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"What Gets Lawyers Sued"

Lawyer Liability in Large Firm Real Estate Practice

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Introduction

If the "real estate" practice is defined to include all representations related to real estate, large firm real estate practice, which often involves representation of developers and creation of investment vehicles, including limited partnerships, is a practice area with significant lawyer liability risks. Those risks, while varied, tend to fall into a few recognizable categories, which are discussed below.

Aiding and Abetting

One recurring factual scenario that characterizes many substantial claims involves a business transaction in which the law firm represented one of the parties to the transaction who is later sued for wrongdoing such as fraud, misrepresentation, or breach of fiduciary obligation. Real estate developments have been known to involve high-risk transactions undertaken by aggressive entrepreneurs, not given to careful disclosure and other legal niceties. Firms who represent such clients have been sued for "aiding and abetting" the client's alleged wrongful conduct because the firm papered the deal and failed to disclose the client's alleged misconduct.

Big firm lawyers can't refrain from real estate work just because some participants in real estate deals are high-risk clients. Law firms can, however, recognize the kind of risks raised by representation of such clients, and subject them to closer than normal scrutiny in the new business intake process. They can also educate young lawyers about the risks associated with this type of representation and encourage all firm lawyers to be sensitive to warning signs, possible indicators of improper disclosure or similar client wrongdoing.

The best time to look for warning signs is before committing the firm to represent a high-risk client. Thus, the first line of defense against high-risk clients is a sound business intake system. This is especially important when considering representation of an entity or individual with which the firm has no prior experience. Too often, lawyers undertake to represent such clients without conducting *any* due diligence.

Client quality review procedures should normally include a second lawyer review of new business intake decisions, a creditworthiness review of potential new clients and existing clients opening new matters, early identification of high-risk engagements, and a due diligence protocol for potentially high-risk clients. Each step is important to an effective screening process.

Second Lawyer Review. A lawyer eager to generate new business may not fully appreciate the risks presented by a marginal client or questionable transaction. Thus, many law firms now require new business intake decisions to be reviewed by a second partner (or committee) whose experience and seasoned judgment will be respected by their peers.

Creditworthiness Review. Many firms now routinely review the creditworthiness of all new clients. In addition to credit ratings, such reviews will often reveal other useful information such as prior bankruptcies, judgments, litigation, and regulatory action involving the potential new client. If a proposed new representation involves an existing or former firm client, the

client's payment history with the firm should also be considered. Experience teaches the people who fail to pay their lawyers often renege on their other business obligations.

High-Risk Engagements. Certain types of engagement tend to involve more risk than others. Several risk factors or warning signs are common to the real estate practice. These include: clients who are raising money from third parties; potential clients who are changing lawyers or auditors in the middle of a transaction (this warning sign becomes a stop sign if the potential client will not permit you to talk to the prior counsel or auditor concerning the reasons for the change); entities or individuals who have sued other lawyers; entities or individuals who present transactions that have no apparent business purpose; and potential clients that have been found liable for financial malfeasance or have entered into consent decrees regarding such allegations. These kinds of matters deserve special attention by the firm's management.

Due Diligence Protocol. In the Internet age, there is little excuse for not discovering that your potential new client has an unsavory past. Various free or low-cost Internet sources can provide valuable information on potential clients. Law firm librarians or other appropriately trained support staff can usually collect and disseminate such information for the new business reviewers without unduly delaying the new business approval process.

Once the new real estate matter has cleared the new business intake process, the firm must continue to take care that it does not "assist" any misconduct by the client. For example, a common allegation in lawyer aiding and abetting cases is that the law firm assisted the client's scheme by issuing an opinion based upon facts that the firm knew were untrue. The situation in *Kline v. First Western Government Securities, Inc.*, 24 F. 3d 480 (3d Cir. 1994), is instructive, although it did not involve a real estate transaction. The court held that a law firm could be found liable on an opinion based on assumed facts where the firm was aware that the assumed facts

appeared inaccurate, even though the opinion letter was studded with warnings. A lawyer who is asked to give such an opinion has two choices, according to the *Kline* court. The lawyer may investigate to determine whether the assumed facts are true; or the lawyer may withdraw. The lawyer may not, however, give the opinion without investigation. Thus, it is important to focus on the transaction as a whole rather than just the narrow legal issues that might be addressed in an opinion ostensibly based on an assumed set of facts.

Even if the representation does not involve giving an opinion, the firm may still be at risk for aiding and abetting their client's misconduct. For example, Section 51(4) of the *Restatement of the Law Governing Lawyers* provides that a lawyer may be liable to a nonclient where the lawyer's client has fiduciary duties to the nonclient and the lawyer knows that appropriate action by the lawyer is necessary to prevent or rectify the breach of fiduciary duty owed by the client to the nonclient where the breach is a crime or fraud or the lawyer has assisted in the breach. The court in *Granewich v. Harding*, 985 P.2d 788 (Or. 1999) applied this concept to hold that lawyers who had represented majority shareholders in a scheme to "squeeze out" a minority shareholder in breach of the majority shareholders' fiduciary duty could be jointly liable with the majority shareholders.

Conflicts of Interest

The severity of many lawyer liability claims arising out of real estate practice has been exacerbated by conflicts of interest. Frequently, in a real estate transaction a big firm lawyer serves two functions. First, the lawyer represents a party to the transaction. In that capacity, the lawyer attempts to gain an advantage for the firm's client with respect to others in the transaction, thereby potentially causing disadvantage to others. But the big firm lawyer often does more. The big firm lawyer is typically the most experienced, or best known, lawyer in the

deal. Those factors lead to that lawyer being asked to take on tasks that benefit the group as a whole. If the deal craters, and others suffer serious economic harm, such activities can lead to a claim that the big firm lawyer was a "lawyer for the deal," and thereby represented all, or at least many, of the participants, in violation of the conflict of interest provisions of the applicable rules of professional conduct.

This violation of the ethics rules is then alleged to be a breach of the lawyer's fiduciary duties to those who now claim to have been "clients" of the big firm lawyer. Because a claim for breach of fiduciary duty does not require the plaintiff to plead or prove actual malpractice, *see Klemme v. Best*, 941 S.W.2d 493 (Mo. 1997), the putative clients may seek damages from the lawyer for failing to protect their interests in the transaction.

Often, there is no letter defining precisely what person or entity the lawyer represents. In many cases, an "I'm not your lawyer" letter written to others in the transaction would have greatly aided the defense of the lawyer liability claim.

Another conflict problem that sometimes causes claims is the situation where a big firm lawyer represents A in a real estate transaction with B, when B is a significant client of the firm (perhaps in another office) on other unrelated matters. After A suffers what it believes is economic harm, it files a malpractice action alleging that its law firm had a conflict of interest (*e.g.,* under 1983 ABA Model Rule 1.7(b) now Model Rule 1.7(b)(2)) that caused the firm to favor the other client in structuring the deal. Sometimes the lawyer has made oral disclosures and obtained oral consent to the representation. However, disputes usually arise as to the adequacy of the oral consent under the relevant ethics rules. The lack of written disclosure and consent makes defense of the malpractice claim more difficult than it might otherwise have been.

There are some steps to avoid such situations:

1. At the outset of a representation, decide exactly which client(s) you will represent in the transaction. If that decision requires consents, get the consents in writing. Consult the firm's ethics committee as to the form of the necessary disclosure and consent.

2. Tell everyone in sight (not just the "client"). Advise all participants in the transaction so that others cannot claim later that they relied on you to represent their interests. A form of "I'm not your lawyer" letter in a real estate context is attached as Appendix A. Appendix B is a form of "representation paragraph" that could be inserted into the transaction documents to accomplish the same purpose.

3. Explain to everyone what your role means, *e.g.,* that non-clients may not rely on you to protect their interests in preparing drafts of documents, and, if they want legal representation, they will have to obtain it from another lawyer. If you attempt to represent multiple clients, treat the representation as a joint representation controlled by 1983 ABA Model Rule 2.2 (whether or not you have that rule in your jurisdiction). That is, make clear to your multiple clients that if a conflict develops between them and they are unable to resolve it, you will have to withdraw from representing any party. Also, deal expressly in the agreement with the sharing of material confidential information. In most cases, all material information, from whatever source, should be shared with all of the joint clients.

4. Put it in writing! If the agreement is not in writing, it is subject to the kind of factual dispute that precludes summary judgment in a subsequent malpractice action.

Real estate lawyers are sometimes asked if the firm can represent both sides of a transaction, with consent from each client. That course of action is risky. It is difficult to be "just

a scrivener" under contemporary conflicts of interest law. *See Layton v. Pendleton*, 864 S.W. 2d 937 (Mo. App. 1993). Even full disclosure and consent may not protect a lawyer for the deal. In *Baldasarre v. Butler*, 625 A.2d 458 (N.J. 1993), the New Jersey Supreme Court held that representing two clients having adverse interests in the same commercial real estate deal was a *per se* violation of the ethics rules, subjecting the lawyer to malpractice liability, even though both clients had consented to the dual representation. The Court found the conflict of interest to be non-consentable.

Investing in Client's Deals

The 1983 version of ABA Model Rule 1.8(a) that is still in effect in most states prohibits a lawyer from entering into a business transaction with a client unless the terms are "fair and reasonable" to the client, are fully disclosed and transmitted "in writing" to the client in a "manner which can be reasonably understood by the client," and the client "consents in writing." Caution suggests that the lawyer also explain in the disclosure and consent letter any respect in which the lawyer's interest may differ from the client's interest. (ABA Model Rule 1.8(a) was amended in 2002 to require that the client be advised in writing of the desirability of seeking the advice of independent counsel, in addition to affording the client a reasonable opportunity to seek such counsel. The 2002 amendments also clarified the nature of the consent to be given by the client under paragraph (a); the writing to be signed by the client must contain the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.)

Law firms should adopt a policy requiring that any investment in a client's transaction be approved by the firm's management committee (or some other designated reviewer). In addition, a member of the firm's ethics committee (or the firm's loss prevention partner) should be

required to approve the form of the disclosure and consent letter to the client. Experience suggests that if the ethics committee doesn't draft the disclosure and consent letter, it frequently won't pass muster if scrutinized by an unforgiving judge or disciplinary committee. *See, e.g., Avianca, Inc. v. Harrison*, 70 F.3d 637 (D.C. Cir. 1995). In *Avianca,* the court held that the lawyer's failure to comply with the literal requirements of the applicable rule (similar to Model Rule 1.8(a)) created a rebuttable presumption of malpractice, and the lawyer's estate was required to disgorge to the client any profits from the transaction. Under *Avianca* and similar holdings, the plaintiff's expert witness in the malpractice case may be allowed to pontificate about your violation of the ethics rules, merely because you failed to focus on the technical requirements of Model Rule 1.8(a).

In *Passante v. McWilliam*, 53 Cal. App. 4th 1240, 62 Cal. Rptr. 2d 298 (1997), decided under Rule 3-300 of the California Rules of Professional Conduct (substantially similar to Model Rule 1.8 (a)), the court held that a lawyer's violation of California Rule 3-300 rendered unenforceable an agreement which would have provided the lawyer a significant equity interest in a corporation (after the lawyer had arranged financing that saved the corporation from extinction). Because the corporation experienced phenomenal growth and success following the refinancing, the lawyer's loss was estimated at more than $30 million. *Avianca* and *Passante* may be extreme examples of the harm that can result from the violation of Model Rule 1.8(a). They serve, however, as examples of the kind of problems that can develop when lawyers, or law firms, overlook the "technicalities" associated with Model Rule 1.8(a).

Drafting Errors

Real estate lawyers in large law firms are not immune from simple drafting errors. When good lawyers produce flawed documents, the reason usually involves inattention at some level.

Perhaps the drafting was delegated to a less-experienced lawyer, and the supervisor failed to provide the appropriate level of review. Perhaps the lawyers involved simply failed to take the necessary time to check for mechanical errors or to consider whether the written terms accurately reflected the transaction. In some actual cases, for example, a transaction involved several operative documents, and the drafter failed to conform all the documents when one part of the deal changed.

In other cases, the words in the document simply may not accurately reflect the reality (or the client's understanding) of the deal. Large law firms typically maintain precedent files of standard transactional documents so that they need not reinvent the wheel for every deal. Word processing and document management software have increased the utility of such tools. But these tools can turn against the lawyer who fails to focus on the differences between the standard deal and the transaction at hand. Such a lack of focus can lead to embarrassment as well as lawyer liability claims.

Occasionally a "drafting error" reflects the failure to grasp a significant legal point. This can occur when the missed point was outside the drafter's area of competence. A common example is the delegation of responsibility for drafting a complex document to an inexperienced associate working with insufficient supervision. If the transaction results in unforeseen tax consequences that could have been avoided if a tax lawyer had reviewed the deal, the inevitable lawyer liability claim will be difficult to defend.

No single lawyer can concentrate in every area of the law. One advantage of large firm practice is the availability of other lawyers who have knowledge of other areas of law. Making full use of the firm's resources when drafting transactional documents will improve the firm's claims experience.

Conclusion

Large firm real estate practice presents two major risk areas. First, as in all complex areas of practice, there are opportunities for garden variety errors. In large projects, the potential for serious economic harm from such errors is obviously significant. Preventing such errors suggests that the time-tested methods of double-checking documents and supervision of associates are more important than ever. The second area of concern, liability for alleged conflicts and aiding and abetting client wrongdoing, is essentially the same concern faced by many transactional lawyers. However, the speculative nature of many real estate deals, combined with the complex and multiple groupings of entities and individuals involved, make real estate work more dangerous than most practice areas. The potential for "lawyer for the deal" claims or representations "adverse" to persons or entities that are clients of the firm on unrelated matters is greater than in some other transactional areas.

The loss prevention solutions to these problems are easy to identify, but difficult to execute. The solutions are: rigorous new business screening procedures to identify high-risk clients; and effective conflict of interest handling, both at the outset of a matter, and as it develops (as new parties enter the fray or the nature of the transaction changes).

Attachment A

Sample "I'm Not Your Lawyer" Letter

[Firm represents only one client.]

Dear Messrs. Able & Baker:

Re: Peerless Project

It was a pleasure to meet you last week. This letter confirms what we discussed about the relationship between you, our client, Brace Builder, and Dewey, Cheatem & Howe LLP concerning the Peerless Project.

As we discussed, our only client in this matter will be Brace Builder. We anticipate that our firm will be preparing most of the documents necessary to effectuate the various aspects of the development. We will, of course, provide you (either directly or, if you should decide to retain counsel, through that counsel) with draft copies of those documents to allow you to comment on their terms, suggest changes, and generally protect your interests. In preparing documents, or doing other work on the project, however, we will be representing only Mr. Builder and his interests. If either of you wishes to have legal representation in this matter, you must obtain it from another lawyer or law firm.

We know that you both have a good relationship with Mr. Builder. However, in a venture such as the Peerless Project, situations could arise where Mr. Builder's interests differ from yours. In any such circumstances, we will be representing only Mr. Builder's interests. You have acknowledged that you understand that to be the case.

[Let me assure you that we have not sent this letter because we anticipate any hostility between you and Mr. Builder during this venture. We expect that you will all enjoy working together on this project. It is best, however, to make sure there is no misunderstanding about relationships between our firm and those with whom we have dealings on a project.]

We look forward to working with you on this project.

Sincerely yours,

Howard H. Howe

cc: Brace Builder

Attachment B

Sample Representation Paragraph

[Firm represents two clients.]

The parties acknowledge that Dewey, Cheatem & Howe LLP has acted as legal counsel only for Brace Builder and Colossal Construction LLC in connection with the subject matter of this Memorandum of Understanding and the Peerless Project. [The other parties] further acknowledge that Dewey, Cheatem & Howe LLP does not represent them and has not counseled them with regard to the advisability of entering into this Memorandum of Understanding or the transactions contemplated thereby.