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Newsletters

So, You Made a Mistake. Do You Need to Tell Your Client?

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I. Introduction

Consider the following hypothetical. A corporate client hires a lawyer in connection with purchasing a controlling interest in an LLC. The lawyer structures the deal to lower the client's tax liability based on his assumption that the LLC had elected to be treated as a pass-through entity.

Unfortunately, the lawyer never asked for the LLC's tax returns as part of due diligence, and five years later, while working on a different deal for the client involving an affiliated entity, the lawyer learns that the LLC has been treated as an S-Corp for tax purposes since its formation. The new deal will use the LLC's anticipated after-tax revenues as collateral for a loan to the affiliate company. The lawyer determines that the error will cause the client to owe back taxes, interest, and late fees and will incur unanticipated future taxes.

Is the lawyer obligated to tell the client about the error? Yes.

A lawyer's duty to communicate with a client is governed by ABA Rule 1.4, which provides that a lawyer has a duty to keep the client reasonably informed about the status of the matter, to consult with the client about how to achieve the client's objectives, and to inform the client of circumstances that might require the client's informed consent. *See* ABA Rule 1.4(a).

Based on this duty, ABA Formal Opinion 481 ("Opinion 481") concludes that a lawyer must "promptly" inform a current client of "material" errors made by the lawyer in the course of a representation. This newsletter provides a framework for analyzing ethical dilemmas like the one presented in the hypothetical above and provides practice guidance on how to comply with Rule 1.4 and Opinion 481.

II. Current Client or Former Client?

The first step when evaluating whether you have a duty to disclose an error is to determine whether the client is a current client or a former client. If the client is a former client, you have no ethical duty to communicate with the client about the issue, although you may voluntarily do so in order to mitigate any potential harm to the former client. *See* Opinion 481 at 2.

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Opinion 481 identifies four categories of representation:

(1) the lawyer is retained as general counsel to handle all of the client's legal matters;

(2) the lawyer is retained for all matters in a specific area;

(3) the lawyer is retained to represent the lawyer in a discreet matter; and

(4) the lawyer is retained whenever the client requires legal representation, but those needs are episodic.

See id. at 6. With respect to categories one and two, Opinion 481 concludes that the client is a current client, even if the lawyer is not working on a current assignment, because the expectation is that the lawyer will handle all matters for the client as they arise. *Id.* With respect to the third category, a discreet representation concludes upon the accomplishment of the purpose for which the relationship was formed. The fourth category is trickier. If the client reasonably expects that the representation is ongoing and the lawyer is essentially "on-call," the client should be considered a current client. *Id.* at 7.

One way to eliminate some of the grey areas in these categories is to use engagement letters that clearly set forth the work to be done and state when that work is considered complete or that the client will be treated as a former client if no work is done on the file for a period of 12 months. Similarly, whenever a lawyer believes that a matter is concluded, the lawyer should send a closing letter or email thanking the client and definitively stating that the engagement has ended.

Regardless of the type of representation, a current client becomes a former client when the lawyer withdraws from the representation, when the client fires the lawyer, or when the client takes actions that are inconsistent with the existence of a continuing attorney-client relationship, such as hiring successor counsel.

In the hypothetical above, although the lawyer's representation in connection with the LLC ended five years earlier, at the time he discovered the error, he was currently representing the client in another matter, which makes him a current client for the purposes of Opinion 481.

III. Material or Non-Material Error?

If you determine the client is a current client, your next task is to determine if the error is "material." Recognizing that mistakes occur along a continuum, Opinion 481 advises that an error is "material" if a disinterested lawyer would conclude that it is: "(a) reasonably likely to harm or prejudice a client; or (b) of such a nature that it would reasonably cause a client to consider terminating the representation even in the absence of harm or prejudice." *Id.* at 2.

As to the first category, an error causes "harm or prejudice to the client" if the error results in financial loss to the client, substantial delay in achieving the client's objectives, or material disadvantage to the client's position. *Id.* at 3. As to the second category, Opinion 481 makes clear that even when an error does not harm or prejudice the client, it may still be a material error if it could reasonably cause the client to lose confidence in the lawyer's ability to perform the representation with competence, diligence, or loyalty. *Id.* at 4.

In the hypothetical above, the lawyer's failure to confirm that the LLC was a pass-through entity before recommending the deal structure is a material error. Although the taxes may have been unavoidable based on the LLC's pre-existing tax election, if the lawyer had done his due diligence, the client may have:

(1) terminated the deal to avoid the taxes entirely, or

(2) consummated the deal, paid the taxes in a timely manner, and avoided interest and late fees.

In addition, if the client was aware of the tax status, he would not have paid the lawyer to structure the deal in a way that would not have saved him any money. For these reasons, a disinterested lawyer would reasonably conclude that the error harmed or prejudiced the client and must be disclosed.

IV. Does the Error Create a Conflict of Interest?

If you determine that the error is material, next, you need to determine if it gives rise to a conflict of interest under ABA Rule 1.7(a)(2), which provides that a conflict exists if there is a "significant risk" that the representation will be "materially limited" by a "personal interest of the lawyer."

Opinion 481 provides little guidance on when such a conflict arises, stating only that "an error may be sufficiently serious that it creates a conflict of interest between the lawyer and the client" and that "[w]here a lawyer's error creates a Rule 1.7 (a)(2) conflict, the client needs to know this fact to make informed decisions regarding the representation, including whether to discharge the lawyer or to consent to the conflict of interest." *Id.* at 3.

Not every material error gives rise to a conflict of interest. Where an error is deemed to be material because it harms or prejudices the client, it triggers a conflict because harm or prejudice creates the possibility of a malpractice claim against the lawyer, which implicates a "personal interest of the lawyer."

But, where an error is deemed to be material because it might "reasonably cause a client to consider terminating the representation, even in the absence of harm or prejudice," it would not give rise to a conflict because it does not implicate a "personal interest of the lawyer," as there can be no malpractice claim in the absence of harm to the client.

In the hypothetical above, the lawyer's error harmed or prejudiced the client, likely giving rise to a malpractice claim and triggering a Rule 1.7(a) conflict of interest.

V. Substance of the Disclosure

If you conclude that a conflict exists, you have two paths to choose from:

(a) tell the client about the error and withdraw from the representation; or

(b) tell the client about the error and ask the client to waive the conflict.

The path you choose will likely impact the scope of your disclosure to the client.

Stick to the Facts

Whether you withdraw or request a conflict waiver, your disclosure should be strictly limited to the facts and should not admit liability or fault. The reason is twofold:

First, most malpractice policies require the insured's cooperation as a condition of coverage, and those provisions typically include language precluding the insured from "assuming or admitting liability." If you admit liability, you may jeopardize your coverage for a future malpractice claim based on the error.

Second, in a future malpractice case, the client will need to prove that, but for the material error, the client would have achieved a better outcome. If, however, the client would have been unsuccessful in the underlying matter regardless of the lawyer's error, it means the error did not cause the client any harm. In that case, admitting liability upfront will only make it more difficult to assert a standard of care defense down the road.

In the hypothetical above, the lawyer's baseline disclosure might go something like this:

> "I wanted to inform you about something that happened in connection with the acquisition of the LLC. I thought the LLC was treated as a pass-through entity, but did not request the LLC's tax returns to confirm that fact. I've recently learned in the deal with the affiliate that the LLC has always been treated as an S-Corp for tax purposes.
>
> This means you will need to amend your tax returns and pay income tax at the entity level for the last five years and going forward. There may be late fees associated with paying the back taxes. It will also impact the LLC's net revenues in connection with the deal for the affiliate."

Withdrawal From Representation

If you intend to withdraw, in addition to your factual description, your disclosure should tell the client that the circumstances give rise to a conflict between you and the client and that you have a professional obligation to withdraw from the representation. If the matter is active, you should tell the client about any upcoming deadlines and tell them to speak with a different attorney as soon as possible.

In addition, if the engagement involves litigation or an adjudicatory proceeding, your withdrawal must comply with ABA Rule 1.16(c), which provides that "[a] lawyer must comply with applicable law requiring notice to or permission of a tribunal when terminating a representation." You will need to consult the particular rules of the jurisdiction where your matter is pending, but typically, withdrawal is permitted as long as there is no trial pending or with leave of court.

If you are required to file a withdrawal motion, you must not reveal any confidential information or make any statement that would otherwise prejudice the client. *See* ABA Rule 1.16(d) and cmts. 3 and 9. "The lawyer's statement that professional considerations require termination of the representation ordinarily should be accepted as sufficient." *Id.* If the court requires further explanation, you should request an *ex parte* hearing and request that the record of the hearing be sealed. *See* ABA Rule 3.3(d).

Conflict Waiver

As a general rule, a conflict waiver should only be considered if there is a possibility that you can fix the error. If the error is unfixable, as would be the case for a missed statute of limitations or failure to file a notice of appeal in a timely manner, your continued involvement serves little purpose.

If you seek a conflict waiver, your disclosure needs to be more fulsome to ensure that the client can provide "informed consent." This requires the lawyer to explain "the relevant circumstances of and the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client," ABA Rule 1.7, cmt 18, and the "reasonably available alternatives to the proposed course of conduct," ABA Rule 1.0(e).

Thus, in addition to your factual description of what occurred, your disclosure should explain that your representation might be "materially limited" by the possibility that the client might have a malpractice claim against you, and there is a risk that your advice will be entwined with considerations of your own self-interest based on that claim.

Your disclosure should then explain why and how you think the issue can be fixed and that if you are successful, it will eliminate any harm to the client. Finally, you should advise the client that it has the right to speak with an independent lawyer about the requested conflict waiver.

In all circumstances, once you speak with your clients orally, you should send a confirmatory writing to the client, reiterating the disclosure and the relevant information to your decision to withdraw or seek a waiver, as the case may be.

VI. Timing of Disclosure

Opinion 481 states that the disclosure of a material error should be "prompt" and that greater urgency is required where the client could be harmed by any delay in notification. *Id.* at 5. Notably, the opinion states that "[w]hen it is reasonable to do so, a lawyer may attempt to correct the error before informing the client" but must take into account the time needed to correct the error. *Id.*

Although the opinion does not elaborate on when it would be "reasonable" to try to correct the error before speaking to the client, the possibility that a material error may create a conflict of interest, suggests that generally speaking, a lawyer should only do so where the error does not create the possibility of harm or prejudice to the client. Indeed, if the error harms or prejudices the client, the lawyer usually must obtain a conflict waiver before continuing to act on the file.

A narrow exception to this course of action exists when, in the absence of immediate action by the lawyer, the client will lose his or her ability to remedy the error (regardless of whether they are represented by the lawyer or new counsel), thereby compounding the error further. In such a situation, a lawyer should take whatever steps are necessary to protect

the client's rights, keeping in mind his or her duty to promptly inform the client thereafter.

In the hypothetical above, the lawyer should likely tell the client as soon as possible, given that the accuracy of the LLC's after-tax earnings will impact whether the affiliate can obtain the subject financing. Moreover, there does not seem to be a way to correct the error, and even if there was, the lawyer would need to obtain a conflict waiver first since the error will materially prejudice the client.

VII. Notifying the Malpractice Carrier

Finally, although not addressed by Opinion 481, a lawyer who commits a material error must consider whether he or she needs to notify their malpractice carrier of the error. Most malpractice policies include a provision that requires a lawyer to notify the carrier of a potential loss as a condition of coverage in a timely manner. If the lawyer fails to report the potential claim in a timely manner, the carrier could disclaim coverage down the road.

The possibility that a carrier may disclaim coverage for lack of notice means that lawyers should be extremely conservative when deciding if a material error gives rise to a potential malpractice claim and should resolve any uncertainty in favor of notifying the carrier of the potential claim. The lawyer in our hypothetical should notify his or her carrier.

VIII. Settlements With the Client

After a lawyer discloses a material error, is it permissible for the lawyer to try to settle any potential malpractice claim with the client? It depends.

ABA Rule 1.8(h) states that a lawyer "shall not . . . settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith."

It's difficult to see how such a settlement would be feasible in a situation where a lawyer hopes to continue to represent the client, where the inherent settlement adversity between the lawyer and the client would be at odds with the conflict waiver's premise that the lawyer would could continue to provide competent and diligent representation.

By contrast, where the lawyer withdraws from the representation, early settlement may be a viable option, but only if the lawyer first advises the client of its right to have independent counsel. Even then, a lawyer should not settle the claim without first reporting the claim to his or her malpractice carrier.

IX. Conclusion

If a lawyer makes a material error in the course of a legal representation, they must promptly disclose the error to a current client, but a lawyer has no ethical duty to disclose the error to a former client.

The substance of the disclosure to a current client will depend on whether the lawyer intends to seek a conflict waiver to continue the representation, but in all cases, the lawyer should stick to the facts and not admit liability.

Generally speaking, a lawyer should err in favor of notifying their carrier of the material error to avoid any future coverage issues under their malpractice policy.

Finally, a lawyer should only settle a malpractice claim arising from the error if they have first notified their carrier of the claim and have advised the client in writing of their right to be represented by independent counsel.