

LIABILITY

Professional liability in a distressed market

BY SELINA HARRISON



In the aftermath of the financial crisis, more companies and individuals are exposed to professional liability risk across all sectors. Valuations have been decimated across the board, and as a result, entities of all types have been desperate to mitigate their financial losses – ultimately causing the number of liability-based lawsuits to rise. This has been notable in certain sectors such as financial services and healthcare. Further, when such claims occur in a bankruptcy situation, they can incur costly handling issues. As such, it is vital for all professionals to be aware of the liabilities that can emerge in the current business environment, and how to deal with them.

Post-crisis liability risk

Liability-based claims are an ongoing concern in most sectors, regardless of the market at large. However, for the financial services, healthcare and legal services sectors, the current market has been particularly challenging. Arguably the financial services sector, has been the hardest hit. In recent months, Wall Street has witnessed several high-profile cases where shareholders have brought claims against banking executives, which has created a toxic environment for directors and officers (D&O) liability risk. This is partly due to the proliferation (or lack thereof) of D&O insur-

ance coverage for personal claims, although such policies are available, not every firm will have taken them out. As a result, the risks associated with holding a top-level executive position is greater than ever. Executives are very aware of this trend, and are increasingly demanding adequate D&O insurance coverage as a provision of their employment.

In addition, medical malpractice has always been a hot liability area, and this remains unaltered through the financial crisis. Indeed, Bill Coffin, a director of publications at the Risk and Insurance Management Society Inc, explains that “there is an expectation among the general public that all medical concerns should somehow be taken care of and when that level of service is not met or when there is an actual incident of incompetence that either fails to address a medical concern or that actually harms a patient, then there is a reflex desire to seek deep compensation in return.” Further, recent legal developments in the US have made the healthcare sector more susceptible to liability claims. In March, the US Supreme Court ruled that drug manufacturers could be sued in a state court over alleged defects, even if the Food and Drug Administration (FDA) had approved its use. The ruling came after an individual was injected with the anti-nausea drug Phenergan, made by Wyeth. The drug label permitted intravenous

injection, but explained that care was needed to avoid hitting an artery, as likely complications included gangrene. This ultimately arose in one case, and the patient’s forearm was amputated. She sued, alleging the drug should be barred from intravenous use altogether. Wyeth appealed to the Supreme Court on the grounds that the FDA had approved Phenergan, but the state jury sided with the claimant, awarding her \$7.4m in damages.

But financial conditions have also refocused claimants’ attention on the advisory community. Legal advisers to dealmakers are finding themselves increasingly and unexpectedly under fire. “There has been an increase in lawsuits against transactional lawyers based on claims that were rarely brought in the past,” notes James Walker, a partner at Richards Kibbe & Orbe. He explains that legal professionals who handle transactions can be vulnerable to professional liability claims as disgruntled investors are increasingly looking to sue their legal professionals as a way of reaping compensation for their losses. “Even sophisticated investors will claim reliance on the legal professionals involved, especially in the absence of clear evidence that such reliance was unreasonable. This was crystallised in recent comments from Judge Jed S. Rakoff in *SEC v. Bank of America*, where Judge Rakoff appeared to criticise the SEC for not targeting the lawyers who made all the relevant disclosure decisions,” adds Mr Walker.

In the *SEC v. Bank of America* case, failures in the conduct of both parties aroused suspicions as to the honesty and competency of each. Indeed, the failures that occurred are among the most common reasons behind legal malpractice claims. This is backed up by the latest edition of ‘The Profile of Legal Malpractice Claims’, published by the ABA Standing Committee on Lawyers’ Professional Liability. “The leading cause of liability claims was the failure to know or properly apply the law. The increase in these claims results from the increasing complexities of specialised legal fields and the failure of counsel to recognise the need to refer to, or at least consult with, an expert in the field,” says Edith Matthai, a partner at Robie & Matthai. According to the publication, the second most

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common cause for a legal malpractice claim was an overall failure to act promptly and to obtain necessary information. Then come cross complaints, wherein a lawyer has to sue to collect fees from a client. Ms Matthai explains that in this turbulent financial climate, these suits have increased as more clients are unable to pay fees, and in turn, more firms are unable to write off the receivables.

Specific issues and legal solutions

However, in the current economic environment, many of the companies facing professional liability claims may also be going through bankruptcy proceedings. In such cases, the bankruptcy process can raise a number of additional issues for all parties – and particularly legal professionals. After the bankruptcy filing, the new trustee and his lawyer will carefully review all pre-filing actions taken by the client’s attorney, to determine whether malpractice has been committed. “Courts generally hold that the bankruptcy trustee has standing to bring most, but not all, professional liability claims. Because the bankruptcy trustee steps into the client’s shoes, the bankruptcy trustee will be permitted to review all information that previously was protected by the attorney-client privilege,” says Dennis P. Waggoner, a partner at Hill Ward Henderson. He adds that because the bankruptcy trustee steps into the client’s shoes, the client’s pre-filing actions may be used as a defence to the trustees’ claims under an in pari delicto theory.

In other cases, the bankruptcy trustee might consider bringing preference or fraudulent conveyance claims to recover fees paid to the attorney prior to bankruptcy – however, failure

to disclose a conflict or the disqualification of a lawyer can allow the lawyer to claim a disgorgement of fees earned during the period of representation. This is clearly a difficult period for legal professionals, but there are ways that they can mitigate their exposure to these claims. Legal firms should “implement well-conceived loss prevention practices – for example, providing clients with engagement letters that limit the scope of representation. They should also specifically exclude related services that will not be handled, and if necessary, provide conflict waivers,” says Mr Walker. Any legal opinion issued by the firm should be reviewed by the firm’s opinion committee before issuance to be certain that the firm is comfortable with any representation made. He adds that “law firms must have comprehensive conflict checking policies and procedures, and keep informed of developments in the case law governing conflicts in the relevant jurisdiction.”

With regard to corporate bankruptcies, class action lawsuits are always a risk – it is quite common for shareholder action to be brought against the directors and officers of these firms for failing to properly identify and manage the risks that brought the firm into ruin. “However, this can be a self-defeating measure, since the bankrupt firm being sued might not have the money to pay what the plaintiffs are seeking. Even so this never stopped class actions before”, observes Mr Coffin. Clearly then, prevention is better than cure when it comes to mitigating liability risk, and the advice of risk managers should be heeded. Prior to the downturn, the opinions of risk managers were often ignored, but now there is a real need for enterprise-wide risk management, and more

upper-management opportunities for risk professionals to have their voices heard. “Organisations, especially public ones, would do to establish the position of Chief Risk Officer, so that all risk decisions can be centralised under a single authority. Establishing a board-level risk committee, containing the CRO, CEO and other pertinent decision makers so that risk can be seen from the highest level possible and dealt with strategically, would also be beneficial,” says Mr Coffin.

Ultimately, improving risk practices is the best way to protect against professional liability claims. Solid operational risk management, consistent communication and alternative methods of dispute resolution should be applied as far as is possible. It may seem obvious, but identifying the risks that give rise to a professional liability will dramatically lower the potential for claims. Importantly, this means listening to and enforcing the advice given by risk managers. Even so, once a potential claims situation arises, it can be diffused earlier if the future defendant makes a faithful effort to address the problem directly, honestly and openly. If a claim progresses to formal dispute, the use of legal mediation before the case goes to trial is beneficial for the defendant, as usually resolves the matter quickly and less expensively. It is also worth noting that the US has been very influential on tort litigation, and as a consequence there is now a highly efficient sub-industry of legal professionals dedicated to bringing class actions to bear. This section of the industry ultimately increases exposure to professional liability risk, and both companies and individuals alike will need to bear this in mind. ■



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