The Lawyers' Lawyer Newsletter

Recent Developments in Risk Management

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Personal Interest Conflicts—Investment in Clients or Their Transactions—Malpractice Insurance Coverage—Policy Exclusions

***American Guarantee and Liability Insurance Company v. Flangas Mcmillan Law Group, Inc., et al.*, 2012 WL 628511 (D. Nev.)**

Risk Management Issue: What are the special risks when lawyers invest in their clients, or their clients' transactions?

The Case: Plaintiff client sued its law firm for legal malpractice. Two attorneys at the firm owned a 27 percent share in the client through a real estate company. An insurance company issued the law firm a professional liability insurance policy that specifically excluded coverage for any claim based upon or arising out of, in whole or part, the alleged acts and omissions by any insured for a business enterprise in which any insured had a "controlling interest." The insurer brought an action for a declaratory judgment that because of this exclusion, the law firm and the individual members were not entitled to coverage in connection with responding to the client's malpractice action. The law firm interposed counterclaims against the insurer and made a variety of motions seeking to prevent the granting of the requested declaratory relief. In considering those motions, and the insurer's own motion for partial summary judgment for the requested relief, and after rejecting the law firm's various positions not directly focused on the merits of matter, the court considered the core question as to whether the exclusion was effective to avoid coverage, as asserted by the insurer, or was too vague to be enforceable, as asserted by the law firm.

After considering the policy language from two perspectives—the language of the exclusion itself, and the entire policy (in order to develop "a true understanding of what risks are assumed by the insurer and what risks are excluded")—the court held that the exclusion was not ambiguous in any respect and was valid and effective. Accordingly, the court granted summary judgment to the insurer. In reaching that result, the court found that "the Policy is intended to exclude from coverage any claim resulting from acts on or behalf of a business enterprise in which any insured has a controlling interest. Insurers have many credible reasons not to assume the kind of risk excluded here. First, insurers need 'to prevent collusive suits whereby malpractice coverage could be used to shift a lawyer's business loss onto the malpractice carrier[.]' [*citation omitted*]. Second, the exclusion seeks to avoid circumstances where an insured intermingles its business relationships with its law practice such that an insurance carrier incurs additional risk of having to cover the insured for legal malpractice claims relating to the conduct of business, rather than out of professional practice."

Risk Management Solution: That investing in clients constitutes a significant personal interest conflict of interest is clear. This case also illustrates that the ramifications of permitting lawyers to take on engagements where these conflicts exist extend beyond the "mere" risk of claims. Depending on the wording of the firm's lawyers' professional liability policy, the claim may be excluded. In order to manage the risk of such claims, as well as the risk of exclusion from coverage, firms need to know if such conflicts may exist before engagements are accepted, in order to determine if the engagement is appropriate. In addition, if

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the firm does decide to accept the risks, it also needs to evaluate whether the necessary disclosure has been made to the client, and an appropriate consent obtained. In order for these risk management steps to proceed, the firm first needs to know at the client intake stage that the conflict exists. Accordingly, firms need to consider including a specific disclosure requirement as to this issue on their new client and matter intake forms. Without the information, the first time the firm will learn of the problem is likely to be when the claim is filed. In this case, that meant that not only was there a claim based on a conflict, but that the firm had no insurance coverage for the defense against or to indemnify the claim.

Engagement Letters—Implications of Failure of Client to Countersign Engagement Letters—Reliance—Suit for Fees

***Asesores Y Consejeros Aconsec CIA S.A. dba Coronel Y Perez Abogados v. Global Emerging Markets North America*, 08 CIV. 9384 (MGC) (S.D.N.Y. 2012)**

Risk Management Issue: How can a law firm confirm the details and scope of an engagement and protect its fee interest in matters where a client fails to countersign and return the engagement letter, and time is nonetheless of the essence?

The Case: A Delaware investment bank retained an Ecuadorian law firm to conduct due diligence on an Ecuadorian company that the bank planned to acquire. The law firm completed its engagement but the deal did not close because the bank was unable to obtain financing. The bank then refused to pay any of the law firm's fees, claming that their engagement did not require payment unless the acquisition of the Ecuadorian company actually took place. The law firm sued for breach of contract and equitable relief. After a bench trial, U.S. District Court for the Southern District of New York Judge Miriam Goldman Cedarbaum found for the law firm, ordering the bank to pay the law firm the full amount of outstanding fees and costs, plus interest.

When the bank had initially contacted the law firm, the firm sent an engagement letter including the terms of its hourly fee, a $20,000 advance deposit, and a requirement that the bill be paid upon receipt, or else the bank would be charged interest. The bank did not, at the time, inform the law firm that the bank's payment of attorneys' fees was contingent upon the bank's successful acquisition of the Ecuadorian company. A witness for the bank testified that it was the bank's "preference" or "practice" to pay if and when the deal closed. The bank had instructed the law firm to begin work immediately due to time exigency, notwithstanding that the law firm had not received a countersigned engagement letter. In connection with the engagement letter, the bank requested two minor changes to the letter, but did not object to any of the payment terms. Nor did the bank inform the law firm its intent not to pay unless the deal closed. The bank never countersigned and returned the engagement letter, despite repeated inquiries by the law firm. Nor did it forward the deposit.

The law firm continued to perform its work to close the deal by the targeted closing date, sending monthly billing statements by email. The bank claimed that it never received the emails and that they landed in the company email junk mail folder, and that the bank therefore did not see the invoices until a few months later, when the law firm started to demand payment. The law firm's records showed repeated email attempts to demand payment of more than $110,000 in fees. The bank never objected to the claim for payment; instead it offered assurances of payment or completely dodged the issue. The law firm completed its work and delivered its report. The bank was ultimately unable to obtain financing to acquire the Ecuadorian company, and the deal fell apart. Two months after the last of the law firm's work for the bank, the bank emailed the law firm to inform it for the first time that the bank would not pay the law firm's bills because the deal did not close, and suggested that the law firm help the bank close the deal so that the law firm could get paid. The law firm immediately denied agreement for payment contingent on the deal, and insisted on full payment. Negotiations were unsuccessful and the law firm filed suit for breach of contract, *quantum meruit* and account stated. The bank claimed that the law firm's fees were excessive.

Applying New York law, Judge Cedarbaum found that an agreement for legal representation does not require a signed contract to be enforceable. Parties can demonstrate the existence of a contract through a showing of objective manifestations of the intent of the parties through the parties' words and deeds. Silence is acquiescence when a party is under a duty to speak but does not do so such that the silence would mislead the other party. Although the engagement letter was never signed, the conduct established that the bank accepted the terms of the law firm's offer by its silence and by its acceptance of the work performed. The court found this to be the result even if it accepted the bank's position that it never intended to accept the hourly fee terms (as evidenced by the bank's refusal to execute the engagement letter). The bank's subjective intent was not enough to avoid the enforcement of the contract.

Risk Management Solution: While law firms sometimes find themselves performing legal services in situations where there exist exigency and client demands that those services go forward before the client countersigns the engagement letter, firms in such situations risk being unable to enforce the terms of their engagement letter against the client's later repudiation. This case is important in that it establishes that law firms may rely on the client's agreement to the terms of the engagement even in the absence of a countersigned engagement letter. Better practice is to ensure a "meeting of the minds" by securing agreement on scope and terms of representation as quickly as possible, and not countenancing delay or evasion on this point. Some firms have established a practice of sending a follow-up communication explaining that the client's continued directions to the firm to provide services will be deemed to be agreement to the terms of the engagement letter. Such a communication helps to establish both that the firm is relying on that conduct as evidencing agreement, and that the reliance is reasonable. The firm here placed itself in a precarious position, and could well have lost its claim in another jurisdiction or under slightly changed facts.

Confidentiality—Law Firm General Counsel—Fiduciary Duties—Attorney-Client Privilege

Garvy v. Seyfarth Shaw LLP, —N.E.2d—, 2012 Ill. App. (1st) 110,115

Risk Management Issue: Are a law firm's communications with in-house general counsel and outside counsel privileged when a current client sues the firm for malpractice?

The Case: Plaintiff client sued defendant law firm for legal malpractice, fraud, and breach of fiduciary duty. In 2001, the client retained the law firm to provide corporate advice related to the management of a family-owned close corporation. Several of the client's family members filed suit against him in 2004 in the Circuit Court of Cook County, based in part on actions the client had taken pursuant to advice from defendant law firm. The client asked defendant to represent him in the litigation. At the direction of its in-house counsel, defendant law firm sent the client a detailed letter regarding the potential conflicts of interest in its representation of him in the litigation due to the prior advice the firm had given him. The letter strongly encouraged the client to seek independent counsel regarding his consent to waive conflicts.

The client retained independent counsel, who asserted legal malpractice claims against defendant law firm on the client's behalf and entered into pre-complaint settlement discussions with defendant. The independent counsel sent defendant law firm a letter regarding the settlement negotiations, adding that the client wanted defendant to continue representing him in the litigation. The independent counsel requested that defendant law firm enter into a tolling agreement regarding the client's claims against defendant, which they did, and settlement discussions continued on the malpractice claims. Defendant law firm retained a third law firm to represent it with respect to the client's malpractice claims. When defendant law firm raised with the client the issue of withdrawing from representing him, the client objected, arguing that withdrawal could sabotage settlement prospects. After settlement discussions in the litigation terminated unsuccessfully, on the third law firm's advice, defendant law firm withdrew as the client's counsel.

Several days later, the client filed a complaint against the law firm. During the discovery process, the client sought the production of the law firm's internal and external communications related to its representation of the client, including all information related to the client's legal malpractice claims. The law firm objected to the client's requests to produce communications between the law firm's attorneys and both in-house and outside counsel related to the client's claims against the law firm, contending that the communications were protected by attorney-client privilege or the work-product doctrine. The circuit court ruled against the law firm, which refused to comply with the resulting order that followed, resulting in a civil contempt and $100 fine entered against it.

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Defendant law firm then appealed. Both the Illinois State Bar Association and the Chicago Bar Association filed *amici curiae* briefs in support of defendant.

The appellate court reversed, holding that the circuit court erred in ordering defendant law firm to produce documents and communications with in-house and outside counsel related to the client's legal malpractice claims. It also vacated the contempt order. First, the appellate court found that the "fiduciary-duty exception" to the attorney-client privilege did not apply. That exception holds that a firm owes a fiduciary duty to its client during the time period when the documents are generated, and therefore that documents created during that time cannot be withheld from the client on grounds of privilege. The appellate court observed that Illinois has not adopted the fiduciary-duty exception, but that even if the state had adopted it, the exception would not apply to this case. Because adversarial proceedings were pending, defendant law firm had sought legal advice in connection with the client's legal malpractice claims against it, not in its fiduciary capacity as the client's counsel in the litigation.

Second, the appellate court took issue with the lower court's conclusion that defendant law firm had not fully disclosed the conflicts and that the court could not determine whether the client's consent to defendant's continued representation was informed. The appellate court found that it was clear from the record that the conflicts were disclosed, that the client sought independent legal advice, and that his consent to defendant law firm's continued representation in the litigation was fully informed. In addition, the appellate court noted that the client had entered into a tolling agreement with defendant law firm in order to preserve his malpractice claims. The appellate court expressed disapproval of the client's attempt to "have it both ways," stating, "he cannot insist that [defendant law firm] continue to represent him in the litigation while he has malpractice claims pending against [defendant], but then use that continued representation to insist that [defendant law firm] produce all documents related to legal advice sought in relation to the malpractice claims generated during that time."

Finally, the appellate court rejected the client's argument that defendant law firm could have no expectation that its communications with counsel would be confidential because of the disclosure requirements imposed by Rules 1.4 and 1.7 of the Illinois Rules of Professional Conduct. To the contrary, as noted by *amici*, the very rules that the client relies on for that proposition recognize that a lawyer's confidentiality obligations do not preclude him from seeking confidential legal advice about his own ethical obligations, and that lawyers are permitted to make confidential reports of ethical issues to designated firm counsel (Ill. R. Prof'l Conduct 1.6(b)(4) cmt. 9 and 5.1 cmt. 3). With respect to the client's work-product claims, the appellate court found that work-product of in-house and outside counsel was not discoverable because the client had not shown that it was impossible for him to obtain information related to his malpractice claims from similar sources.

Risk Management Solution: This case represents a welcome rejection of the case law that has developed holding that, at least as to communications with law firm's in-house general counsel, there is no attorney-client privilege if the communications relate to a continuing client of the law firm. Those cases hold that the firm's fiduciary duties to the client "trump" the privilege. Notably, a similar rejection of that reasoning may be found in another recent case, *Tattletale Alarm Systems, Inc. v. Calfee, Halter & Griswold, LLP, et al.,* 2011 WL 382627 (S.D. Ohio 2011), which contains a thorough analysis of the competing legal principles. Central to the Illinois Appellate Court's determination was the fact that the client had been fully informed as to the potential conflicts of interest arising from the law firm's continued representation of him. This case underscores the need for thorough conflict waivers *documenting* that consent was informed. In the absence of such documentation, the decision could have come out quite differently. Although this case upheld the law firm's right to assert its privilege, firms would be in a stronger position if they did not concurrently represent clients suing them for malpractice. Once claims are asserted against a firm, that firm should, as soon as reasonably possible, cease representing the affected client, at a minimum with respect to the matter that is the subject of the claim.

RPC 4.4—Receipt of Confidential Documents From Third Party—Motion to Disqualify Counsel

***Merits Incentives, LLC, et al. v. Eighth Judicial District Court of the State of Nevada, et al.*, 262 P.3d 720 (Nev. 2011)**

Risk Management Issue: When an attorney receives confidential documents regarding a case from an anonymous source, what steps must the lawyer take in order to avoid disqualification and to comply with his or her ethical obligations?

The Case: A manufacturer sued its three distributors (collectively, "Petitioners") for fraud and breach of contract. In an unrelated action commenced prior to that suit, Petitioners sued a former employee of one of the distributors, alleging that he stole trade secrets. The district court in that case permanently enjoined the former employee from distributing any of the stolen information to Petitioners' "customers, manufacturers, suppliers, or business partners."

After filing suit against Petitioners, the manufacturer received an anonymous package from Lebanon at its New York headquarters on September 24, 2009. The envelope bore Lebanese stamps and the phrase "Highly Confidential," but was otherwise unmarked. The package contained a disk and a note stating that the package should be forwarded to the manufacturer's counsel, an attorney in Las Vegas. On October 15, less than a month after receiving the package, the manufacturer's counsel served on Petitioners a supplemental pretrial discovery disclosure pursuant to Nev. R. Civ. P. 16.1. The disclosure identified the disk received by the manufacturer from an unidentified source, and included a copy of the disk as well as a copy of the envelope it arrived in. At the time, Petitioners did not object to the manufacturer having the disk.

In January 2010, the manufacturer used some of the documents from the disk in a deposition of one of Petitioners' employees, and Petitioners still did not object or argue that any of the documents were privileged. On May 14, 2010, nearly eight months after the manufacturer first disclosed its receipt of the disk, Petitioners first objected to the manufacturer's use and possession of the documents on the disk through a motion to the district court, requesting dismissal of the manufacturer's case or, in the alternative, prohibition of the manufacturer's use of confidential and privileged documents and for disqualification of the manufacturer's counsel. The district court declined to dismiss the case or disqualify the manufacturer's counsel and his firm. The court found that the manufacturer and its counsel "conspicuously set forth" their receipt of the disk in the Nev. R. Civ. P. 16.1 disclosure, and that neither the manufacturer nor its counsel knew of the injunction Petitioners had against the former employee. The court also concluded that Petitioners failed to show that any of the documents contained on the disk, except a draft affidavit, were privileged. The court excluded the use of the draft affidavit, but otherwise allowed the use of the documents contained on the disk. Petitioners then sought a writ of *mandamus* in the Nevada Supreme Court to instruct the district court to reconsider the disqualification motion.

The Nevada Supreme Court affirmed the factual findings and the decision of the district court, but took the opportunity to adopt a notification requirement for situations where an attorney receives documents or evidence from an anonymous source or from a third party unrelated to the litigation. It also set forth factors for district courts to consider in determining whether an attorney who reviews privileged information under such circumstances should be disqualified.

With respect to notification, the Court found that Nevada has no ethical rules governing the specific situation presented. Petitioners argued that the manufacturer's counsel's conduct violated Nev. R. Civ. P. 4.4(a) ("[i]n representing a client, a lawyer shall not . . . use methods of obtaining evidence that violate the legal rights of [a third] person") and 8.4(d) ("[i]t is professional misconduct for a lawyer to . . . [e]ngage in conduct that is prejudicial to the administration of justice"). The Court found that these rules did not apply because the manufacturer's counsel did not play any part in obtaining the opposing party's documents and was not complicit in any actions used to wrongfully obtain these documents. Both parties agreed that Nev. R. Civ. P. 4.4(b), which provides that "[a] lawyer who receives a document relating to the representation of the lawyer's client and knows or reasonably should know that the document was inadvertently sent shall promptly notify the sender," was inapplicable because the disk was not inadvertently sent to the manufacturer's counsel. Nonetheless, the district

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court appeared to have applied Rule 4.4(b) by analogy, concluding that the manufacturer's counsel met his ethical duties because he promptly notified Petitioners of his receipt of the disk.

The Court agreed with the district court's reasoning in adopting a notification requirement. An attorney who receives documents regarding a case from an anonymous source must promptly notify opposing counsel, or risk being in violation of his or her ethical duties and/or being disqualified as counsel. Notification must adequately put opposing counsel on notice that the documents were not received in the normal course of discovery and describe, with particularity, the facts and circumstances that explain how the document or evidence came into counsel's or his or her client's possession. In this case, the Court concluded, the manufacturer's counsel did just that through a Nev. R. Civ. P. 16.1 disclosure. Therefore, the district court correctly concluded that the manufacturer's counsel fulfilled his ethical obligations.

The Court then addressed the issue of disqualification. Noting that the Supreme Court of Texas had resolved a similar issue in *In re Meador*, 968 S.W.2d 346 (Tex. 1998), the Court agreed with the Texas Court's reasoning that "[w]ithout doubt, there are situations where a lawyer who has been privy to privileged information improperly obtained from the other side must be disqualified, even though the lawyer was not involved in obtaining the information." However, "it is impossible to articulate a bright-line standard for disqualification where a lawyer, through no wrongdoing of his or her own, receives an opponent's privileged materials." The Court then adopted the factors identified by the Texas Court in determining whether disqualification is appropriate. The nonexhaustive list includes: (1) whether the attorney knew or should have known that the material was privileged; (2) the promptness with which the lawyer notifies the opposing side that he or she has received its privileged information; (3) the extent to which the attorney reviews and digests the privileged information; (4) the significance of the privileged information; i.e., the extent to which its disclosure may prejudice the movant's clam or defense, and the extent to which return of the documents will mitigate that prejudice; (5) the extent to which the movant may be at fault for the unauthorized disclosure; and (6) the extent to which the nonmovant will suffer prejudice from the disqualification of his or her lawyer.

In the instant case, the Court concluded that the factors weighed in favor of the district court's determination that the manufacturer's counsel and his firm not be disqualified. Most of the documents on the disk were not privileged, and the manufacturer's counsel stated that he did not review the document the court determined was privileged. Further, the manufacturer's counsel made multiple disclosures to Petitioners, which indicated that he was not trying to deceive them or conceal his receipt of the disk from them. Accordingly, the Court denied the petition for writ relief.

Nev. R. Civ. P. 4.4(b) is identical to the ABA Model Rule of the same number. The ABA has stated that "if the providing of the materials is not the result of the sender's inadvertence, Rule 4.4(b) does not apply to the factual situation. . . . A lawyer receiving materials under such circumstances is therefore not required to notify another party or that party's lawyer of receipt as a matter of compliance with the Model Rules. Whether a lawyer may be required to take any action in such an event is a matter of law beyond the scope of Rule 4.4(b)." Although Nevada now has law requiring notification, other Model Rules jurisdictions may not. (Some jurisdictions, such as New Jersey and the District of Columbia, go even further than Nevada in the case of inadvertent disclosures, requiring the recipient lawyer, once he or she realizes a document is privileged, to cease reviewing it, notify opposing counsel, and return the document).

Risk Management Solution: The ethics rules in some jurisdictions may not require notification of the opposing party of receipt of materials from an anonymous sender. However, because of the risk of disqualification, if counsel reads a document that turns out to be privileged, even if it was received totally innocently, counsel should be extremely careful before reviewing documents received from an anonymous source and counsel should stop reading immediately if it appears that a document may be subject to a claim of privilege, and consider both the ethics rules and applicable case law in the relevant jurisdiction to determine the scope of his or her obligations as to the materials.

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