law firm was responsible for more than $292 million in damages attributable to securitizations. The settlement was for $22 million, funded by the primary insurer's remaining policy limits of $8 million. The law firm signed a $4 million promissory note payable to the FDIC in four equal annual installments of $1 million, plus interest. They agreed to cooperate in pursuing a $10 million claim from the law firm's excess insurance policy with Reliance Insurance Company, which was in receivership in Pennsylvania. If the FDIC received less than $8 million as a result of the Reliance claim, the law firm would pay the difference based on a formula. Thus far, the FDIC had received $12,942,521, which included interest, under the settlement agreement, where total losses were $565 million. The court awarded a credit to Grant Thornton of $1,343,750.57, which is the product of multiplying the amounts presently received plus the additional guaranteed recovery ($15,692,521) times the ratio of damages caused by Grant Thornton ($25,080,777) to the total damages for which the law firm could have been liable ($292,899,685.20), which is 8.563 percent.

Attorney Hired by Guardian Has an Attorney-Client Relationship With the Ward

Branham v. Stewart, 307 S.W.3d 94 (Ky. 2010)

A 2010 Kentucky Supreme Court decision examined a lawyer's duties when retained in multiple capacities. Gary Ryan Stewart suffered severe injuries in a car accident in which his father and brother were killed. He was a minor at the time of the accident. His mother, Vicky Backus, retained attorney Ira Branham to represent her in three capacities: (1) individually, (2) as Next Friend of Gary Ryan Stewart, and (3) as administrator of the deceased brother's estate in filing tort claims. Shortly after filing suit, Branham represented Backus on her petition for appointment as the statutory guardian of Stewart, who was then still a minor. Backus was required to post a $5,000 bond, but no surety was required. After

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her appointment as guardian, Backus settled all tort claims for $1.3 million. Backus and Branham allocated one-half of the total settlement to Stewart and the other half to Backus, individually, and to Stewart's deceased brother's estate. After deducting expenses, Branham apparently paid the net proceeds for Stewart's claims to Backus as Stewart's guardian. Backus apparently never filed any accounting in the guardianship proceedings and allegedly dissipated the funds belonging to or intended to benefit Stewart.

The trial court granted summary judgment on plaintiff's claims that the lawyer should have demanded that Backus post a larger bond or provide a surety, because the lawyer owed no duty to the minor. The appellate court reversed, and the lawyer appealed. The Supreme Court of Kentucky held that a lawyer pursuing a claim on behalf of a minor does have an attorney-client relationship with the minor, and that relationship means that the lawyer owes professional duties to the minor, who is the real party in interest. It is thus possible for the minor to state a claim for legal malpractice or breach of fiduciary duty against the attorney who has been retained by a person acting as the minor's next friend or statutory guardian. Thus, the court affirmed the court of appeals' opinion reversing the summary judgment and remanded for further proceedings.

Although the lawyer was retained by plaintiff's guardian *ad litem*, the minor was a real party in interest. The role of guardian and next friend was to further the ward or minor's interests. The potential for conflict with plaintiff's interests, with the mother as an individual and administrator of her deceased son's estate, did not diminish the duties owed the minor as a client.

Insurance

Policy Rescinded for Failing to Disclose Pending Disciplinary Investigation

***Continental Cas. Co. v. Law Offices of Melbourne Mills, Jr., PLLC*, 2010 WL 996472 (E.D. Ky. 2010)**

Although a Kentucky lawyer knew that a disciplinary investigation was pending concerning the handling of a Fen-Phen action, in 2003, he answered: "no" in his insurance application about whether "any attorney [had] been disbarred, suspended, formally reprimanded or subject to any disciplinary inquiry, complaint or proceeding for any reason other than non-payment of dues during the expiring policy period?" In 2005, the lawyer and others were sued by Fen-Phen clients concerning their handling of settlements, and the court eventually ruled that the lawyers favored their fee interests over their clients' interests, and consequently awarded damages of $42 million.

The insurer defended under a reservation of rights and sought to rescind. The court agreed, finding the answer on the application to be a material misrepresentation, especially because the lawyer knew of the investigation, and that he had been subpoenaed to provide records relating to the Fen-Phen action. The court stated: "There can be no doubt that the bar complaint and investigation concern the very type of risk that Continental agreed to assume when it issued the policy of insurance, and any reasonable person must find these misrepresentations or omissions material."

Continental would have conducted an investigation into the ongoing investigation by the Kentucky Bar Association. Armed with this information, Continental would have taken "one of several potential restrictive underwriting actions in order to address the potential exposure, including substantially increasing the premium for the renewal policy for the August 21, 2003 to August 21, 2004 policy period, decreasing the limit of liability offered for such policy, or both, among other options."

Privilege

Pennsylvania Supreme Court Splits on Rationale for Subject Matter Waiver; Avoids Decision on Scope of Privilege for In-House Counsel-to-Client Communication

***Nationwide Mutual Ins. Co., et al v. Fleming et al.*, 992 A.2d 65 (2010)**

In summary, a split decision by the Pennsylvania Supreme Court informed, but did not finally decide, the important principal issue on appeal: whether and under what circumstances the attorney-client privilege applies to communications by in-house counsel relating to litigation and reflecting confidential information from the client as well as legal advice to the client. The court instead decided the case by finding subject matter waiver, while disagreeing on the application of that rule here as well.

The Pennsylvania Supreme Court affirmed a lower court's result by virtue of an even split among the four sitting justices. The discovery dispute arose out of a suit by an insurance company (Company) against its former insurance agents (Agents). During the discovery process, the Company produced two documents but withheld a third on the basis of attorney-client privilege.

The first document produced was a memo drafted by an in-house lawyer outlining reasons why the Company had severed ties with the Agents. It had been sent to a group of employees, including other in-house lawyers. The second document pertained to the Company's policy for dealing with the Agents' defections. It was drafted by a Company administrator and had been sent to a group of officers and employees.

The third document, which was not produced, contained litigation strategy about the departures. It was drafted by the Company's in-house general counsel and sent to Company executives and members of the Company's legal team. It stated that the Company could not reasonably expect the lawsuits to succeed and that the primary purpose of the litigation was to send a message to current employees.

The trial court reviewed the withheld document *in camera* and found that the Company waived its attorney-client privilege for the withheld document when it produced the two other documents. The trial court relied materially on its conclusion that the Company had selectively produced two favorable documents on the same subject matter, but withheld the allegedly privileged document, which was less than favorable.

On initial appeal to the superior court, the court determined that the withheld document was not privileged. It held that the attorney-client privilege protects client-to-attorney communication, but that communications from attorney to client are privileged only to the extent that they contain and would reveal confidential communications from the client, thus not including the attorney's legal advice.

The Pennsylvania Supreme Court accepted review to consider the question of the scope of the attorney-client privilege in Pennsylvania law, specifically whether and under what circumstances the attorney-client privilege applies to communications by in-house counsel relating to litigation and reflecting both confidential information from and legal advice to the client. The Pennsylvania Supreme Court split 2-2 (with two other justices not participating) on the ultimate question of whether the document was protected from discovery. The result below (requiring disclosure of the document) was consequently affirmed but without majority approval for the reasoning of either of the lower courts on the questions of privilege or waiver.

Two justices voted to affirm the lower courts' result, discussing privilege law generally but ultimately treating the withheld document as privileged *arguendo* and thus not deciding that issue. Rather, these two justices concluded, as did the trial court, that the Company waived any privilege to the withheld document when it produced the two other documents, particularly because of the Company's apparent attempt to use the privilege as both a sword (with the produced documents) and a shield (with the withheld document). The Court found persuasive state and federal case law for recognizing and applying the principle of subject matter waiver.

The two remaining justices voted to reverse the lower courts' result, finding first that the document was privileged, adhering to a 109-year-old precedent that would categorically protect all attorney-to-client communications. These justices relied heavily on the briefs of *amici curiae*, including the Association of Corporate Counsel, recognizing the significant interests at stake in protecting the ability of in-house counsel to communicate candidly with the companies they advise. These justices also would have recognized the doctrine of subject matter waiver that is set forth in federal case law and which was applied by the two affirming justices. However, they disagreed with the conclusion of the other two justices. Rather, they would have concluded that no waiver occurred here because although the produced documents were similar to the withheld document, there was not a sufficient subject-matter nexus to merit waiver of the privilege.

This much-awaited decision (the case was argued in March 2008) reflects a significant fissure in the Pennsylvania Supreme Court as to how to define the scope of privilege for attorney-to-client communications, not only in the context of in-house counsel communications but also more generally. The two justices who did venture an opinion on the issue supported categorical protection — even if that meant overprotection — of communications from a lawyer to a client.

Conflicts

Expert Witness Work Leads to Conflict of Interest, Imputed Disqualification

***Outside the Box Innovations, LLC v. Travel Caddy, Inc.*, 369 Fed. Appx. 116 (Fed. Cir. 2010)**

In summary, a law firm was disqualified on appeal because one of its partners had submitted a declaration as an expert witness on attorneys' fees for the opposing party at trial.

An attorney acted as an expert witness on attorney fees for plaintiff at trial. Defendant then sought to retain the attorney's firm, King & Spalding, for appellate work on the same matter. Plaintiff moved to disqualify the firm based on Georgia's conflict of interest rule, Georgia Rule of Professional Conduct 1.7. Plaintiff argued that its position on appeal would rely in part on the attorney's expert testimony. Therefore, if the attorney's firm were representing defendant, it potentially would have to challenge the testimony of one of its own attorneys in order to adequately represent defendant.

Before applying Rule 1.7, the court stated that it doubted that the attorney who had testified as an expert witness only on attorney fees had an attorney-client relationship with plaintiff. The court nonetheless held that the prospect of the firm needing to challenge its own attorney could materially and adversely affect the firm's representation of defendant. Even assuming that this conflict was waivable, the court disqualified the firm because there was no showing that defendant had received written information about the material risks, been given an opportunity to consult with independent counsel, or, in fact, waived the conflict.

Regardless of whether a lawyer serving as an expert witness has established an attorney-client relationship with the party for whom he or she testifies, the lawyer's firm must be cognizant of the real potential for imputed conflicts. This opinion serves as a stark reminder that conflicts of interest can arise when circumstances may compromise the representation for a range of possible reasons, other than multiple client conflicts, and that at a minimum, the lawyer or firm would be well advised to obtain informed consent before undertaking the representation.

Court Rejects a Mandatory Disqualification Rule for a Law Firm's Current-Client Conflict of Interest, and Denies Motion to Disqualify the Firm

Wyeth v. Abbott Laboratories, 692 F. Supp. 2d 453 (D.N.J. 2010)

In summary, even though a law firm was deemed to have a current-client conflict of interest under Rule of Professional Conduct 1.7 — the rule regulating current-client conflicts of interest — disqualification in a major patent infringement case was not an appropriate remedy. Rather than automatically disqualifying the firm, the court assessed a number of factors, including: prejudice to the parties; complexity of the case; whether the two matters were related or there was any risk of use of confidential information; whether there was any overlap in the firm's personnel working on each matter; the amount of time the firm had invested in each matter and the cost and time involved with retaining new counsel; and whether both matters were active.

Plaintiff (Wyeth) sued defendants, Abbott Laboratories and Boston Scientific Corporation (BSC), for patent infringement. BSC was represented by the law firm of Howrey LLP (Howrey). Wyeth moved to disqualify Howrey based on Rule 1.7 because the firm was concurrently representing Wyeth in a patent matter in Europe. Finding a violation of Rule 1.7, a U.S. magistrate judge granted Wyeth's motion, holding that such violations result as a matter of law in mandatory disqualification.

On appeal, the U.S. district judge reversed, concluding that adoption of the mandatory disqualification rule was clearly erroneous. The court's holding mirrored that of another federal judge in Delaware, who had ruled on the same issue in a companion case involving the same parties. The district judge applied a fact-specific approach that involved a range of factors. The court first found that Howrey's independent professional judgment would not be impaired by the conflict. Notably, the two matters were unrelated and continents apart, and Howrey had created an ethical screen between personnel working on each matter. Wyeth also failed to identify any confidential information available to Howrey that could be used in the present matter. The court further relied on the fact that Howrey had only billed 70 hours to Wyeth in the overseas matter — all of which was from 2008 — and that Wyeth planned to replace Howrey as counsel in that matter.

The court held that the risk of potential prejudice to the parties weighed in favor of BSC. For example, Howrey had built expertise specific to both BSC and the complex technology at issue in the present matter by serving as the company's litigation counsel for 10 years. Disqualifying Howrey, the court held, would deprive BSC of that firm's depth of experience, and the company would further suffer the delay and expense of transitioning to new counsel. Wyeth, on the other hand, failed to identify any prejudice it would suffer as a result of Howrey's continuing representation of BSC.

Importantly, the court held that its interest in maintaining public confidence in the legal system and protecting the integrity of the proceeding would not be served by disqualifying Howrey. In fact, a mandatory disqualification rule, the court noted, could encourage the filing of vexatious disqualification motions and unduly limit clients' choice of counsel.

This court joined a growing majority of courts that treat the question of the appropriate remedy for a conflict of interest as a separate legal question, the answer to which is not automatic but rather depends on a range of factors that go well beyond the basic determination that a conflict of interest may exist under the Rules of Professional Conduct. This opinion also demonstrates how the nationalization and globalization of law firms can affect application of ethical rules. The court in effect recognized that in a world where law firms and their clients operate on such large scales, strictly applying the conflicts rules to automatically disqualify counsel could cause more harm than the underlying conflict itself.