Mendes & Mount LLP

Possible Impact of the Current Economic Downturn on Lawyers' Professional Liability Claims

By Anthony P. Spain

If history offers any indication, and it typically does, law firms should expect an increase in both the number and severity of professional liability claims as a result of the global economic crisis. However, firms' efforts to manage risks in the wake of past financial difficulties may soften the blow, even though the current downturn is more severe than its predecessors.

It sometimes seems lawyers have targets painted on their backs even in the best of times. When the economy worsens, though, those bulls eyes grow larger for three primary reasons. First, law firms often find themselves entangled in large, finance-related crises by virtue of serving as counsel to key players, including brokerages, banks and real estate concerns. Second, those who lose money in a downturn are more motivated to recover those losses, and lawyers' pockets look much deeper in tough times. And third, because they also are exploring ways to reduce costs and increase income, law firms often assume risks they would avoid in a more stable climate. Sometimes, those risks come back to haunt them.

This article examines which areas and actions ultimately may result in liability problems in the current economic environment. Understanding the impact of dire economic conditions on law firms can help those businesses avoid potential pitfalls and prepare themselves for the increase in lawsuits that may come their way.

Connected as counsel

If the incidence of claim activity against law firms during the past quarter century were plotted on a graph, the two most conspicuous peaks would coincide with two of our nation's most troubling economic periods.

The first occurred during the recession of the late 1980s and early 1990s. Law firms were subject to numerous lawsuits relating to failed savings and loans or other financial institutions. That recession also unveiled many fraudulent schemes which were the underpinning of the apparent earlier success of those financial institutions. During that period, the lawyers who were targeted were lawyers who generally had a very close working relationship with the owners and founders of those financial institutions. They were involved in setting up the financial institutions and sometimes played major roles in "stepping in" between federal regulators and those financial institutions.

The second serious economic downturn in the United States in that period occurred between 2000 and 2002. The collapse of the dot com bubble and the events of September 11, 2001, were major drivers of economic problems during that period. But, the situation was compounded by a weak real estate market that caused the collapse of some questionable corporations and deals that were propped up by what had been a strong economy. Although there was no financial institution crisis during this period, many lawyers' professional liability claims were filed in regards to illegal tax shelters. These tax shelter losses were limited to a number of firms which had a significant tax shelter practice.

Not all economic crises or scandals necessarily result in increased professional liability claims against lawyers. For example, in recent years, our country has experienced large corporate failures caused by accounting irregularities; mutual fund pricing scandals; laddering issues in the securities industry; and the back-dating of stock option problems.

continued

While attorneys and their insurers have not escaped from these events unscathed, those most affected primarily were accountants, directors and officers, investment banks, financial advisors, rating agencies, and their insurers.

However, there clearly is evidence that deeper economic downturns do have a more dramatic impact on law firms. And no downturn during our generation has been as severe as the one in which we find ourselves today.

Claims tied to current problems have begun to surface and should be more evident in the near future. It's important to understand there typically is a lag between the date of involved acts and the date that major lawyers' professional liability claims are made against the insured. In one sampling of claims made from 1999 to 2003 conducted by our firm, the average time lag was slightly more than two years. Some claims were filed in just a few months while others took up to six years. Given that lag, it's unclear what the eventual impact on lawyers could be as a result of this current recession.

There is reason for some optimism, though, because law firms seem to have not been as close to the heart of key issues as they were during past downturns. For example, law firms were not involved in the origination and marketing of subprime loans or the broking of loans or servicing of those loans. While there certainly could be claims against lawyers emanating from collection work and foreclosure activities, overall claims against law firms should be limited since lawyers were not primary players in the subprime debacle.

On the flip side, work done by attorneys on behalf of their clients to securitize subprime loans and in the marketing and underwriting of offerings of collateralized debt obligations ("CDO") is cause for concern.

There also has been apprehension about the role law firms may have played in the recent spate of fraud and Ponzi schemes. When these frauds began to unravel in the last several months, a key concern was whether any law firms played a significant role in representing those entities in their dealings with regulators. In some of the largest financial institution cases and other cases brought by bankruptcy trustees, a main thrust of claims against attorneys has been the fact that they improperly inhibited the ability of federal and state regulators to do their jobs, thus helping to perpetuate the fraud. So far, no such notifications with those allegations have surfaced. It will be at least several more months, though, before these fraudulent schemes have "shaken out" and insurers have a better idea whether there will be claims against attorneys arising from these schemes.

It is possible large firms are not associated with most of these schemes because the perpetrators of the fraud are mindful that if major law or accounting firms are involved with their businesses, the underlying fraud may be unearthed. The Madoff case is an excellent example; he used a very small accounting firm and, to date, no major law firms are known to have served as regular outside counsel for Madoff.

As a result of the high profile financial collapses and frauds which have surfaced in the past year, there will be enormous pressure on federal and state regulators to prevent future frauds. While this may not cause claims against law firms directly, it should heighten the focus of the SEC, the IRS and other federal and state regulators. This renewed vigor could cause them to look more closely at the actions of attorneys.

Attractive, deep pockets

Lawsuits against lawyers resulting from their roles in financial crises is one issue during economic downturns. More commonly, though, law firms find themselves on the defense simply because clients have lost money and are seeking ways to recover their losses. For lack of other options, suits against law firms become an attractive alternative.

In early 2008, for instance, firms began facing legal malpractice claims which were connected directly to the collapsing real estate market. In one common scenario, the law firm represented the seller of a commercial property or large multi-unit residential property and the purchaser provided the law firm's client with a substantial "non-refundable" down payment toward the purchase price of the property. Because transactions can take several months to close, often because properties are still being built, severe drops in value can occur between the time the down payment was made and when the closing was scheduled to take place.

continued

Obviously, these situations create a strong incentive for the purchaser to find a way out of the deal. Frequently, the potential purchaser is able to point to an error in the contract or offering materials which allows them to rescind the transaction and receive back the otherwise nonrefundable down payment. Often, the mistakes are scrivener errors which, while not major, may be enough to allow a purchaser to rescind the deal. Several of these claims have been brought under the federal ILSA statute which applies to real estate developments of 100 units or more. However, just as many cases are not ILSA-related. Instead, the purchaser is able to focus on a basic flaw in the contract which is the basis for rescission.

This problem can be potentially enormous. One case, for example, involves a lost $15 million down payment on a commercial property in New York. In another matter, the owner of five condominium units not only is seeking rescission for those units, but also has asked his state's attorney general to issue an order of rescission applicable to150 other pending contracts for sale. In that case, the drafting error was very minor. But, if the rescission order is granted, the law firm's client will have to repay deposits valued in the tens of millions of dollars. There also have been instances where class-action attorneys have filed lawsuits on behalf of potential purchasers seeking not only across the board rescission, but also additional damages.

It is essential that in any risk management or underwriting exercise, both insurers and their law firms look carefully at this area of practice to see whether anything can be done to mitigate these types of claims.

There also are a variety of claims which can be brought against a law firm which is associated with a client fraud. Generally, these claims come from two sources. The first is the client itself. In the most outrageous frauds, the client is often insolvent; thus, these claims will come from the bankruptcy trustee or a receiver. The other source of fraud-based claims comes in the form of investor lawsuits. Although investors often do not have a direct client relationship with a law firm, they often will pursue claims against the wrongdoer's outside lawyers. Traditionally, a major basis for such claims was aider and abettor liability in that the law firm is alleged to have aided and abetted the wrongdoing of the fraudster.

The cost of defending a major financial fraud claim can be daunting and can completely exhaust or significantly erode a law firm's insurance coverage. The stakes often are so high in these claims that there is enormous pressure on firms and their insurers to reach large settlements which cap the exposure.

One other area of concern relates to trust work. With the collapse of the real estate market and the fall of the stock market, the value of many trusts has diminished dramatically during the past year. When trust assets shrink, it can cause difficult family squabbles into which law firms sometimes are drawn. This is particularly problematic when the law firm has done work for the trustee or serves as a trustee. In such instances – especially when the law firm does relatively minor and incidental legal work for different family members – it is not always clear who the firm's client truly is. This can create an attorney-client relationship which can be in conflict with their independent actions as a trustee.

In any instance where the attorney represents multiple parties in a transaction or litigation, there is the chance for a significant claim. This problem is exaggerated in a bad economy where the collapse of a transaction or the loss of a lawsuit may put the clients under major financial pressure, thus causing them to point to the attorney as the source of their problems.

The enemy within

Clients aren't the only parties in search of capital during challenging economic times. To combat falling income, law firms sometimes resort to extraordinary measures to reduce costs and increase billing. Some of these moves may put firms at risk of malpractice suits.

On an almost daily basis recently, layoffs are affecting non-legal staff, associates and even partners. Such contraction can raise a variety of issues. For example, work which might normally be conducted by more experienced attorneys is done instead by junior level attorneys. Partners also become overworked or overstretched, sometimes leading to costly errors in judgment and, possibly, malpractice suits.

continued

During tough times, firms also may consider taking clients that they might not entertain normally and delve into areas of practice which traditionally are out of their area of expertise. Despite the loss prevention mantra of the last few decades, law firms remain susceptible to allowing substandard clients in the door. Certainly, the worst scenarios are those where the "bad client" is involved in a financial fraud and the law firm is pulled into the abyss.

It's not uncommon for law firms to turn their focus to litigation to make up for lost business in other areas of practice. When this happens, individual partners, under severe pressure to produce billings, have been perceived to prolong litigation – which may not be in the client's best interest – simply to justify more billable hours.

Fee disputes between law firms and their clients also are more evident during harsh economic periods. This may be inevitable since many clients are in poor financial condition and are having trouble paying their legal bills. Still, firms that typically avoid fee suits are more likely to pursue them in times like these, and that almost certainly will increase the frequency of counterclaims for malpractice.

A silver lining?

Law firms may be somewhat insulated by the current economy. Considering the costs of pursuing major litigation against a law firm or other professional, some clients will think twice before undertaking the time, cost and difficulty of pursuing litigation in order to recover losses. There also may be a societal tendency to view these losses as being related to broad economic problems which are not the fault of any group or the malfeasance of any one professional.

So far, there has not been any outcry by the public or legislators as to putting the responsibility for the economic collapse on lawyers. Most of the focus at this stage seems to be on the investment banking industry and the securities industry in general, and the unsustainable structures they had in place which caused the house of cards to fall. This is in stark contrast to past economic crises in which lawyers had intimate involvement in the setup and running of many of those financial institutions driving the downturns.

Whether it is through good loss prevention or just fortuity (most likely some combination of both), it seems outside lawyers generally have not been involved in crafting the structure of the failed financial vehicles which currently are making the news.

The global economic crisis surely will create some increase in the frequency and severity of professional malpractice suits. In addition to real estate, there almost certainly will be major claims relating to corporate, securities, trusts and estates, litigation and tax. There are instances where the damages will be exaggerated. Ultimately, though, it's possible the impact on law firms will not be as severe as it was during other recent financial crises.

CNA

The information, examples and suggestions presented in this material have been developed from sources believed to be reliable, but they should not be construed as legal or other professional advice. CNA accepts no responsibility for the accuracy or completeness of this material and recommends the consultation with competent legal counsel and/or other professional advisors before applying this material in any particular factual situations. This material is for illustrative purposes and is not intended to constitute a contract. Please remember that only the relevant insurance policy can provide the actual terms, coverages, amounts, conditions and exclusions for an insured. All products and services may not be available in all states and may be subject to change without notice. CNA is a registered trademark of CNA Financial Corporation.

Copyright © 2009 CNA. All rights reserved.