



Hard Economic Times Mean More Malpractice Claims

Assessing the Increased Risk and Coping with a Claim

Del O'Roark, Loss Prevention Consultant, Lawyers Mutual Insurance Company of Kentucky

Last September the ABA held a conference on “Lawyer Risk in a Struggling Economy.”¹ The program covered an economic perspective on the risks of practicing law in hard times, the elevated risk associated with insolvent clients, the mortgage crisis and real estate lawyer liability, and preparing a lawyer to survive being a defendant. The purpose of this article is twofold. First, to succinctly report the major points made at the conference on the heightened malpractice risks during these difficult times. Second, to provide an analytical approach to managing a malpractice claim from the time of its inception through adjudication.

ABA Conference on “Lawyer Risk in a Struggling Economy”

Hard Times

The panelists² who provided an economic perspective on the increased risks during hard times began by observing that large law firms have suffered a significant fall off in profitability in 2008. One example of this is that equity partners in large firms have experienced a 9.1% decrease in profits in 2008 as compared with a 9.3% increase in 2007. Smaller firm profitability is flat to declining revenues. This comes at a time when client resistance to fees is growing while the costs of practice are going up. This environment leads to lawyers fighting over a static supply of business. The risks are that economic pressure will cause lawyers to take matters beyond their competence, accept clients that would normally be screened out, accept matters with little or no merit, and resort to aggressive billing that can lead to allegations of fraud and fee disputes leading to malpractice claims.

Another major area of risk discussed was that the hard economic environment has caused a dramatic increase in lawyers changing firms. Receiving firms are not vetting new hires as well as they should. Some firms have later learned to their regret that the new hire was not admitted to the bar, had a history of bar discipline, or faced potential large malpractice claims. It is equally important to thoroughly integrate a new hire into the firm’s policies and management system – especially with regard to control of funds.

Mortgage Crisis Risks

The theme of this topic was that all professionals involved in a mortgage deal that has gone bad are targets. As one panelist³ put it “Every lawyer in the room at the time of closing will be sued by a bank stuck holding the bag.” While it is too soon to tell how big this crisis will be for lawyers, the expecta-

tion is that malpractice claims will mushroom for real estate lawyers.

It was noted that claims stemming from the mortgage crisis so far are primarily against solo practitioners and small firms. Typically the buyer alleges the lawyer gave insufficient legal advice. These claims usually involve situations when the lawyer works for a small fee, has no written retainer agreement with a particular client, and the mortgage involves abusive lending practices. Abusive practices include:

- Liar loans – the borrower has no income and no assets;
- Adjustable mortgages with unrealistically high interest adjustments;
- High cost predatory loans that include huge balloon payments;
- Negative amortization loans;
- Home savors – distressed home loan advisors pay off first loan and then saddle the borrower with a high cost worse loan or take title to the home with a promise to return often dishonored; and
- Flip cases – when a home is sold back and forth between related parties inflating the price of the home until the last seller skips town.

Adding to these risks for real estate lawyers are that:

- Many courts are relaxing privity malpractice requirements making it easier for third parties to make a claim against lawyers no matter how innocently involved in an allegation of abusive lending practices;
- Fraud claims are now easier to assert; and
- Judges are much less sympathetic to lawyers as shown by the difficulty that defense counsel are having in obtaining dismissal from a suit on the basis that the lawyer was an innocent participant in a closing.

On a final grim note it was observed that many claims include both a negligence and fraud allegation. If the lawyer successfully gets the negligence claim dismissed, this still leaves the fraud claim which is not covered by a lawyers liability insurance policy other than a possible duty to defend.

The Elevated Risks Associated with Insolvent Clients

The first elevated risk stressed in this topic was that lawyers in these times regardless of the nature of a representation must be sensitive to the financial status of all clients – not just in terms of whether fees will be paid or when the matter con-

cerns financial problems. For example, lawyers routinely advise businesses in the regular course of business, represent corporations and their subsidiaries, and are often asked by clients to advise on estate plans that shield assets. These ordinary lawyer activities can incur substantial new risks if the client's financial status is problematic. For example:

- The business client suddenly facing insolvency greatly increases a lawyer's duties to competently advise on financial issues over and above the regular course of business. If the lawyer lacks expertise in insolvency and bankruptcy law, the risk of malpractice is substantial.
- When a subsidiary of a corporate client turns insolvent, a lawyer representing the entire corporation may have a conflict of interest. Failure to resolve the conflict can lead to allegations of malpractice and bar complaints.
- Estate planning lawyers must be cautious with clients asking for what is cynically called a "felicitously timed estate plan." If insolvency is imminent or litigation in the offing, an unsuspecting lawyer risks becoming embroiled in allegations of fraud and violation of bankruptcy law.

The panelists⁴ then highlighted "The Unique Perils of Representing Parties in Bankruptcy." What follows is an outline of the major risks covered in the hope this is useful in identifying issues for further research.

- Certification by attorney – the signature of a debtor's lawyer certifies that a bankruptcy filing is not an abuse.
- Mandatory advice – bankruptcy law requires that a client be given certain advice.
- Major bankruptcy deadlines in unlikely places – *e.g.*, filing proof of claims; real estate lease assumptions; deadlines for filing Plans of Reorganization.
- Risks of collusion with other bidders in bankruptcy auctions.
- Jurisdictional risks – filing proof of a claim may give unwanted jurisdiction to the bankruptcy court over counterclaims brought by the debtor.
- Violations of Automatic Stay.
- Transfers and Consequences – voidable preferences; fraudulent transfers; fees paid by the wrong entity; "asset planning"; attorney holding funds; and violation of security agreements.
- Potential plaintiffs are increasing in number:
 1. Debtor in-Possession – 11U.S.C. §1107
 2. Chapter 7 Trustee – 11 U.S.C. §§701-2
 3. Chapter 11 Trustee – 11U.S.C. §1104
 4. Creditors' Committee
 5. Chapter 11 Plan Trustee or Administrator – 11U.S.C. §1123(b)(3)
 6. Individual creditors
 7. State Receivers

Space limitations do not permit more detail, but the ABA kindly granted permission to post the materials the panelists prepared for this program on Lawyers Mutual's Website. It is an outstanding review of the malpractice risks of practicing

bankruptcy law and highly recommended professional reading for all lawyers. Go to www.lmick.com, click on Risk Management, Subject Index, and look for the article *The Elevated Risks Associated with Insolvent Clients* under Bankruptcy.

One of the first risks emphasized at the conference was that hard economic times tempt lawyers to accept matters outside their competence. With more clients and potential clients facing insolvency there is a temptation to dabble in bankruptcy. If you are not a well-qualified bankruptcy lawyer, do not give in to this temptation unless you are prepared to make the intense effort required to competently represent your client. If a current client needs advice on insolvency, do not hesitate to associate with a lawyer with bankruptcy law experience. Overcome your fear that you will lose the client. The pitfalls of bankruptcy law are just too great for on-the-job training.

Coping with a Claim

The conference topic "Preparing a Lawyer to Survive Being a Defendant"⁵ began by emphasizing that the role reversal of a lawyer being a defendant instead of the lawyer in-charge is emotionally destabilizing leading to what is called "Litigation Stress Syndrome." Dr. Ronald Hofeldt explained this syndrome as follows:

"A suit, which is a source of stress unlike any other, has far-reaching ramifications. The allegations often generate feelings of outrage and embarrassment. The time-line for the litigation process is unpredictable and the outcome uncertain. A wide range of symptoms is commonly seen in litigants. These include self-doubt, anxiety, depression, anger, withdrawal and loss of confidence. This reaction is called Litigation Stress Syndrome. If unrecognized or unaddressed, the defendant's inability to manage the demands of litigation may adversely impact the outcome of the case and leave a permanent professional scar."⁶

In conjunction with the discussion of how to deal with the stress a lawyer encounters when sued for malpractice, panelist Robert Baker offered this advice when defending the lawyer:

- Meet personally with your lawyer client and ask the client to bring the underlying file.
- Impress upon the lawyer client that this litigation must be taken seriously as it can have ramifications beyond the lawsuit, *i.e.*, insurance, state bar, etc.
- The lawyer client must study the file, not just read it. Encourage the lawyer client to make notes when studying the file, *i.e.*, why certain decisions were made, was a mistake made? If so, was the lawyer's client informed of the mistake?
- Think about what went wrong – what could have been done to alleviate the error, if there was an error or mistake.
- What was the lawyer's relationship with the client? Did it go sour? When and why did it go sour?
- Is a billing issue involved? What, if anything, was done

to correct it?

- Standard of care issues. Discuss with the lawyer client. In four of five legal malpractice cases, the standard of care is the main issue. Was it met? If not, why not?
- Causation. Was the lawyer's client harmed by the act or omission? The client must show that the loss suffered was in fact caused by the alleged attorney malpractice.⁷

This program brought to mind an article I wrote several years ago "So, You've Been Accused Of Legal Malpractice? – Well, Don't Just Do Something – Sit There!"⁸ The purpose of the article was to provide a calm and cool systematic method of managing a malpractice claim as it develops. The point of the article was not to let Litigation Stress Syndrome undermine a professional response to the problem. Instinctively, the first reaction of many lawyers accused of malpractice is to do something – anything – fast. Following an instinct for self-preservation by moving fast could be exactly what not to do. The best practice is to proceed with all due deliberate speed to meet professional responsibilities and protect your own interest when facing a malpractice claim. What follows is an update of that article's analysis of how to manage a malpractice claim.

The Four Phases of Risk Managing a Malpractice Claim

While the development of a malpractice claim follows no set sequence, the process is divisible into four phases:

- Discovery of the malpractice;
- Notification to client and insurance company;
- Claims repair; and
- Adjudication.

The risk management considerations of each phase are:

Phase I: Discovery of the Malpractice

When a lawyer is served with a complaint claiming malpractice or receives a demand letter for money because of malpractice, it is obvious that prompt action is required concerning the matter, the client, and the firm's professional liability insurance company. Less obvious is what to do when a lawyer learns that something may have gone wrong in a representation that has the potential to become a malpractice claim (usually referred to as an "incident"), but either has not been discovered by the client or has not yet resulted in damage to the client. At this discovery phase of the development of a malpractice claim these risk management considerations apply:

1. Formal written instructions concerning incidents and claims and how to report them internally should be part of every firm's standing operating procedure. Lawyers and staff must be thoroughly trained to be on the alert for potential malpractice and how and to whom to report malpractice issues of any kind.
2. There is a strong tendency for an accused lawyer to overreact upon first learning of an incident or claim. It is critical to

appreciate that while malpractice is an urgent matter, there is virtually always reasonable time available to carefully and deliberately assess the situation before taking any action at all. The accused lawyer should immediately discuss the merits of the matter with another lawyer in the firm (*e.g.*, designated loss prevention partner) or, if a sole practitioner, informally with a trusted lawyer friend as a matter of professional courtesy. The matter must be addressed objectively with a realistic assessment of the malpractice exposure without making premature admissions or retaining defense counsel without coordinating with the firm's malpractice insurance company.⁹ This assessment should cover:

- Is it clear that negligence occurred?
- Can the problem be repaired or minimized?
- What is the maximum liability exposure?
- What caused the problem?
- Is a tolling agreement appropriate to allow more time to properly evaluate and resolve the situation?

3. Simple cases of misunderstanding when, in fact, no malpractice is involved are usually resolved by consultation between the lawyer and the client. If, however, more is involved, the accused lawyer should proceed according to the considerations discussed in the following Notification Phase.

4. It is important to appreciate that from the moment a malpractice claim arises until it is resolved, enormous stress is placed on a firm or sole practitioner. Administrative steps must be taken to preserve the client file in its current posture and to separately maintain records concerning the malpractice issue. The accused attorney is mentally distracted from normal work as well as deeply involved in time-consuming work on the malpractice claim. In partnerships other lawyers use considerable time in working with the problem. Contemplation of cost in terms of lost time, defense cost, insurance deductible amounts, and indemnity all in the context of the uncertainty of the litigation process is demoralizing for a protracted period of time. Sole practitioners and firm partners must make an extraordinary effort from the outset to control the human cost of a malpractice claim as well as the economic cost if the law practice is to come out of this crisis in a healthy state.

Phase II: Notification to Client and Insurance Company

Once satisfied a matter involves a genuine issue of malpractice, consideration must be given to the professional responsibility of the lawyer to notify the client and the procedure for invoking the firm's professional liability insurance coverage. Key considerations are:

1. Under the Kentucky Rules of Professional Conduct a lawyer is required to "keep a client reasonably informed about the status of a matter and promptly comply with reasonable requests for information."¹⁰ Patently, a question of malpractice is a matter that must be promptly brought to a client's attention. This may be done by telephone or letter,

but the preferred procedure is a personal meeting with the client followed with a letter. Two complete files should be made – one for the firm and one for the client at the appropriate time. It may be prudent to have another lawyer from the firm along with the errant lawyer when the client is advised of the problem. It is imperative that no representation be made to the client that the firm's malpractice insurance will cover the claim. While candor is required when first notifying a client of an apparent error, admissions against interest concerning details of the error or value of the claim should not be made. It is best not to apologize when informing a client about a malpractice issue beyond saying "I'm sorry this happened." An apology that overtly or indirectly concedes error will be introduced at trial if the situation goes that far. There usually should be no attempt at this juncture to settle the claim.

2. Although there is no requirement to notify the insurance company before notifying the client, it is best to do so. Using the insurance company's claims counsel as a resource in analyzing the merits of suspected malpractice and how best to inform the client is highly beneficial. Bar-related companies like Lawyers Mutual uniformly encourage early reporting by insured lawyers for the very purpose of helping in assessing the merits of a claim, assisting in notifying the client, and having the earliest possible opportunity to conduct claims repair.

3. Too many lawyers delay too long in reporting claims or incidents to their insurance company for fear of increased insurance cost or from simple denial of the problem. To appreciate the danger in delayed reporting it is crucial to understand that the standard lawyers professional liability policy is a one-year in duration, "claims made" policy. Claims made means that the policy in effect at the time the malpractice claim against the lawyer is first made and reported covers that claim. If a lawyer fails to report the claim to the insurance company while that policy is still in effect, insurance coverage for that claim is lost at policy expiration even if the policy is renewed. For example, one firm failed to report during the one-year period of their policy a claim even though three lawyers in the firm had received early in the policy year "Notice of Claim" letters for malpractice from the Federal Deposit Insurance Corporation (FDIC). This claim was not reported until the following year after the policy had expired and been renewed without the firm risking an increase in premium for the claim on the renewal policy. This was held to be a violation of the claims made policy terms and the firm thereby lost their insurance coverage for the FDIC claim.¹¹ The only way to assure compliance with the claims made feature of legal malpractice insurance policies and invoke coverage is to report claims and incidents promptly and always be mindful of when a current policy is due to expire.

4. All lawyers liability insurance policies contain provisions on when and how to report a claim or incident. While telephonic reports are useful for immediate assistance, claims typically must be reported in writing to invoke coverage. The

Internet offers an expeditious vehicle for prompt reporting. Usual requirements for written reports are:

- Names of claimants,
- Date the alleged error was discovered,
- Summary of the circumstances,
- Estimate of the potential liability,
- Copies of relevant documents, and
- The insured lawyer's views on defenses or claims repair that may be available.

A big advantage of this procedure for accused lawyers is that it requires them to carefully think through the problem at the outset of the claim that results in a rapid appreciation of the risk for lawyer and insurance company.

5. Insurance policies contain provisions requiring the cooperation of the insured lawyer and specific guidance on appointment of defense counsel. Insured lawyers should not retain defense counsel without prior coordination with their insurance company. Even if the insurance company denies coverage or issues a reservation of rights letter concerning some aspect of the claim, the insurance company may still have a duty to defend the claim. Independent counsel at the insured lawyer's own expense may be necessary to resolve reservation of rights and duty to defend issues if contested.

Phase III: Claims Repair

After a thorough assessment of the malpractice and proper notifications, every effort then should be made to cure the error, mitigate its effects or at least keep the problem from becoming larger. Specific claims repair actions are determined on a case-by-case basis, usually through the cooperative efforts of the accused lawyer, defense counsel, insurance company claims counsel and other interested parties. Some examples of effective claims repair are timely appeals, requests for reconsideration, alternative legal remedies for the client, discovery of the availability of other applicable insurance, negotiated cooperation of other parties mitigating the error and, on occasion, by condonation by loyal clients who have been otherwise treated professionally in the matter or over a period of many years.

Phase IV: Adjudication

The adjudication of a malpractice claim involves the same legal method as any other civil legal dispute. Claims are denied, negotiated settlements are reached, and contested lawsuits are conducted. As in other civil cases, alternative dispute resolution is an increasing method of adjudication. It is beyond the scope of this article to delve into the special considerations of malpractice claim adjudication such as use of expert testimony to establish the standard of care, the "case within the case" aspect of claims involving litigation errors, defenses such as the lawyer malpractice statute of limitations, and the unique tripartite relationship of insured lawyer, insurance company and defense counsel. Mallen and Smith's *Legal Malpractice* (2008 Ed.) includes Chapter 30, "Insurance Counsel" and Chapter 34,

“Litigation of the Legal Malpractice Action” that are highly recommended. What is important to appreciate is that in the adjudication phase of a malpractice claim the accused lawyer is a defendant and should behave as such. With professional reputation and pride at stake, along with a potentially large monetary loss, being a defendant in a malpractice action is easily the most difficult thing a lawyer faces in a legal career. These circumstances require strong support from the lawyer’s firm, family, defense lawyer, and insurance company.

Conclusion

The message of the ABA’s program *Lawyer Risk in a Struggling Economy* is that we are entering a time of enhanced risk for lawyers that threatens a substantial increase in malpractice claims. Risk managing your practice, to include a thorough understanding of your malpractice insurance claims reporting requirements, has never been more important. You may never face a claim, but if you do, spend some time when the unexpected happens to “just sit there” and carefully think through how to deal with one of the most difficult experiences you can have as a lawyer. I hope the systematic approach recommended in this article for managing the risk will aid you in that deliberation. ☺

ENDNOTES

1. ABA Fall 2008 National Legal Malpractice Conference, September 3-5, 2008 The Palace Hotel, San Francisco, CA.
2. Ward Bower, Altman Weil, Inc.; Anthony Davis, Hinshaw & Culbertson, New York, NY; William D. Henderson, Associate Professor of Law, Indiana University School of Law.
3. Panelists were Richard D. Hoffman, Nixon Peabody, San Francisco, CA; Colleen McNicholas, Zurich North

4. America, New York, NY; Lisa L. Shrewsberry, Traub, Lieberman Straus & Shrewsberry LLP, Hawthorne, NY.
5. William C. Saturley, Nelson, Kinder, Mosseau & Saturley, PC, Manchester, NH; Jo Beth Earl, Hanover Professionals; Richard Levine, Nelson, Kinder, Mosseau & Saturley, PC, Boston, MA.
6. Panelists were Robert C. Baker, Baker, Keener & Nahra LLP, Los Angeles, CA; Ronald L. Hofeldt, M.D., Psychiatrist Specializing in Litigation Support, Salem, OR; Bruce Lee Schafer, Oregon Professional Liability Fund, Lake Oswego, OR.
7. Conference Materials, *Litigation Support: Helping the Defendant Attorney Survive a Lawsuit*, page 43.
8. Conference Materials, *Steps in Preparing Your Attorney Client*, page 66.
9. *Kentucky Bench & Bar*, Vol. 58 No. 1, Winter 1994.
10. It is not unusual for a lawyer in an emotional state to erroneously notify a client of malpractice when, in fact, none had occurred. Sometimes the promise is made that insurance will cover any problem without the lawyer’s prior coordination with the firm’s insurance company. Promises like this usually impress the insurance company as a disingenuous ploy by the lawyer to save fees at the insurance company’s expense – a particularly bad way to start off a sensitive relationship. At the other end of the spectrum is the lawyer who casually gave the complaining client his insurance company’s 800 number. That’s asking for it from all sides!
11. *Kentucky Supreme Court Rule 3.130; Kentucky Rule of Professional Conduct 1.4, Communication.*
12. *National Union Fire Insurance Co. of Pittsburgh v. Baker & McKenzie*, 997 F.2d 305 (7th Cir. 1993). This case includes an analysis of the Claims Made feature of malpractice insurance policies. If you are unclear on how it applies, read this decision.

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