There But For the Grace of God Go I:

A Look at the Modern Transactional Legal Malpractice Case

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Two decades ago the typical legal malpractice case was easy to describe: the lawyer failed to file a complaint within the statute of limitations, and the client lost the cause of action. The resulting malpractice lawsuit usually turned on the merits and value of the lost claim. Today, however, we often see a very different set of circumstances giving rise to malpractice claims.

Consider three hypothetical examples that share common attributes. The examples illustrate the statement of the California Supreme Court in a recent malpractice decision, *Viner v. Sweet*, 135 Cal. Rptr. 2d 629, 636 (2003), quoting Bauman, *Damages For Legal Malpractice: An Appraisal of the Crumbling Dike and Threatening Flood*, 61 Temp. L. Rev. 1127 (1988):

> "When a business transaction goes awry, a natural target of the disappointed principals is the attorneys who arranged or advised the deal. Clients predictably attempt to shift some part of the loss and disappointment of a deal that goes sour onto the shoulders of persons who were responsible for the underlying legal work."

In all three examples, a commercial lawyer allegedly makes an error of drafting or disclosure that is ancillary to the underlying deal, which creates an opportunity for an unhappy client to seek to shift a financial loss to his or her (usually former) lawyer. The lawyer, as a result, becomes the scapegoat for the client's dissatisfaction.

The Scapegoat Problem

Example 1. The seller's law firm drafts an agreement for the sale of a business. Patent licenses are a small part of the assets being sold. The sale agreement is ambiguous about the breadth of the assignment required. On the closing date, the buyer has not obtained necessary regulatory approvals for the acquisition. Rather than acknowledge this, the buyer presents the seller with a patent license assignment that the seller believes is unreasonably broad and refuses to sign it.

The buyer promptly sues the seller, alleging breach of the sale agreement. The seller's law firm represents the seller in defending the lawsuit. The principal defense is that the buyer lacked regulatory approval and could not close the deal. After filing the lawsuit, the buyer obtains the necessary approval and the parties settle the lawsuit by agreeing to reduce the sales price and close. The seller then sues its law firm, alleging that the reduced sales price resulted from negligent drafting related to the patent assignment. The seller also alleges that the law firm mishandled the lawsuit by defending on the ground that the buyer lacked regulatory approvals, which the seller claims the law firm put forth in order to deflect attention away from its handling of the patent assignment issue.

Example 2. A law firm represents a limited partnership that is in financial trouble and seeking to sell its business. After months of effort, only one buyer is located. The price and other terms are negotiated at arms length, but the buyer insists on closing immediately. Under the partnership agreement, a sale requires approval by a majority in interest of all partners, and the general partners alone have the votes needed. However, the partnership agreement also requires that all partners, limited and general, get notice and be informed of the details of the sale. There is insufficient time to notify the limited partners.

The law firm, assuming that the general partners know what the agreement says, does not advise the general partners that failure to give notice could result in a lawsuit against the general partners by the limited partners. The general partners complete the sale, inform the limited partners and pay the limited partners' share of the proceeds. A limited partner files suit alleging the general partners breached the partnership agreement and violated their fiduciary duties by not providing the required notice. The general partners settle the lawsuit and then sue the law firm for the substantial cost of their defense and settlement.

Example 3. A law firm represents a bank in connection with an asset-based loan. One of the borrower's subsidiaries is subject to a statutory lien in favor of suppliers of agricultural commodities that subordinates the bank debt to the suppliers' claims. The law firm does not inform the bank of the existence of the statutory lien. Two years later the borrower goes bankrupt, and the borrower's key officers are charged with financial fraud that caused the bankruptcy. The bank recovers only a small portion of its loan and sues the law firm, claiming that had it known of the statutory lien, it would not have made the loan and would, therefore, not have suffered any loss.

Defense to the Scapegoat Problem: Causation

While there are many defenses to the scapegoat problem in the three examples, the most important is causation. Under Illinois law, a malpractice plaintiff must prove that "but for" the lawyer's negligence, the client would not have suffered the claimed loss. This rule applies to transactional malpractice claims, as well as those for litigation malpractice. *See Serafin v. Seith*, 284 Ill. App. 3d 577, 587, 672 N.E.2d 302, 309-10 (1st Dist. 1996); *Owens v. McDermott Will & Emery*, 316 Ill. App. 3d 340, 342, 736 N.E.2d 145, 149 (1st Dist. 2000).

In Example 1, the firm can defend on the ground that even if it negligently drafted the provisions dealing with the patent assignment, that caused no harm. Rather, the deal failed to close because of the buyer's lack of regulatory approval. The seller did not lose the buyer's lawsuit; the seller settled the lawsuit for economic reasons, not because the lawyer advanced one argument over another.

In Example 2, the firm can defend on the ground that the failure to provide the limited partners with information about the sale caused no loss because the limited partners did not have enough votes to block the sale, and there was, in any case, no other purchaser for the failing business. Whether or not the limited partners were informed of all the economic terms of the transaction in advance did not affect the sale or the amount they received for their interests.

Example 3 is subtler. "But for" causation existed: the bank could show that but for the law firm's failure to advise it of the lien in favor of agricultural suppliers, it would not have made the loan and suffered a loss. But the lawyers can argue that the actual cause of the bank's loss was the officers' fraud, which was unrelated to the priority of suppliers' liens against the borrower's subsidiary. This example presents the question of whether all that malpractice plaintiffs must prove is "but for" causation or whether the plaintiffs must also prove what is usually referred to as "loss causation" resulting from the lawyer's actions.

The distinction is important because if all that is necessary is to show that the lawyer was the "but for" cause of the loss, then the lawyer becomes an insurer of the client's transaction. If, for example, the bank was not repaid because an uninsured fire destroyed the borrower's business, few would argue that the lawyer is responsible for the bank's loss, even though the bank can argue that but for the lawyer's negligence it would not have made the loan. Negligent lawyers are not guarantors of their clients' transactions regardless of what causes them to go badly.

Courts that have addressed the issue in malpractice cases have reached this same conclusion. For example, in *Mercer Savings Bank v. Worster*, No. CA-1273, 1991 WL 239346 (Ohio App. 1991), a lawyer negligently conducted a title search that failed to disclose an existing mortgage. Thinking it would hold a first mortgage, the client extended a loan, but held only a second mortgage. When the borrower defaulted, the client recovered less than if it had held a first mortgage. The client sued the lawyer, claiming that it was entitled to the full amount of its loan because "the harm caused was the making of the loan," and "it would never have made the loan" if the client had known about the prior mortgage. The lawyer successfully argued that the client was entitled to a lesser amount, which was equal to what the client would have received if it actually held the first mortgage. The court agreed with the law firm's position. 1991 WL 239346, at *3. "If the attorney is incorrect in providing such assurance [concerning priority], the lender should be entitled to recover from the attorney what it would have received if circumstances were as the attorney represented. In other words, the lender is entitled to recover what it would have received if it had, in fact, held the first mortgage." *Id.* at *4. *accord, Cramer v. Spada*, 610 N.Y.S.2d 662 (N.Y. App. Div. 1994); *Schuman v. Investors Title Ins. Co.,* 338 S.E.2d 611 (N.C. App. 1986). In Illinois, courts followed the loss-causation rule in cases outside the malpractice context. *See Martin v. Heinold Commodities, Inc.*, 163 Ill. 2d. 33, 59-63, 643 N.E.2d 734, 747-48 (1994). *See also Restatement (Second) of Torts* § 552B.

In Example 3, according to these cases, the bank would lose its malpractice claim unless the bank could show that it would have fared better than it did if the bank had been entitled to be paid ahead of the suppliers of agricultural commodities. If neither the bank nor the suppliers would have been paid, however, the bank could not get over the loss causation hurdle.

These examples illustrate the observation of the California Supreme Court in *Viner* that lawyers are being sued for actions that have little to do with what caused the losses. It is possible, of course, in the three examples to identify steps that the lawyers could have taken to minimize or eliminate the risk of a claim. But in the real world these steps are not always taken, and, in many such cases, a reasonable lawyer without 20/20 hindsight would not be expected to take such steps.

Preventing the Scapegoat Problem

In Example 1, the lawyer could have attached a form of patent assignment to the sale agreement before it was signed to eliminate issues over the form of assignment. But in many complex business transactions, there can be disputes about closing documents (particularly ones that the parties view as relatively unimportant to the deal) or provisions in the agreement that can be read as ambiguous by a party looking for a claim. In addition, in Example 1 the conflict of interest allegation arising from the lawsuit could have been avoided if the lawyer referred the client to another firm to litigate the matter, or sent the client a conflict disclosure and obtained knowing consent to the possible conflict before undertaking representation in the buyer's lawsuit. Although prudent, those steps are not always required. When the lawyer and client are both looking at the transaction in the same way (after the failure to close, both believed it was because the buyer lacked regulatory approval), there may be little reason to anticipate that the client will later criticize the lawyer for asserting a defense that at the time seemed most appropriate.

In Example 2, it would have been possible for the lawyer to have told the general partners that they could be sued if they did not provide detailed financial information to the limited partners, even if the lawyer believed the general partners were aware of the notice requirement in the partnership agreement, while explaining to the general partners that there was no way for them to provide the required notice in the time available. The lawyer in Example 3 should have known about the lien in favor of agricultural providers and informed the client.

Issues Inherent in Lawyer-Client Relationships that Lead to Scapegoat Lawsuits

First, the three examples illustrate that when an aspect of a transaction turns out badly, some clients blame the lawyer and seek to shift the resulting loss to the lawyer, even though there were other more substantial factors that generated the outcome. To defend, the law firm must either show that its work was not negligent or, if it was negligent, the law firm must show that the negligence was not the "but for" or "proximate cause" of any injury. (Of course, as a technical matter, the former client bears the burden on these issues, but it is fair to say that any defense will try to disprove these two elements.)

Second, clients often assume that if the lawyer's work was imperfect, that is all that the plaintiff must show to recover. The law is to the contrary. The law requires the client to prove the following: (i) but for the lawyer's failure the client would not have been injured; and (ii) the lawyer's negligence actually caused the specific loss in question under loss-causation principles. To establish that the client's loss would have occurred anyway takes time and considerable effort. In Example 2 the general partners may assert, after the fact, that if they had been informed of the obligation to inform the limited partners of the proposed transaction in all its details, they would have done so or abandoned the transaction. This leads to a type of "what if" question that may be difficult to resolve without a trial, but also difficult to resolve at trial because it is dependent on speculation. *See Viner*, 135 Cal. Rptr. 2d 629 (client alleging transactional malpractice must prove how transaction would have been negotiated absent the alleged malpractice, despite inherent difficulties of such proof).

Third, Example 1 illustrates another common aspect of the modern commercial malpractice case – that conflicts of interest are alleged whenever possible. The client claimed that the law firm acted improperly in defending the lawsuit by emphasizing the buyer's inability to close. The client claimed the law firm did this in order to deflect attention from its failures related to the patent assignment. Even if one assumes that representing the client in the lawsuit with the buyer was a violation of Rule 1.7(b) of the Illinois Rules of Professional Conduct (because the lawyer was representing a client when the lawyer's personal interest was adverse to the client's), case law holds that violating a Rule of Professional Conduct does not by itself give rise to liability; it is only evidence of a failure to adhere to the required standard of care. *See Owens*, 316 Ill. App. 3d at 353, 736 N.E.2d at 157; *Nagy v. Beckley*, 218 Ill. App. 3d 875, 879-81, 578 N.E.2d 1134, 1136-38 (1st Dist. 1991). Even then the causation element must be proven.

A lawyer should be careful in performing legal work and cautious in any dealing that could later be characterized as putting the lawyer's interest at odds with that of the client. Based on the types of current malpractice cases, these steps are not likely to foreclose all claims, including those in which the lawyer's conduct was not the cause of the loss.

Perhaps this is no surprise. Much has been written about how law firms are becoming more like businesses. In many cases, the personal relationships and loyalties between lawyers and clients are attenuated. As law firms and clients both focus mainly on their respective bottom lines, it is not surprising to see law firms, like other businesses, become targets of lawsuits by parties seeking to transfer losses to someone else.

If there is a silver lining, it is that often a loss from a complex commercial deal or lawsuit results from a web of causes having little or nothing to do with the lawyer's alleged errors. "Before the loss can be shifted, however, the client has an initial hurdle to clear. *It must show that the loss suffered was in fact caused by the alleged attorney malpractice* . . . . Courts are properly cautious about making attorneys guarantors of their clients' faulty business judgment." *Viner*, 135 Cal. Rptr. 2d at 636 (*quoting* Bauman).

This is not much comfort to the lawyer or firm named as a defendant in a malpractice pleading, but it may defeat the claim or at least significantly reduce the price of settlement. ■

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