Legal Malpractice and Its Avoidance

Legal Malpractice
Enron’s Professional Intersection
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Chapter 28

LEGAL MALPRACTICE

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§ 28.1 Scope Note

This chapter addresses the legal concepts which define lawyers' professional liability. In order to avoid legal malpractice, practitioners must have heightened awareness of what constitutes such liability. After a study of the cases and the principles of professional responsibility and liability that are reflected in them, the practitioner and his firm should have this heightened awareness, allowing for the development of means by which legal malpractice and breach of fiduciary duty claims can be avoided. Throughout the text are suggestions and pointers on enhancing one's professional practice as well as claims avoidance, including at the end some helpful checklists\(^1\) and forms of retainer agreements\(^2\) and pleadings\(^3\).

The lawyer's relationship with his or her client is fiduciary in nature. The lawyer's fiduciary duties to the client fall into two basic groups, the duty of loyalty and the duty of care. The duty of loyalty\(^4\) is at

\[ \text{See infra, §§ 28.47—28.49.} \]

\[ \text{See infra, §§ 28.50—28.51.} \]

\[ \text{See infra, §§ 28.52—28.55.} \]

\[ \text{See infra, § 28.19.} \]
issue in cases involving disqualification for conflict of interest\(^5\) and misappropriation of client funds.\(^6\) The duty of care\(^7\) is the subject of cases involving a cause of action for legal malpractice, considered first in the text below. The cause of action for legal malpractice has three basic elements: conduct that violates the standard of care,\(^8\) causation,\(^9\) and damages.\(^10\) The malpractice plaintiff must of course prove these elements to obtain a judgment.

Several defenses reappear with some frequency in legal malpractice actions, including the argument that the plaintiff and defendant were not in privity and thus the lawyer had not been engaged to represent the non-client who has brought suit;\(^11\) the argument that the lawyer chose one of several reasonable choices that were available—the "lawyer's judgment rule;"\(^12\) and the Statute of Limitations. By statute effective September 4, 1996, the latter is now three years, having previously been six.\(^13\) It can be extended by the "continuous representation" doctrine which is borrowed from the "continuous treatment" doctrine in medical malpractice cases, delaying the commencement of the running of the statute until the lawyer-client relationship has ended,\(^14\) or by estoppel where the lawyer has concealed his or her malpractice.\(^15\) In addition, there is no apparent reason why traditional negligence defenses such as lack of foreseeability and supervening act could not apply in the appropriate factual settings.\(^16\) It should be noted that concealment of malpractice by a lawyer is generally not a separate cause of action from the malpractice cause of action itself.\(^17\) Whatever defenses are asserted, it is important that to the greatest extent possible, the positions taken should be consistent with the positions previously taken on behalf of the former client, who is now the plaintiff.\(^18\)

Several other avenues of liability exist for lawyers under New York law apart from a traditional cause of action for malpractice. These include liability for acts of independent contractors such as process servers,\(^19\) a statutory cause of action for treble damages under Judiciary Law § 487 for deceiving the court or another party,\(^20\) vicarious liability for partners' misdeeds,\(^21\) and liability for indemnity and contribution, which presents some issues different from regular malpractice claims.\(^22\)

6. See infra, § 28.22.
7. See infra, § 28.3.
8. See infra, §§ 28.4—28.7.
10. See infra, § 28.10.
11. See infra, § 28.11.
15. See infra, § 28.15.
16. See infra, § 28.16.
17. See infra, § 28.17.
19. See infra, § 28.23.
Disputes between lawyers and their clients over unpaid fees are a fertile source of malpractice claims and other problems for lawyers, but alternate dispute resolution ("ADR") can ameliorate these problems considerably. ADR, being a creature of contract, is usually provided for in a retainer agreement, and caution must be used in providing for ADR in such agreements, since they are given strict scrutiny by the courts. In particular, there should be disclosure to the client that an arbitration clause in a retainer agreement may waive the client’s right to later sue the lawyer for legal malpractice in court, since the arbitrators, by rendering an award on the lawyer’s fee claim, may negate a later finding that the lawyer committed any malpractice. Where fee disputes are litigated instead of resolved through ADR, statutory limitations may apply. The lawyer should also keep in mind the benefits of pursuing unpaid fees as a cause of action for "account stated," which can cut off various client defenses to the claim. However, a claim for unpaid fees is always subject to a standard of reasonableness. Since doing business as a partnership subjects the partners to vicarious liability for their partners’ acts, even intentional wrongful acts, the New York Legislature has created a new form in which law firms can do business, the Limited Liability Partnership ("LLP"). The advantages of this more protected form of doing business are discussed.

The traditional way that lawyers protect themselves from liability is through lawyers professional liability insurance, and the text discusses a number of important aspects of such insurance so the practitioner can be sensitive to the issues and avoid possible coverage problems. These include the "claims made" nature of the coverage; "tail" coverage to extend the protection after termination of a policy; what constitutes a claim and when it is considered to be "made" for purposes of policy coverage; the lawyer’s professional capacity to which the coverage applies, and various typical exclusions, limits, deductibles and defenses, the giving of notice, cancellation of the policy, and coverage for innocent partners when their "guilty" partners are denied coverage. The application for coverage is crucial, because any material misrepresentation thereon can give the insurer the right to rescind the policy.

23. See infra, § 28.27.
25. See infra, § 28.29.
27. See infra, § 28.31.
28. See infra, § 28.32.
29. See infra, § 28.33.
30. See infra, § 28.34. See Chapter 2 "Non-corporate Entities: Limited Liability Companies and Partnerships," supra.
31. See infra, § 28.35.
32. See infra, § 28.36.
33. See infra, § 28.37.
34. See infra, § 28.38.
35. See infra, § 28.39.
36. See infra, § 28.40.
37. See infra, § 28.41.
38. See infra, § 28.42.
39. See infra, § 28.43. See Chapter 31 "Insurance," infra. See also, Haig, et al., Commercial Litigation in New York State Courts (West 1996) Ch. 52 "Insurance."
Where the insurer puts its own interests ahead of those of its insureds, it can be held liable for "bad faith" under New York law.\textsuperscript{40} Special insurance problems are presented where a firm is going out of business, and insureds must exercise caution to maintain their coverage in such circumstances.\textsuperscript{41}

\section*{§ 28.2 Strategy}

Few lawyers specialize in legal professional liability litigation. Organization of the cases into a special discipline or subspecialty within the law has been rare. Yet the utility of doing so is great. By studying the elements of the causes of action, the defenses thereto, and the practical contexts in which claims arise, an overview is developed that the practitioner can incorporate into his or her practice and the firm's culture, so that reliable steps can be taken to avoid problems. Some of these steps include: documenting the lawyers' due diligence in transactional work; having appropriate diarizing systems in place so that clients' claims can be timely asserted and litigation deadlines met; articulating to clients why a particular option is being pursued or recommended and documenting the rationale; drafting clear retainer letters which do not mislead the client or unrealistically raise expectations; having appropriate systems in place to check for conflicts; following proper billing procedures and resolving fee disputes by mediation or arbitration; obtaining professional liability insurance and understanding what to do in relation to a malpractice claim by cooperating with the insurer and assigned defense counsel when a claim arises; and understanding what procedures and practices the firm should follow to supervise its partners and associates. Suggestions will be made, but they are only a starting point, for lawyers and firms are responsible, each of them, for analyzing their practices, ascertaining potential pitfalls, and instituting the appropriate procedures to avoid malpractice.

\section*{§ 28.3 The Duty of Care}

Malpractice generally refers to a breach of the professional standard of care owed by the attorney to his or her clients. A viable claim requires proof: (a) that the attorney failed to exercise ordinary skill and knowledge in representing the plaintiff (i.e., a breach of the duty of due care); (b) that the attorney's negligence was the proximate cause of the plaintiff's injury (i.e., that "but for" such negligence, the plaintiff would have had a favorable outcome in the underlying litigation); and (c) that the plaintiff suffered actual damages as the result of the attorney's negligence.\textsuperscript{1} As stated by one court, "[a] \textit{prima facie} case of legal

\begin{footnotesize}
\begin{enumerate}
\item Parmisani v. Grasso, 218 A.D.2d 870, 629 N.Y.S.2d 865 (3d Dept 1995); Lavanant v. General Accident Ins. Co., 212 A.D.2d
\end{enumerate}
\end{footnotesize}
malpractice requires a showing that the attorney failed to exercise that
degree of skill commonly exercised by an ordinary member of the legal
community, and that the client incurred damages as a direct result of the
attorney’s actions.” It will be noted that “due care” means just ordinary
care. An attorney would have to hold himself or herself out as an expert
or specialist in a particular area to be held to a higher standard.

In Zarin v. Reid & Priest, the Appellate Division, First Department,
held that in order to establish the elements of proximate cause and
actual damages in a legal malpractice case, the plaintiff must show that
“but for” the attorney’s negligence, what would have been a favorable
outcome was an unfavorable one. In this case, the test was said to be
“whether a proper defense would have altered the result of the prior
action.”

In order to establish the necessary causation, a claim for legal
malpractice committed in a litigation context requires, almost by defini-
tion, a “trial within a trial.” The plaintiff must, before a second jury and
judge, establish that he would have prevailed on his claim or defense in
the first trial; i.e., that “but for” the defendant lawyer’s malpractice the
underlying action would have resulted in a victory and not a loss. The
plaintiff must show that the inability to prevail on the valid claim or
defense he or she originally possessed was a direct result of the attor-
ney’s malpractice; in other words, that counsel’s violation of the mini-

450, 622 N.Y.S.2d 726 (1st Dep’t 1995);
Alva v. Hurley, Fox, Solig, Caprari & Kelle-
her, 156 Misc.2d 550, 593 N.Y.S.2d 728
(Sup.Ct., Rockland County, 1993); Luniew-
ski v. Zeitlin, 188 A.D.2d 642, 561 N.Y.S.2d
524 (2d Dep’t 1992); Zarin v. Reid & Priest,
184 A.D.2d 385, 585 N.Y.S.2d 379 (1st
Dep’t 1992); Mills v. Papas, 174 A.D.2d
790, 570 N.Y.S.2d 726 (3d Dep’t 1991); Ni-
tis v. Goldenthal, 128 A.D.2d 687, 513
N.Y.S.2d 186, 188 (2d Dep’t 1987); Fidel v.
Sullivan, 93 A.D.2d 964, 463 N.Y.S.2d 279
(3d Dep’t 1983); Mendoza v. Schlossman, 87
A.D.2d 605, 448 N.Y.S.2d 45 (2d Dep’t 1982);
Parksville Mobile Modular, Inc. v. Fabricant,
73 A.D.2d 595, 422 N.Y.S.2d 710
(2d Dep’t 1979).

See infra, § 28.48 for a drafting checklist
for a malpractice complaint, § 28.49 for a
drafting checklist for an answer to a mal-
practice complaint, §§ 28.52 and 28.53 for
sample complaints, and §§ 28.54 and 28.55
for sample answers.

2. Sohns v. Little Prince Productions,

3. Unlike some states, New York does
not formally recognize particular legal pro-
fessional specialties, except patent law and
admiralty.

4. 184 A.D.2d 385, 585 N.Y.S.2d 379
(1st Dep’t 1992). The underlying facts were
as follows. Zarin accumulated losses of
$3,435,000 while gambling on credit at a
casino in Atlantic City. After the casino
sued him to collect, he settled for $500,000.
Thereafter, the IRS issued a Notice of Defi-
cency claiming that Zarin had $3,435,000
in income in 1980 from “larceny by trick
and deception” and $2,935,000 in income in
1981 based upon his $500,000 settlement of
the $3,435,000 casino claim. After the law
firm, Reid & Priest, was unsuccessful in its
attempt to overturn the deficiency, Zarin
hired new counsel and moved for reconsider-
ation on the grounds of “insolvency,”
which motion was denied. However, on ap-
peal, the Third Circuit, without considering
his insolvency argument, reversed based
upon the arguments that had been ad-
vanced by Reid & Priest. Simultaneously
with the Third Circuit appeal, Zarin com-
menced an action against Reid & Priest for
malpractice and breach of fiduciary duty,
alleging that the firm had engaged in a
course of conduct designed to cover up its
negligence by failing to admit its error. The
Appellate Division, First Department, dis-
missed the complaint against the law firm.

5. 184 A.D.2d at 387, 585 N.Y.S.2d at
381 (citation omitted).
mally appropriate standard of care was the cause of the client’s loss of the claim or defense.

Persuasive proof of legal malpractice may frequently require expert testimony. In Greene v. Payne Wood & Littlejohn, the court expounded that a malpractice action ordinarily must involve a factual determination for a jury. Nevertheless, “expert testimony will be necessary to establish that the attorney breached a standard of professional care and skill,” and expert testimony will supplement that of lay witnesses to resolve the predominant issue of whether the defendant lawyer “made an honest mistake of judgment” in selecting one of a number of reasonable courses.

§ 28.4 The Duty of Care—Specific Acts—Erroneous Advice

A legal malpractice suit may be brought as a result of an attorney’s advice to a client rather than as a result of handling litigation for the client.1

The elements of a cause of action for an attorney’s erroneous advice are as follows: (1) in the context of the attorney-client relationship, (2) the attorney negligently (3) gave improper advice, (4) which was a proximate cause of the client’s doing of things he would not otherwise have done, (5) resulting in harm and damage to the client.2

In Cicorelli v. Capobianco,3 the defendant lawyer, in representing sophisticated real estate dealers, had advised them that they had no further obligations under a conditional contract for the sale of real property when in fact they were bound to diligently apply for rezoning and to pay taxes on the property. The lawyer asserted the clients’ own contributory negligence as a defense, and at trial the jury found that the clients were thirty-five percent responsible for their loss. The Appellate Division, Second Department, reversed, pointing out that the lawyer’s superior position, in effect, “canceled out” the clients’ own negligence:

8. See infra, § 28.12 for a discussion of the lawyer’s judgment rule.

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1. Werls v. Rumsey, 278 N.Y. 186, 15 N.E.2d 572 (1938) (the client had committed usury after relying on the lawyer’s erroneous advice that the mere obtaining of an estoppel agreement would cure the problem).

2. Marks Polarized Corp. v. Solinger & Gordon, 124 Misc.2d 266, 476 N.Y.S.2d 743 (Sup.Ct., Queens County, 1984) (allegations of the lawyers aiding and abetting a fraud by having issued certain opinion letters, allegedly without having properly investigated the relevant facts, which letters had allegedly supported and facilitated the independent fraudulent acts by others, were insufficient to allege the necessary causation element).

3. 89 A.D.2d 842, 453 N.Y.S.2d 21 (2d Dep’t 1982).
In this instance, neither client was an attorney and, as defendant [the attorney] himself testified, neither was better qualified than he to legally terminate the contract. Although plaintiffs were experienced real estate dealers, they sought to have defendant represent them in this transaction because of his superior knowledge of the legal issues involved. In light of defendant's erroneous advice, it would be improper to hold plaintiffs responsible for failing to apply for rezoning and for failing to pay taxes on the property.  

There are limits, however, to what the attorney is required to know. There is no cause of action for erroneous advice where the mistake is on a point that is not well settled in the law. As the court aptly stated in Gimbel v. Waldman:  

No attorney is bound to know all the law and he is therefore held not to be an insurer or a guarantor with respect to his judgment or advice and is not liable for every mistake that may occur in practice. "But, as the law is not an exact science there is no attainable degree of skill or excellence at which all differences of opinion or doubts in respect to questions of law are removed from the minds of lawyers and judges. Absolute certainty is not always possible." . . . Thus the rule generally accepted is that if the law on the subject is well and clearly defined, has existed and been published long enough to justify the belief that it was known to the profession, "then a disregard of such rule by an attorney at law renders him accountable for the losses caused by such negligence or want of skill; negligence, if knowing the rule, he disregarded it; want of skill, if he was ignorant of the rule."  

In Gimbel, the court dismissed the legal malpractice claim against the lawyer, as "the profusion of cases and diversified expressions on the subject [of the lawyer's advice] indicate that the point is not wholly free of doubt or from debate." This case is of considerable value in defending a legal malpractice claim grounded on a lawyer's allegedly erroneous advice.

The lawyer’s erroneous advice can be actionable even when it is not strictly legal advice. In the case of Papaioannou v. Lukas, 1 purchasers of a restaurant brought a professional liability claim against the attorney who had represented them in the purchase because he had permitted certain representations as to income and expenses to be stricken from the contract of sale for the restaurant. The court held that there were triable issues of material fact, not related to the representations, but involving the nature of the advice given to the buyers, the reasonable

4. 89 A.D.2d at 842, 453 N.Y.S.2d at 22.  
5. 193 Misc. 758, 84 N.Y.S.2d 888 (Sup. Ct., N.Y. County, 1948).  
6. 193 Misc.2d at 761, 84 N.Y.S.2d at 891 (citations omitted).  
7. Id.  
care exercised in the giving of such advice and whether it resulted in the injury to the plaintiffs.9

Generally, in the private sale of a business, it is the client, and not the attorney, who must, and usually does, make the decision either to go forward or to decline the deal. The Papaitoannou court arguably expanded the attorney’s responsibilities to negotiation strategy and business advice, beyond the attorney’s traditional legal role of preparing documents and advising the client as to the legal effect of the instruments drafted and the transactions contemplated.10

Library References:
West’s Key No. Digests, Executors and Administrators © 74.

§ 28.5 The Duty of Care—Specific Acts—Incompetent Tax Advice

Liability for malpractice in the giving of incompetent tax advice depends upon whether the client would ordinarily have incurred the tax liability or whether such liability is caused by, rather than merely deferred by, the lawyer’s erroneous advice. The issue is whether a client’s liability that proceeds from the client’s own nondelegable obligation to pay tax can ever be the basis of recovery in legal malpractice litigation.

In Yiouti Restaurant Inc. v. Sotiriou,1 the court held:

We agree with the Supreme Court that the plaintiff corporation was entitled to summary judgment on the issue of liability,... The defendant [attorney], who was retained by the plaintiff corporation to handle the purchase of a restaurant, concedes that he failed to give notice of the sale at least 10 days prior to the closing as required by Tax Law § 1141(c). Under this provision, the plaintiff could not have been held personally liable for the restaurant’s sales taxes if timely notice had been filed, or if the defendant had instructed the plaintiff to withhold sufficient funds from the seller for at least 90 days. The Supreme Court’s determination that defendant [attorney] was liable for legal malpractice in his representation of the plaintiff in the sale transaction was therefore proper.2

9. 170 A.D.2d at 289, 566 N.Y.S.2d at 17.
10. PRACTICE POINTER: In such contexts, the lawyer is advised not only to memorialize the advice given and the rationale for selecting the chosen course of action over other available options, but also to advise the client to consult a business or financial expert, to protect both the client and counsel. See also, Chapter 6 “Buying and Selling a Small Business,” supra.

§ 28.5

2. Id. at 744–745, 542 N.Y.S.2d at 768 (citations omitted).
The corporate purchaser, but for the attorney's errors, would not have had to pay the tax, and therefore the court held that the defendant was liable for malpractice.

_Youti_ is distinguishable from those cases where the malpractice plaintiff had tax liability that he would have had anyway without the incompetent advice. Those are cases in which the tax liability is and always has been that of the taxpayer-client, who only incurs tax penalties as a result of the lawyer's erroneous advice. The rationale of these cases is that a taxpayer cannot shift a tax liability that is his or hers from the outset. Note that the taxpayer-client should also properly owe any interest on the delayed tax liability, as the taxpayer-client has had the use of the funds during the period of delay in the payment of his or her taxes. The tax penalty imposed in _Youti_ differs in that it would not have been imposed except for the professional malpractice, as the tax itself was owed only because of the malpractice.

§ 28.6 The Duty of Care—Specific Acts—Proper Withdrawal

A legal malpractice claim may result from a situation where the attorney has withdrawn from a case without adequately protecting the client.

In _Hartwich v. American Transit Ins. Co._, a motorcyclist killed a pedestrian. The cyclist's insurer employed a certain law firm as its "in-house" counsel. This law firm, when it had cases outside of the metropolitan area, retained other law firms such as the third-party defendant in _Hartwich_. Due either to the failure of the in-house counsel or the third-party defendant, the plaintiff obtained a default judgment in the underlying action. After the default, neither firm appeared for the cyclist at the subsequent inquest on damages, and the court awarded the plaintiff substantial damages.

After these failures and the award of damages, the defendant cyclist assigned his claims to the injured plaintiff, who filed suit against the insurer on those claims for breach of contract, negligence and bad faith. The defendant insurer then brought a third-party claim against the outside counsel seeking indemnity or contribution on the grounds of breach of contract and professional malpractice.

The third-party defendant law firm moved for summary judgment, relying in part on a letter it had written to the defendant insurer advising that it would withdraw from the representation of the insured


unless the insurer responded immediately to the letter. In denying summary judgment, the court held that “serious questions of fact” were raised “as to the extent of [the] participation” of the third-party defendant law firm and “the effect of the attempt of [the law firm] to withdraw its representation by a mere letter.”

CPLR 321(b) clearly provides that the attorney of record may withdraw as counsel by filing with the clerk of the court a consent signed by the withdrawing attorney and acknowledged by the party being represented. Notice of such withdrawal must be given to all other parties. Alternatively, the withdrawing attorney may move for an order allowing withdrawal, on notice to the client and all other parties. In order to avoid a malpractice claim, an attorney should withdraw by one of these two methods prescribed by the CPLR, which balances the competing needs to protect both clients and their withdrawing counsel.

§ 28.7 The Duty of Care—Specific Acts—Detecting Fraud

In a case decided by the Appellate Division, First Department, attorneys were held to have no duty to detect fraud. In Schimenti v. Whitman & Ransom, the court stated:

This action for legal malpractice based upon defendant’s alleged failure, in representing plaintiff as subordinate lienor in several mortgage foreclosure proceedings, to investigate and discover claimed fraud and collusion by the borrower and the senior lienor bank, was properly dismissed on the ground that defendant had no reason to believe, at any relevant time, that such an investigation was necessary, and no duty, as the IAS court aptly explained, “to draw up a list of possible misuses of plaintiff’s money, and then unleash a team of investigators, lawyers, and accountants to see if any misuse theory held water.”

In affirming dismissal of the complaint, the court further pointed out that, even if there were such a duty, the malpractice claim would not be viable absent any showing that “but for” the attorneys’ breach of that duty, plaintiff would have prevailed in his fraud defense in the foreclosure proceedings.

§ 28.8 The Duty of Care—Causation

Notwithstanding sloppy practice or unethical conduct by the lawyer, a malpractice claim is not viable unless the sine qua non of loss
causation can be demonstrated. In Sherwood Group Inc. v. Dornbush, Mensch, Mandelstam & Silverman, the court required a showing of proximate cause and dismissed the lawsuit because market factors rather than legal advice had caused the loss. If damages are proximately caused, then the "but for" test is satisfied. Clearly, however, the damages claimed may not be too speculative to be recoverable.

Gewirtz v. Wenig is a case which demonstrates that there is a significant gap between true malpractice and disappointment. Disappointment can create the loss of a client relationship but not a legal malpractice cause of action. In Gewirtz, a personal injury plaintiff recovered a $1.3 million verdict against a virtually judgment-proof defendant. The jury also exonerated two "deep pocket" defendants who could have made the plaintiff whole for his injuries. During the underlying trial, the court stated for the record that the lawyer "did not provide effective assistance during the trial because of his lack of preparation and lack of understanding of the issues and the evidence which was a shock and affront to the Court and that it was an absolute misfortune for an individual with such injuries as sustained by [the plaintiff] to have been represented in the manner [the lawyer] represented him."

The plaintiff, urged on no doubt by his essentially empty victory and the trial judge's hostile remarks about his former trial attorney, brought suit, even though he had prevailed. The plaintiff claimed that his attorney, in his trial preparation, had not diligently discovered and presented evidence of the alcohol and marijuana use of a driver defendant of a second vehicle.

The court, in applying the principle of loss causation, held:

[Plaintiff] must sufficiently show that "but for" the defendants' alleged wrongs, the plaintiff would have prevailed against [the other defendants] in the personal injury action. As to the particular acts alleged, they must not have been mere errors of judgment and must have fallen below the ordinary and reasonable skill and knowledge commonly possessed by a member of the profession.

The plaintiff here did prevail in the personal injury action, albeit against only one defendant. However, none of the other plaintiffs prevailed over the other defendants either, despite the competent and skillful representation of their counsel.... It thus appears that plaintiff may now be seeking in this malpractice action to attack

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1. 191 A.D.2d 292, 594 N.Y.S.2d 766 (1st Dep't 1993). See Perry v. Klein, 198 A.D.2d 576, 603 N.Y.S.2d 227, 228 (3d Dep't 1993) ("Even assuming, arguendo, that all the ... acts/omissions fall below the degree of skill exercised by an ordinary member of the legal community, in our view none are a proximate cause of plaintiff's damages as a matter of law").
4. Id.
indirectly the negative jury verdicts ... and the order of the trial judge refusing to set them aside because, as found by the trial judge, the plaintiff had a full and fair chance to explore all theories of liability and put them before the jury.... The plaintiff's case was weak as to causation....

While the court sympathizes with plaintiff that he may never realize the entire $1.3 million verdict he won at trial because the award was won against the only defendant who was virtually judgment proof ... in the circumstances of this case the court must conclude that plaintiff has not sufficiently demonstrated that "but for" the alleged errors of his trial counsel he would have recovered a verdict against the [other defendants].

The court, in granting summary judgment to the defendant lawyer, did not address the questionable propriety of the prior trial judge's hostile remarks.

A 1992 Court of Appeals decision, Prudential Ins. Co. v. Dewey Ballantine Bushby Palmer & Wood, also reinforces the concept that loss causation is the key element in determining professional liability. It entails tracing the flow of information developed or opined upon by the lawyer and determining whether, in fact, his error or omission caused the loss sued upon. Invariably, where there is a contract of engagement or a specific undertaking of the lawyer to a particular person or class to furnish such information or evaluation, what settles the issue of liability is whether the lawyer's error or omission in the given context is causative of loss.

In Prudential, the defendant law firm, at the specific direction of U.S. Lines, drafted and delivered an opinion letter to Prudential which contained an assurance that certain mortgage documents that were to be recorded in connection with the debt restructuring prepared by other counsel represented "legal, valid and binding" obligations of U.S. Lines and that neither federal nor state law would interfere "with the practical realization of the benefits of the security intended to be provided" by the documents. Prudential ultimately accepted the law firm's opinion letter as satisfactory and permitted the recording of the mortgage documents. Prudential later learned that one of the recorded documents erroneously stated the outstanding balance of the first preferred fleet mortgage securing the debt as $92,885, rather than the correct sum of $92,885,000. As a result, Prudential suffered significant losses when U.S. Lines subsequently filed for bankruptcy. Prudential thereafter sued the law firm, contending that its opinion letter had falsely assured Prudential that the mortgage documents in question would fully protect its existing $92,885,000 security interest. Although Prudential acknowledged that it was not actually in privity with the law firm, it nevertheless contended

5. Id. at 23 (emphasis added).
that the relationship between them was sufficiently close so as to support a cause of action in negligence.\(^7\)

While the court found a possible basis for professional liability in the undertaking at the client's direction, liability could not be established due to the absence of causation. The court's reasoning on this point was as follows:

The opinion letter initially made clear that, in rendering its opinion, [the law firm] had relied in part upon certificates of certain public officials and corporate officers, and upon corporate documents and records, with respect to the accuracy of material factual matters which were not independently established. Then, with reference to the mortgage documents in issue, the letter simply stated that those documents represented "legal, valid and binding" obligations of U.S. Lines, which, when recorded, would be enforceable against it "in accordance with [their] respective terms," whatever those terms might be. No specific dollar amount was assured.\(^8\)

Thus, a duty of care was owed but "the facts [did] not prove a breach of that duty."\(^9\) In other words, the basis for possible liability existed, but liability did not follow because causation could not be established. Accordingly, the court affirmed the appellate division's affirmance of dismissal of the action against the law firm.

Obviously, where it is demonstrated that the unfavorable outcome in the prior case was the direct result of the malpractice plaintiff's own actions, the "but for" test is not satisfied and legal malpractice is not established.\(^10\) If the evidence does not demonstrate causation, malpractice does not exist.

§ 28.9 The Duty of Care—Causation—The Doctrine of Compelled Settlement

Illustrating the importance of the causation element for legal malpractice is the so-called "doctrine of compelled settlement." In order to prove legal malpractice, the plaintiff must show the element of causation, i.e., that "but for" the defendant attorney's malpractice, a more beneficial result would have occurred for the client.

Prior to 1977, the strict rule of causation in New York permitted recovery on a legal malpractice claim only in cases where the plaintiff had lost his claim or defense in the first case, which was litigated to conclusion.\(^1\) Thereafter, an exception to the strict rule of causation was developed called the "compelled settlement doctrine."

7. 80 N.Y.2d at 380-381, 590 N.Y.S.2d at 832-833. With respect to the privity issue see infra, § 28.11.
8. 80 N.Y.2d at 386, 590 N.Y.S.2d at 836.
9. Id.

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The compelled settlement doctrine recognizes that plaintiffs in legal malpractice cases should have been entitled to assess the risks and costs of ongoing litigation in the underlying matter and settle that matter when appropriate under the circumstances, mitigating their damages without destroying their subsequent legal malpractice claim. It has been argued that the doctrine spawns malpractice litigation and has a high susceptibility to abuse. In a not far-fetched scenario, while the original litigation is continuing, new counsel enters the case behind the scenes before the first counsel withdraws or is discharged, makes an assessment of the status of the litigation, and advises the client to settle or drop the case and then proceed against the most collectible recovery source, the first lawyer’s professional liability insurance policy.

At times, the exception has been referred to as the “coerced” settlement doctrine, although economic pressures, which are present throughout all litigation, very rarely amount to genuine duress, and the “compelled” settlement is always, in fact, a voluntary, knowing act by the settling client. The real issue is why the client chose to settle.

A review of the cases is useful in understanding the doctrine. N.A. Kerson Co. v. Shayne, Dachs, Weiss, Kolbrenner, Levy and Moe Levine, followed the original pre-1977 rule that the clients could not sue their former lawyers for legal malpractice based upon the mistakes of that counsel prior to a settlement. Such errors were not actionable because the settlement by its terms had terminated the underlying litigation, eliminating proof of causation—i.e., that the errors had caused the client’s monetary loss. The court held that the legal malpractice litigation was “merely a collateral means of attacking a stipulation of settlement which has already withstood direct attack.” However, in a concurring opinion, Justice Suozzi planted the seed of the compelled settlement doctrine. While agreeing with the majority that the settlement was valid, Justice Suozzi rejected the proposition that it constituted an “automatic waiver” of a malpractice claim, articulating that “an action . . . for legal malpractice must stand or fall on its merits.”

Justice Suozzi’s dicta precipitated a further elaboration by Justice Greenfield in Becker v. Julien, Blitz & Schlesinger, P.C. and the

4. 59 A.D.2d at 551, 397 N.Y.S.2d at 143. During the trial of the prior mortgage foreclosure action, the parties and their attorneys had entered into a stipulation of settlement which was dictated on the record in open court in the presence of the trial judge and had been questioned by the judge, who had confirmed that the parties understood the terms of the stipulation of settlement and were entering into it voluntarily. Subsequently, the malpractice plaintiff claimed that its former counsel had misrepresented certain facts to the trial judge during the settlement negotiations in chambers, which had caused the plaintiff to settle the case.
5. 59 A.D.2d at 553, 397 N.Y.S.2d at 144.
creation of the compelled settlement doctrine. The underlying suit had been an action in the U. S. District Court for the Southern District of New York for commissions against a corporate defendant. The case was settled for $45,000 plus sums previously received of $64,000. In the subsequent malpractice action, however, the plaintiff contended that his agreement to the settlement "had been coerced and that had it not been for the malpractice of the defendants in their handling of his case, he would have recovered $5,000,000." The defendant lawyers countered that the plaintiff's voluntary settlement constituted a bar to a subsequent legal malpractice claim. The court, however, held to the contrary, reasoning as follows:

The fact that the ... case has been irrevocably terminated does not, in and of itself, preclude a malpractice claim ... In many, if not most instances involving an alleged malpractice by attorneys, the underlying litigation has been terminated—by allowing the Statute of Limitations to lapse, by suffering a default or dismissal and the like. Often it is the very fact of termination of the action which gives rise to the claim for malpractice. Where the termination is by settlement rather than by dismissal or adverse judgment, malpractice by the attorney is more difficult to establish, but a cause of action can be made out if it is shown that assent by the client to the settlement was compelled because prior misfeasance or nonfeasance by the attorneys left no other recourse.8

Having articulated the existence of the exception, however, the court nonetheless found it inapplicable. "When informed further as to the prospects of losing the case altogether, plaintiff thereafter accepted the offer [and] that does not spell out a case of coercion ... Recognition of the inevitable is not tantamount to duress." The Becker case, as with several others, thus states the proposition but does not clearly delineate its application to particular facts.16

7. Id. at 65, 406 N.Y.S.2d at 413.
8. Id. at 66, 406 N.Y.S.2d at 413-414 (emphasis added).
9. Id. at 67, 406 N.Y.S.2d at 414.
10. See, e.g., Bernstein v. Oppenheim & Co., 160 A.D.2d 428, 554 N.Y.S.2d 487 (1st Dep't 1990) (language in the case reciting what has come to be known as the "lawyer's judgment rule" effectively undermined application of the compelled settlement doctrine); Wolstenroof v. Sassower, 124 A.D.2d 582, 507 N.Y.S.2d 728 (2d Dep't 1986) ("the claim is viable despite the plaintiff's settlement of the underlying matrimonial action because it is alleged that the settlement of that action was effectively compelled by the mistakes of the defendant, the plaintiff's former counsel"); Cohen v. Lipsig, 92 A.D.2d 536, 459 N.Y.S.2d 98 (2d Dep't 1983) (the court held sufficient the malpractice plaintiff's claims of counsel's poor selection of trial counsel in a personal injury case, the trial counsel's inadequate preparation and conduct at trial, the absence of informed consent to the retention of trial counsel, and the failure to obtain records of special damages for a twelve year period prior to trial counsel's retention; although the compelled settlement doctrine was stated, nowhere did the court express its reasoning why plaintiff's settlement of the underlying action was compelled because of the mistakes of the defendant, the plaintiff's former counsel).
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The best case demonstrating that coercion or compulsion in fact rarely plays a part in the way cases are settled is Broad v. Conway.11 The plaintiffs claimed that they had previously been “forced” to settle the underlying action. However, the district judge’s examination of the record of the underlying action showed that the prior district judge, after the plaintiffs had expressed dissatisfaction with their counsel in his chambers, had specifically questioned them, on the record and in open court, as to whether influence or coercion had been exerted upon them in any way to cause their assent to settlement. Upon their negative response, the prior court had dictated the terms of the settlement into the record. The plaintiffs were thereby properly estopped from raising the issue of whether they had been coerced into settling the underlying case. In fact, the judge in the malpractice case noted that the plaintiffs had been actively involved in the negotiations while the settlement was being placed on the record and that the prior judge had given them ample time to discharge their counsel and retain new counsel.12

§ 28.10  The Duty of Care—Damages

In a legal malpractice case, one of the elements a plaintiff must prove is actual damages, even though occasionally the extent of the loss is not fully apparent at the time the malpractice was committed because the underlying case has been cut short. In Alva v. Hurley, Fox, Selig, Caprari & Kelleher,1 the court expressed the legal malpractice elements as follows:

An action for legal malpractice requires proof of three essential elements: (1) the negligence of the attorney; (2) that the negligence was a proximate cause of the loss sustained; and (3) proof of actual damages.... New York generally subscribes to the view that the value of the underlying (usually lost) claim is the measure of damage in a legal malpractice action.2

Recovery against the attorney is only allowed to the extent the underlying judgment would have been collectable.3 The court also held that the malpractice defendants were not precluded from presenting evidence showing mitigation of the plaintiff’s damages.


12. PRACTICE POINTER: Claims can be avoided in this context if lawyers fully discuss with their clients the options during the course of representation, discuss the advantages and disadvantages of settlement, specifically including factors such as probable litigation costs and risk of loss, and memorialize the pertinent facts and issues to eliminate second-guessing by subsequent counsel. Where the client makes an informed judgment on the settlement of the case and the reasons are documented, it is hard to see how the compelled settlement doctrine can be successfully applied in a subsequent legal malpractice suit.

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1. 156 Misc.2d 550, 593 N.Y.S.2d 728 (Sup.Ct., Rockland County, 1993).

2. Id. at 553, 593 N.Y.S.2d at 730 (citation omitted).

3. Id. at 553, 593 N.Y.S.2d at 730.
A plaintiff cannot recover speculative lost profits. In Brown v. Samalin & Bock, P.C., the plaintiff sued his former lawyer, claiming that as a result of the lawyer’s inadequate handling of a real estate matter on his behalf, he could not enforce a contract for the purchase of property, subdivide it, and realize an investment profit. The Second Department, accentuating the disfavored nature of the legal malpractice remedy, held that the lower court had properly granted summary judgment on the lost profits cause of action, since, as a matter of law, it was too speculative to support a recovery.

Further, in a legal malpractice case in New York, no recovery is allowed for emotional distress. In Green v. Leibowitz, an action for legal malpractice, the court dismissed a cause of action for intentional infliction of emotional distress. The court a fortiori also pointed out that a cause of action for negligent infliction of emotional distress does not lie in a legal malpractice action.

5. 168 A.D.2d at 532, 563 N.Y.S.2d at 427.
6. The standard for establishing intentional infliction of emotional distress is set forth in Fischer v. Maloney, 43 N.Y.2d 553, 402 N.Y.S.2d 991, 373 N.E.2d 1215 (1978) ("liability has been found only where the conduct has been so outrageous in character and so extreme in degree, as to go beyond all possible bounds of decency, and to be regarded as atrocious, and utterly intolerable in a civilized community").
8. The court held:

As a broad principle, recovery may be had for the intentional infliction of emotional distress where one who, without just cause or excuse, and beyond all bounds of decency, purposely causes a disturbance of another’s mental and emotional tranquility of so acute a nature that harmful physical consequences might be not unlikely to result... even though no demonstrable physical consequences actually ensue... The gravamen of a cause of action for the intentional infliction of emotional distress is that the conduct complained of is especially calculated to cause, and does cause, mental distress of a very serious kind... The conduct complained of in the case at bar, viz., intentional misrepresentations concerning the status and filing of the plaintiff’s disability claim, does not rise to a level of extreme outrage, nor does it exceed all bounds usually tolerated by decent society... Nor can the plaintiff’s factual allegations support a claim that the defendants’ conduct was especially calculated to cause emotional distress.

118 A.D.2d at 756, 500 N.Y.S.2d at 148. (emphasis added) (citations omitted).
9. 118 A.D.2d at 757, 500 N.Y.S.2d at 148 (rejecting the plaintiff’s contention that recovery may be had for the negligent infliction of emotional distress whenever a direct duty to the plaintiff is owed and a breach of that duty results in emotional injury; while, in New York, physical injury is no longer a necessary element of a cause of action to recover damages for negligent infliction of emotional distress, nevertheless, courts have never recognized a cause of action as broad as that asserted by the plaintiff, which would encompass the ordinary case of legal malpractice; while physical injury is no longer a necessary element, the cause of action must, nevertheless, be premised upon a breach of duty which unreasonably endangers the plaintiff’s physical safety). See also, De Rossa v. Michelman, 184 A.D.2d 490, 584 N.Y.S.2d 202 (2d Dep't 1992) (legal malpractice action); Lancellotti v. Howard, 155 A.D.2d 588, 547 N.Y.S.2d 654 (2d Dep't 1989) (medical malpractice action).
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Damages for pain and suffering are likewise not recoverable, as such damages are not in issue unless there has been a physical injury.\textsuperscript{10} Nor is an award of punitive damages allowable in a legal malpractice action where the conduct does not “transcend mere carelessness” and no evidence is provided showing that the attorney’s motive was “malicious, intentional or reckless.”\textsuperscript{11} For such an award to be made, there must be a showing that the defendant attorney acted with “an evil or wrongful motive or with a willful and intentional misdoing, or with a reckless indifference equivalent thereto.”\textsuperscript{12}

§ 28.11 The Duty of Care—Defenses—The Privity Rule

The traditional strict privity rule in New York has been that an attorney is not liable to third parties, not in privity, for harm caused by professional negligence. \textit{Deeb v. Johnson}\textsuperscript{1} addresses the traditional strict privity rule as it applies to legal malpractice cases. In \textit{Deeb}, co-executors of an estate sued to recover an increased tax liability of more than $59,000 from the defendant lawyer based on his alleged faulty drafting of a marital deduction provision in the decedent’s will. The Third Department sustained a dismissal of the complaint, holding:

The firmly established rule in this State is that, “absent fraud, collusion, malicious acts or other special circumstances, an attorney is not liable to third parties, not in privity, for harm caused by professional negligence.” ... While we recognize that a limited exception to the privity rule has been carved out in the case of accountants, courts have “repeatedly and recently declined to enlarge the application of this exception to [other] professionals.”\textsuperscript{12}

Similarly, in \textit{Weiss v. Manfredi},\textsuperscript{3} the Court of Appeals dismissed a widow’s malpractice cause of action on behalf of her three minor children against her former attorneys, alleging their failure to preserve the children’s rights to certain settlement proceeds, due to lack of privity between those children and the defendant attorneys.

Until recent years, a strict privity requirement was uniformly upheld for legal malpractice matters,\textsuperscript{4} unlike cases involving certain other

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professionals such as accountants, where "near privity" has been held to suffice.\(^6\)

In 1992, in *Prudential Ins. Co. v. Dewey Ballantine Bushby Palmer & Wood*,\(^6\) the Court of Appeals extended the concept of "near privity" as developed in the accountants cases to apply to lawyers in the same factual setting, that of providing a formal opinion relied upon by a non-client, which setting the court characterized as a basis for a negligent misrepresentation claim\(^7\) (as opposed to a claim premised on negligent performance of services). The court stated that "[a]lthough the defendants in many of the prior cases addressing this issue have been accountants, there is no reason to arbitrarily limit the potentially liable defendants to that class of professional."\(^8\)

However, the court affirmed dismissal of the claim against the opining lawyers, holding that as a matter of law their opinion was simply not misleading and therefore not actionable. The "near privity" test was articulated as consisting of three critical criteria:

1. an awareness by the maker of the statement that it is to be used for a particular purpose;  
2. reliance by a known party on the not in privity with testator's attorney);  
Kramer v. Belf, 106 A.D.2d 615, 462 N.Y.S.2d 898 (2d Dep't 1984) (beneficiaries of will not in privity with executor's attorney);  
Levine v. Graphic Scanning Corp., 87 A.D.2d 755, 448 N.Y.S.2d 692 (1st Dep't 1982) (shareholder not in privity with special litigation counsel to corporation who rendered opinion regarding transfer of restricted stock);  
Cronin v. Scott, 78 A.D.2d 745, 432 N.Y.S.2d 656 (3d Dep't 1980) (plaintiffs not in privity with attorney for other party in commercial business transaction);  
Gifford v. Harley, 62 A.D.2d 5, 404 N.Y.S.2d 405 (3d Dep't 1978) (plaintiff not in privity with his litigation opponent's attorney);  
Joffe v. Rubenstein, 24 A.D.2d 752, 263 N.Y.S.2d 867 (1st Dep't 1965) (wife not in privity with husband's attorney);  
Quintel Corp. v. Citibank, 589 F.Supp. 1235 (S.D.N.Y.1984) (limited partners not in privity with attorneys for limited partnership);  
Stratton Group, Ltd. v. Spraygen, 466 F.Supp. 1180 (S.D.N.Y.1979) (directors and officers of corporation not in privity with corporation's attorneys);  
Jacobsen v. Overseas Tankship Corp., 11 F.R.D. 97 (E.D.N.Y.1950) (plaintiff not in privity with attorney for litigation opponent). See also, Calamari v. Grace, 98 A.D.2d 74, 469 N.Y.S.2d 942 (2d Dep't 1983) (title insurance case that surveys the privity cases for lawyers in *dicta*). The exceptional case is Baer v. Broder, 86 A.D.2d 881, 447 N.Y.S.2d 538 (2d Dep't 1982), in which a widow was allowed to sue an attorney for malpractice, even though she was not in privity with the attorney at the time of the alleged malpractice (a narrow exception, as explained in Calamari, *supra*).


8. 80 N.Y.2d at 381, 590 N.Y.S.2d at 833. The authors are aware of one earlier case where the concept of "near privity" was held sufficient to sustain a cause of action against attorneys who were not in actual privity with the pleader. Financial Guaranty Insurance Co. v. Drexel Burnham Lambert, Inc., N.Y.L.J., 4/12/90, Justice Pecora (unreported elsewhere).
statement in furtherance of that purpose; and (3) some conduct by
the maker of the statement linking it to the relying party and
evincing its understanding of that reliance.9

It would be wrong to presume, based upon this case, that the Court
of Appeals has torn down the "citadel of privity" for lawyers. Rather the
substitute "near privity" rule should be limited to cases factually similar
to Prudential Ins. Co. v. Dewey Ballantine Bushby Palmer & Wood,10
which involved the giving of an opinion to a non-client under circum-
stances meeting the three criteria listed above.

That the traditional strict privity requirement for legal malpractice
claims retains its full vigor in other settings is shown by post-Prudential
cases such as the Fourth Department's decision in Deni v. Air Niagara,11
where shareholders of a corporation were denied permission to amend
their complaint to name the lawyers representing the corporation and its
president, as those lawyers were not in privity with the plaintiff share-
holders.

It should be recalled that the foregoing privity concepts only apply
in cases where the attorney is accused of negligence; there is no such
privity constraint where the attorney is accused of fraud or intentional
tortious conduct.12 Also, an attorney who volunteers to perform certain
tasks for a non-client takes himself out of the privity rule, as he has at
that point undertaken a duty to the non-client and must not perform
that duty negligently.13

The privity rule was arguably stretched "to the limit," conceptually,
in Hirsch v. Weisman.14 Plaintiffs retained a law firm to represent them
in a personal injury action, and that firm in turn retained trial counsel
to try the case. At the outset of trial, trial counsel settled the case for
$80,000. Later, the plaintiffs sued the first law firm for malpractice,
alleging that the plaintiffs had settled too cheaply as they had believed
that the settling defendant had only $100,000 of liability insurance when

9. 80 N.Y.2d at 384, 590 N.Y.S.2d at 834–835.
Whitman & Ransom, 83 A.D.2d 862, 442 N.Y.S.2d 26 (2d Dep't 1981) (uncharacterized
intentional wrongful conduct); Cronin v. Scott, 78 A.D.2d 745, 432 N.Y.S.2d 656
(3d Dep't 1980) (commercial fraud); Drago v. Bucagurino, 61 A.D.2d 282, 402 N.Y.S.2d
250 (3d Dep't 1978), rev'd on other grounds 46 N.Y.2d 778, 413 N.Y.S.2d 910, 386
N.E.2d 821 (1978) (prima facie tort); Walter
v. Doe, 93 Misc.2d 286, 402 N.Y.S.2d 723
(Civ.Ct., N.Y. County, 1978) (wrongful restraining of bank account); Quintel Corp. v.
Citibank, 589 F.Supp. 1235 (S.D.N.Y.1984) (“fraud or collusion or a malicious or torti-
sious act”).
(Sup.Ct., Queens County, 1977) (borrower's attorney who volunteered to file
documents for lender to perfect lender's security interest, and then did so negligently,
therefore, had no lack of privity defense).
14. 189 A.D.2d 643, 592 N.Y.S.2d 337
(1st Dep't 1993).
that amount was, in fact, $500,000. The lower court allowed plaintiffs to amend to add trial counsel as a defendant.

The Appellate Division, First Department, in the midst of a confusing discussion of the Statute of Limitations, reversed on the basis that trial counsel was not in direct privity with the plaintiffs. This decision seems at least questionable, as trial counsel was certainly representing the plaintiffs' interests at the trial of the personal injury action. It is difficult to understand how the retention arrangements resulted in anything other than an attorney-client relationship between the plaintiffs and trial counsel, at least for purposes of the trial.

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§ 28.12 The Duty of Care—Defenses—Lawyer's Judgment Rule

Another critical defense to a legal malpractice claim is the lawyer's good faith exercise of discretionary judgment—the "lawyer's judgment rule." If the standard of care is not specifically defined and the lawyer exercises reasonable judgment throughout the representation, that attorney should not be held to have committed legal malpractice. The essence of this rule is that a lawyer, after adequate disclosure of material facts and risks, is protected from civil liability where he or she engages in a good faith exercise of discretionary judgment. Therefore, the lawyer's judgment and resulting conduct must be reasonable but not necessarily correct.

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1. PRACTICE POINTER: In order to ensure that juries will properly apply the lawyer's judgment rule, the following proposed jury instruction sets forth the guiding principles:

As I have stated, an attorney is liable to his or her client if the plaintiff proved that the attorney's conduct fell below the standard of ordinary and reasonable skill and knowledge commonly possessed by a member of the profession in that community under the same circumstances. Where, in his or her counseling, or in the action taken on behalf of his or her client, he or she disclosed to the client the material facts and risks that would have affected the client's interest, he or she is not liable for an honest mistake of judgment if the proper course was open to reasonable doubt. The selection of one among several reasonable courses of action does not constitute legal malpractice. The attorney is not held to be infallible.

In determining whether the attorney made adequate disclosure to the plaintiff and whether the attorney chose one of several reasonable courses of action, you may also consider whether the plaintiff met his or her responsibility to apprise the attorney of all the material facts known, or that with reasonable diligence should have been known by the plaintiff.

Where standards do not dictate the lawyer's course of action and there are a number of reasonable options, the lawyer's advice and conduct should not subject him or her to liability. Lawyers, therefore, should contemporaneously memorialize what they disclose to their clients about the risks for a course of action and the rationale for its pursuit. This should be done in a spirit of fairness and decency and not with an attitude to "paper the file" against the client, but to document and ensure the lawyer's due diligence, which is an essential for professional responsibility and avoidance of malpractice liability.
In Bernstein v. Oppenheim & Co., P.C., the Appellate Division, First Department, stated the lawyer's judgment rule as follows:

An attorney is liable in a malpractice action if it can be proved that his conduct fell below the ordinary and reasonable skill and knowledge commonly possessed by a member of the profession... However, an attorney is not held to the rule of infallibility and is not liable for an honest mistake of judgment where the proper course is open to reasonable doubt... Thus, "selection of one among several reasonable courses of action does not constitute malpractice."

The zone of discretionary judgment in a civil litigation context, where the required judgments are spontaneous and the standards are not well defined, was well articulated in Hanlin v. Mitchelson. In this case, the court addressed the issue of whether a trial lawyer in an arbitration proceeding negligently permitted the taking of evidence seemingly extraneous to the claims and defenses until a counterclaim was asserted in connection with a written submission at the end of the case. The court recognized the well settled principle that an attorney cannot be held liable for malpractice for discretion exercised during the course of litigation and further noted that:

In a litigation a lawyer is well warranted in taking chances. To some extent litigation is a game of chance. The conduct of a lawsuit involves questions of judgment and discretion as to which even the most distinguished members of the profession may differ. They often present subtle and doubtful questions of law. If in such cases a lawyer errs on a question not elementary or conclusively settled by authority, that error is one of judgment for which he is not liable. The court dismissed the complaint against the lawyer, pointing out that a client is responsible for his own failure to provide material information to the lawyer. It was undisputed that the lawyer had not learned of the evidence supporting the counterclaim, despite his adequate preparation, until it was elicited from a witness during the arbitration hearing. While an attorney does have the responsibility to investigate and prepare his

3. Id. 160 A.D.2d at 429, 554 N.Y.S.2d at 489 (emphasis added; citations omitted); see also, Brook Plaza Ophthalmology Associates, P.C. v. Fink, Weinberger, Fredman, Berman & Lowell, P.C., 173 A.D.2d 170, 569 N.Y.S.2d 25 (1st Dep't 1991) ("while other options may have been available to defendants, their choice of one of several reasonable alternatives certainly does not amount to malpractice").
5. Id. at 456. See Stroock & Stroock & Lavan v. Beltramini, 157 A.D.2d 590, 591, 550 N.Y.S.2d 337, 338 (1st Dep't 1990) (proceeding in court rather than in arbitration "at worst amounts to an error in professional judgment which does not rise to the level of malpractice"); accord, Parksville Mobile Modular, Inc. v. Fabricant, 73 A.D.2d 595, 600, 422 N.Y.S.2d 710, 717 (2d Dep't 1979) (it is well settled that an attorney may take chances, and "[i]f in such cases a lawyer errs on a question not elementary or conclusively settled by authority, that error is one of judgment for which he is not liable"). See also, Zarin v. Reid & Priest, 184 A.D.2d 385, 585 N.Y.S.2d 379 (1st Dep't 1992).
client's case, the court recognized that "an attorney should not be held liable for his ignorance due to a client's failure to apprise him of all of the facts."

The lawyer's judgment rule, while most often encountered in a civil litigation context, applies with equal force in criminal and regulatory matters. It arises in criminal matters where an inquiry is made to determine whether the accused received effective legal representation. In the course of a criminal trial or appeal, the lawyer is required to exercise judgment on an immediate basis. Time to consult and deliberate with the client is oftentimes not present. This is not to say that the lawyer is free to proceed in derogation of the client's communicated needs, wants or interests. In general, the attorney must consult with the client on fundamental issues of strategy and consider those stated needs and objectives. Regarding the zone of appropriate discretion, the rule in the context of criminal matters is as follows:

In the final analysis, the defense strategy of a lawyer is not independent of the client's wishes. While it is the responsibility of an attorney to provide the client with his or her best advice, that attorney must ultimately not only consult, but take into account the needs and desires of the client.

_Brook Plaza Ophthalmology Associates v. Fink_ illustrates the application of the lawyer's judgment rule in a regulatory setting. Here, the plaintiff medical corporation hired the defendant law firm to assist in filing an application with the New York State Department of Health ("DOH") to construct and operate a free-standing ambulatory surgical center ("ASC"). The filings were delayed, there were changes in the law, and DOH suggested that plaintiff's application would fare better if it were to seek approval for a multi-specialty facility. New filings were made and ultimately accepted, but not before the client discharged the defendant attorneys. The client then filed a lawsuit, claiming legal malpractice and breach of contract by the attorneys. The Appellate Division, First Department, held that the defendants were not negligent in their representation of the plaintiff, nor did they breach the retainer agreement. The defendant attorneys' conduct did not fall below the ordinary and reasonable skill and knowledge commonly possessed by other members of the profession. "While other options may have been

7. See People v. White, 73 N.Y.2d 468, 541 N.Y.S.2d 749, 539 N.E.2d 577 (1989), cert. denied White v. N.Y., 493 U.S. 859, 110 S.Ct. 170, 107 L.Ed.2d 127 (1989) ("a defendant having accepted the assistance of counsel, retains authority only over certain fundamental decisions regarding the case ... and an attorney is not necessarily guilty of ineffective assistance for failing to argue issues the client requests, even if hindsight shows that one of these issues would have been meritorious on appeal;") it is generally accepted that counsel should "winnow out weaker arguments on appeal and focus on one central issue if possible, or at most on a few key issues"").
available to defendants, their choice of one of several reasonable alternatives certainly does not amount to malpractice."

The doctrine only applies where the lawyer exercises discretion. In Canavan v. Steenburg, the court held that the real estate lawyer who failed to match the description in the deed to the survey map did not have discretion. The plaintiff's expert opined that all lawyers handling a real estate closing would have correlated the two documents so that the client's subsequent sale of the property would not have been diminished by the easement with which the client was burdened, due to the error.

Further the protection of the lawyer's judgment rule is limited by the reasonableness of his or her choice. The rule will not extend so far as to protect the lawyer who, though arguably confronted with several reasonable choices, makes an unreasonable one.

The zone of discretionary judgment is also measured by the lawyer's duty to disclose material facts and risks which create significant consequences to the client. Where the lawyer has disclosed the material risks, the zone of discretionary judgment is considerably enlarged, if not absolute.

The opposite can unfortunately also be true. In Camarda v. Danziger, Bangser & Weiss, the court held that in the alleged absence of material disclosure by the transactional lawyer, the complaint against him was legally sufficient. Similarly, in Lama Holding Co. v. Shearman & Sterling, the complaint was held to withstand a motion to dismiss because it alleged that the law firm had specifically undertaken to advise a group of foreign investors prior to their purchase of stock concerning the possible effects on plaintiffs' interests of a tax bill then under consideration by Congress and then had allegedly failed to do so. Likewise, in DuPont v. Brady, the court held as sufficiently stated a complaint that a lawyer had failed to disclose to a client purchaser of securities a fee arrangement from an issuer of those securities, notwithstanding its description in the disclosure document and notwithstanding the long-standing relationship between the lawyer and the client.

Library References:

West's Key No. Digests, Executors and Administrators $=433.

10. 173 A.D.2d at 170, 569 N.Y.S.2d at 25.


13. 167 A.D.2d 152, 581 N.Y.S.2d 233 (1st Dep't 1990) (plaintiff commenced action for legal malpractice against defendants to recover for alleged negligent representation in connection with the sale of plaintiff's shares of stock; the complaint "can be read to allege that defendants' representation fell below the ordinary and reasonable skill and knowledge commonly possessed by members of the legal profession in that given the facts known, they failed to advise plaintiff that the leveraged buy-out could be viewed as a fraudulent conveyance in violation of applicable law").


§ 28.13 The Duty of Care—Defenses—Statute of Limitations

The professional malpractice cause of action is one partaking of both contract and tort. Without the contract of retention, there would be no tort of malpractice, and where the professional sues for an unpaid fee, the action is certainly in contract. However, the New York State Legislature has made it clear that a claim for legal malpractice is governed by the three-year statute, not a six-year statute. On September 4, 1996, Governor Pataki signed into law a bill amending CPLR 214(6) to provide for a three-year statute of limitations "for malpractice, other than medical, dental or podiatric malpractice, regardless of whether the underlying theory is based in contract or tort."

Prior thereto, the Court of Appeals had held that the six year contract statute applied to a claim for legal malpractice. In Santulli v. Englert, Reilly & McHugh, P.C., the Third Department had held that a

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1. An open issue is how the change in the law affects claims accruing between three and six years before the change but not yet sued upon. The amendment to CPLR 214(6) says only that it "shall take effect immediately." (Senate Bill 7590/Assembly Bill 3197, § 2). Interestingly, NYSBA Legislation Report No. 76, dated March 2, 1995, had recommended that, because the amendment deals with a statute of limitations, the effective date might better specify a fixed date, rather than state "immediately." The Report offered the suggestion that the amendment be made effective "for all claims arising on and after ______ date," but obviously the Legislature rejected this approach. A literal reading of the CPLR, as now amended, suggests that an action filed on September 3, 1996 gets the six-year statute (by virtue of then operative case law), but on September 4 the three-year statute, meaning that the Amendment in effect "lapped off" three years for such accrued but unfiled claims. However, the "Justification" section of the Bill states that the Legislature "reaffirms its prior intent" that a three-year statute apply, suggesting that the Legislature believes that the courts were always wrong in applying a six-year statute. If so, what happens to a pre-existing action that was filed more than three years after accrual where the Statute of Limitations has been asserted as an affirmative defense but not yet litigated? How the amended CPLR 214(6) gets applied to accrued claims, both filed and unfiled, is certain to be litigated, and until then the answers are unclear. Two courts have rendered conflicting decisions. On January 17, 1997, the Supreme Court, New York County, held that the three year Statute of Limitations provided for by CPLR 214(6) was only to be applied prospectively. Garcia v. Director, N.Y.L.J., 1/17/97, p.26, col.2 (Sup.Ct., N.Y. County). On the other hand, the Supreme Court, Nassau County, has held that the three year Statute of Limitations in CPLR 214(6) barred a legal malpractice action for a 1991 claim which was otherwise timely filed in April 1996, prior to the amendment of CPLR 214(6). Russo v. Waller, 171 Misc.2d 707, 655 N.Y.S.2d 313 (Sup.Ct., Nassau County, 1997). See also Ackerman v. Price Waterhouse, N.Y.L.J., 5/13/97, p.25, col.6 (Sup.Ct., N.Y.County); FDIC v. Shea & Gould, 1997 WL 401822 (S.D.N.Y.1997); Keller v. Lee, 1997 WL 218435 (S.D.N.Y.1997); Estate of Joseph Re v. Kornstein Veisz & Wexler, 958 F.Supp. 907 (S.D.N.Y.1997); Mason Tenders District Council Pension Fund v. Messera, 958 F.Supp. 869 (S.D.N.Y.1997); Durkin v. Shea, 957 F.Supp. 1360 (S.D.N.Y.1997); and see Housman & Hirsch, Courts Split on Application of Statute of Limitations Amendment, N.Y.L.J., 3/7/97, p.1, col.1; Housman & Hirsch, Retroactivity of Amendment on Statute of Limitations, N.Y.L.J., 5/5/97, p.1, col.1; Arnoff & Jacobs, The Effect of the Continuous Representation Doctrine, N.Y.L.J., 6/30/97, p.3, col.1.

2. 78 N.Y.2d 700, 579 N.Y.S.2d 324, 566 N.E.2d 1014 (1992). The underlying facts were as follows. In October 1980, the plaintiff agreed to sell his business, with the purchase price secured by a first mortgage on real property. Although the mortgage instrument was not executed at closing be-
legal malpractice cause of action was not time-barred because it was grounded on the contractual relationship between the parties and, therefore, subject to the six-year contract Statute of Limitations; however, following legal precedent, the court had dismissed the breach of contract cause of action because the attorney had not promised a specific result.

The Court of Appeals rejected the defendant’s argument that the contract cause of action had been properly dismissed. The court then turned to the malpractice cause of action and further rejected the defendant’s argument regarding the applicable Statute of Limitations. The court noted that the question of the appropriate Statute of Limitations to be applied in actions for professional malpractice (other than medical, dental or podiatric) had been raised on prior occasions and in those cases the court had concluded that “the choice of an applicable Statute of Limitations properly related to the remedy rather than to the theory of liability.” The court noted that in Sears, Roebuck & Co. v. Enco Assocs., the liability of the defendants, “whether verbalized as in tort for professional malpractice or as in contract for nonperformance of particular provisions of the contract, arose out of the contractual relationship of the parties,—i.e., absent the contract between them, no services would have been performed and thus there would have been no claims.” Similarly, in Santulli, all potential liability of the defendant arose out of the agreement retaining the firm as attorneys for the plaintiff with respect to the sale of his business. In Santulli, as in Sears, the court saw no significant difference flowing from the manner in which the liability is classified or described, “for in any event, ‘an agreement to exercise due care in the performance of the agreed services is to be implied.’”

cause the mortgagor was absent, it was executed shortly after the closing and then recorded. In April 1981, the plaintiff paid all his legal fees in full. After this, the buyer made twenty payments to the plaintiff on the mortgage debt and then defaulted. In May 1983, when the plaintiff sought defendant’s assistance in collecting the amounts due on the mortgage, he discovered that the description of the property in the filed mortgage instrument was erroneous, with the more valuable portion of the property omitted from the security for the debt. He advised the defendant of the problem and they discussed a possible foreclosure action. In August 1983, the defendant attorney advised the plaintiff that his firm had a potential conflict with regard to the mortgage foreclosure action, because the partner who was actually involved in the transaction would probably be called to testify. In September 1985, more than three years after the error was committed, the plaintiff sued for malpractice and breach of contract.

3. The defendant argued that a cause of action for breach of contract in the context of an attorney-client relationship may be sustained only where there is either a specific promise by the attorney to perform and there is a complete failure of any performance or where the attorney has undertaken a specific task and has failed to perform that task. The court noted that certain prior cases on which the defendant had relied were not only inapplicable, but should not be followed, concluding that the breach of contract cause of action had been adequately stated and should not have been dismissed. 78 N.Y.2d at 706, 579 N.Y.S.2d at 327.

4. 78 N.Y.2d at 707, 579 N.Y.S.2d at 327.


6. Id.

7. Santulli, 78 N.Y.2d at 707, 579 N.Y.S.2d at 327, quoting Sears, 43 N.Y.2d at 396, 401 N.Y.S.2d at 770.
The Santulli court concluded that an "action for failure to exercise due care in the performance of a contract insofar as it seeks recovery for damages to property or pecuniary interests recoverable in a contract action is governed by the six year contract Statute of Limitations (CPLR 213, subd. 2)." Since the plaintiff in Santulli sought recovery for damages to his pecuniary interests due to the error in a mortgage filing, the court held that the six year Statute of Limitations applied.

Presumably, the Santulli analysis remains relevant to cases to which the new amendment to CPLR 214(6) does not apply, but otherwise the statute will be three years. The Legislature, in the pointed language of the "Justification" section of the bill which became law, made it clear that the statute is not to be "toyed with" by courts in the future:

The legislature of the State of New York had originally expressed its intent in enacting the statute of limitations for actions for general malpractice in CPLR Section 214(6) to be three years and actions for medical malpractice to be two and one half years as governed by CPLR Section 214–a.

The Courts have recently expanded the statute of limitations, in cases where the essential actions complained of consist of malpractice, to six years under breach of contract theory, thereby abrogating and circumventing the original legislative intent.

Unless the legislature reaffirms its intent as to the statute of limitations to be applied in cases governed by both Section 214(6) and 214–a of the CPLR, the Courts will continue to expand the statute of limitations in general malpractice cases as well as medical malpractice cases to be governed by the six year breach of contract theory as set forth in CPLR Section 213(2).

It is essential that both Sections 214(6) and 214–a of the CPLR be amended to reaffirm the legislative intent that where the underlying complaint is one which essentially claims that there was a failure to utilize reasonable care or where acts of omission or negligence are alleged or claimed, the statute of limitations shall either be three years if the cases comes within the purview of CPLR Section 214(6), or two and one half years if it comes within the purview of CPLR

8. 78 N.Y.2d at 707, 579 N.Y.S.2d at 327.

9. In a closing paragraph, the court stated that to the extent a legal malpractice claim "seeks damages different from or greater than those customarily recoverable under a breach of contract claim, CPLR 214(6) [the three-year negligence Statute of Limitations] will govern." 78 N.Y.2d at 709, 579 N.Y.S.2d at 329. To some, this puzzling statement indicated the necessity for a plaintiff to still plead a breach of contract count in order to be certain of getting the benefit of the six year contract Statute of Limitations. However, subsequent cases recognized no such fine distinction, simply applying the six year Statute of Limitations unhesitatingly to a legal malpractice claim. See Lyons v. Donnelly, 204 A.D.2d 696, 612 N.Y.S.2d 246 (2d Dep't 1994); Padilla v. N.Y.C. Transit Authority, 184 A.D.2d 760, 585 N.Y.S.2d 491 (2d Dep't 1992); Barth v. Barth, Sullivan & Lancaster, 179 A.D.2d 1049, 579 N.Y.S.2d 283 (4th Dep't 1992).
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Section 214-a, regardless of whether the theory is based in tort or in a breach of contract.\(^\text{10}\)

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§ 28.14 The Duty of Care—Defenses—Statute of Limitations—Continuous Representation Tolling Doctrine

The continuous representation tolling doctrine, first applied in medical malpractice cases,\(^\text{1}\) grew out of the need to delay the commencement of the Statute of Limitations where it was unfair to expect the patient (client) to commence litigation. In malpractice claims, the rule is that the Statute of Limitations begins to run from the date of the act of malpractice, not the first injury to the plaintiff, which can be years later.\(^\text{2}\) This rule, while favorable to professionals, can result in some harshness to the plaintiff, whose claim can become time-barred long before he or she even discovers that it exists. Unlike some states, New York does not allow the commencement of the Statute of Limitations to be tolled until the plaintiff discovers the loss, the so-called “discovery rule.”\(^\text{3}\)

Instead, the potential harshness of New York’s rule for plaintiffs is mollified somewhat by the continuous treatment doctrine, delaying commencement of the Statute of Limitations until the end of the doctor’s treatment of the patient for the matter at issue, thus giving the doctor the chance to finish the treatment and the patient the opportunity to allow the doctor to “do his best” to heal the patient before the patient sues the doctor for malpractice.

This rule gradually began to be applied in cases involving non-medical professionals. In one early legal malpractice case applying the doctrine, the court explained:

We believe that the rule is equally relevant to the conduct of litigation by attorneys. The resemblance between the continuous treatment of a condition of a patient by a physician and the continuous representation of a client in a lawsuit by an attorney is more than superficial. In both instances the relationship between the parties is marked by trust and confidence; in both, there is

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\(^{10}\) Senate Bill 7590/Assembly Bill 3197, § 2.

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presented an aspect of the relationship not sporadic but developing; and in both the recipient of the service is necessarily at a disadvantage to question the reason for the tactics employed or the manner in which the tactics are executed ... [t]hat it would be ludicrous to expect a patient to interrupt a course of treatment by suing the delinquent doctor ... holds true as well in the case of a client who has confided his cause to an attorney. The client is hardly in a position to know the intricacies of the practice or whether the necessary steps in the action have been taken. For better or for worse, the client must depend on his attorney to pursue the litigation diligently and according to the rules.4

In 1982, the Court of Appeals first addressed the doctrine as it applied to attorneys in Greene v. Greene.5 The case involved a former client who pressed claims against counsel seeking rescission of a trust agreement and an accounting for fund mismanagement by the same counsel as trustee. In holding that the Statute of Limitations was tolled by the attorney's continuous representation, the court focused on the attorney's "superior knowledge" as a fundamental rationale for the tolling rule. The court recognized that a person seeking professional assistance cannot be expected to question and assess the techniques employed by the professional or the manner in which the services are rendered.6

Shortly thereafter, the Court of Appeals had another opportunity to address the effect of the continuous representation on the Statute of Limitations. In Glaum v. Allen,7 the court explained that since the court confronted a factual situation which involved two distinct tolling issues. The plaintiff was injured in April 1969 while voluntarily assisting a city firefighter, and in October 1969, the plaintiff's attorney commenced an action on the plaintiff's behalf against the City of Amsterdam under the Volunteer Firemen's Benefit Law. However, this attorney failed to file a notice of claim against the city. In 1974, the claim under the Volunteer Firemen's Benefit Law was transferred to the Worker's Compensation Board where the referee ruled against the plaintiff on the grounds that he was not an employee of the city. A year later, the Worker's Compensation Appeals Board reversed the referee's decision and awarded benefits to the plaintiff, but the Appellate Division, Third Department, reversed again and dismissed the complaint. Shortly before this decision, the plaintiff's attorney died. The successor attorneys appealed the Third Department's decision, which was affirmed. Within ninety days after this decision, the new attorney filed a notice of claim and an action against the city. The action was dis-


6. 56 N.Y.2d at 94, 451 N.Y.S.2d at 50.

7. 57 N.Y.2d 87, 93, 453 N.Y.S.2d 674, 678, 439 N.E.2d 390 (1982). In Glaum, the court confronted a factual situation which involved two distinct tolling issues. The plaintiff was injured in April 1969 while voluntarily assisting a city firefighter, and in October 1969, the plaintiff's attorney commenced an action on the plaintiff's behalf against the City of Amsterdam under the Volunteer Firemen's Benefit Law. However, this attorney failed to file a notice of claim against the city. In 1974, the claim under the Volunteer Firemen's Benefit Law was transferred to the Worker's Compensation Board where the referee ruled against the plaintiff on the grounds that he was not an employee of the city. A year later, the Worker's Compensation Appeals Board reversed the referee's decision and awarded benefits to the plaintiff, but the Appellate Division, Third Department, reversed again and dismissed the complaint. Shortly before this decision, the plaintiff's attorney died. The successor attorneys appealed the Third Department's decision, which was affirmed. Within ninety days after this decision, the new attorney filed a notice of claim and an action against the city. The action was dis-
continuous representation rule operates to toll the Statute of Limitations, its application is limited to situations in which the attorney who allegedly was responsible for the malpractice continues to represent the client in that case. In *Glamm*, the Court of Appeals also articulated another key concept underlying the continuous representation doctrine: the inherent tension caused when a client has to be a “watchdog” over his or her own counsel. The court stated:

Neither is a person expected to jeopardize his pending case or his relationship with the attorney handling that case during the period that the attorney continues to represent the person. Since it is impossible to envision a situation where commencing a malpractice suit would not affect the professional relationship, the rule of continuous representation tolls the running of the Statute of Limitations on the malpractice claim until the ongoing representation is completed.

New York courts limit the application of the continuous representation doctrine to the same or related matters in an ongoing attorney-client relationship. For example, in *Luken Lamellen U. Kupplungbau v. Lerner*, a legal malpractice and breach of contract action arising from the alleged failure of a patent attorney to prepare, file and prosecute a U.S. patent application, the Second Department reasoned that for the continuous representation doctrine to apply, there must be clear indicia of an ongoing, continuous, developing, and dependent relationship between the client and the attorney, which often includes an attempt by the attorney to rectify an alleged act of malpractice.

The court went on to point out that the doctrine’s application, despite its predicate on the trust and confidence in the relationship between the client and the professional, “is limited to instances in which the attorney’s involvement in the case after the alleged malpractice is for the performance of the same or related services and is not merely the

missed. In April 1980, eleven years after the injury, the plaintiff sued the deceased attorney’s estate for legal malpractice. Although the defendant asserted a Statute of Limitations defense, the Court of Appeals ultimately held the action to be timely, reasoning that there were two separate and distinct “continuous treatment” periods that tolled the running of the Statute of Limitations. The first dated from the failure of the plaintiff’s first attorney to file a notice of claim with the city, continued during the litigation before the Worker’s Compensation Board, and terminated with his death. The second distinct period began with the attorney’s death and continued for eighteen months pursuant to CPLR 210(b), which provided for an eighteen month toll upon an attorney’s death. Obviously, for any claim to be viable and for the tolling provision to apply, “the claim of malpractice against the attorney must have been in existence prior to the attorney’s death.” Accordingly, the court held that the action was timely since the action had been brought within three years from the date of expiration of the eighteen month period.

8. 57 N.Y.2d at 84, 453 N.Y.S.2d at 678.
9. 57 N.Y.2d at 93, 453 N.Y.S. at 677-78.
11. 166 A.D.2d at 506, 560 N.Y.S.2d at 789.
continuity of a general professional relationship." 12 The court then ruled that, even though the erroneous patent application dated back to 1974, the statute was tolled through 1981 (presumably the termination of the professional relationship) and held the action to have been timely commenced in December 1983, since the defendant had continued to represent the plaintiff with regard to the same patent from which the alleged malpractice stemmed.

In actions involving professionals other than attorneys, courts have adhered to the principle that continuous representation involves "an uninterrupted course of reliance and services related to the particular duty breached." 13 In addition, they recognize that "[t]he mere recurrence of professional services does not constitute continuous representation where the later services performed were not related to the original services." 14

These principles were upheld by the Court of Appeals in Santulli v. Englert, Reilly & McHugh, P.C. 15 In discussing the continuous representation doctrine, the court concluded that the courts below had correctly decided that the doctrine was not applicable under the facts of the case, as there clearly had been no further representation of plaintiff by defendant following payment of the defendant lawyer's bill in April, 1981. 16

§ 28.15 The Duty of Care—Defenses—Statute of Limitations—Extension by Estoppel

Even where the continuous representation doctrine does not apply, the Statute of Limitations for professional malpractice can be extended by another method, equitable estoppel. In the leading case Simcoski v. Sasoli, 1 the Court of Appeals articulated the doctrine. On October 19, 1970, the defendant surgeon performed an operation on the plaintiff's neck, allegedly injuring certain nerves and causing allegedly permanent injuries to the plaintiff's right side. She later alleged that when she asked the surgeon about the problems on her right side, he allegedly advised her, willfully, falsely and fraudulently, with knowledge of his negligence, that her post-operative problems would disappear if she would continue a course of physical therapy. In January, 1974, after the Statute of Limitations had run against the surgeon, she was allegedly

12. 166 A.D.2d at 507, 560 N.Y.S.2d at 789.
advised for the first time that her injury had been caused by the surgeon’s negligence. The plaintiff sued in 1976, and the surgeon moved to dismiss based upon the Statute of Limitations. The Court of Appeals held that principles of equitable estoppel were applicable to relieve plaintiff from the proscriptions of the Statute of Limitations, as “a defendant may be estopped to plead the Statute of Limitations where plaintiff was induced by fraud, misrepresentations or deception to refrain from filing a timely action.” The rule is not open-ended, however. The plaintiff must exercise due diligence in bringing an action once the truth is known, and such due diligence is “an essential element” of the doctrine which the plaintiff has the burden to establish.

The doctrine was refined by the Court of Appeals in a subsequent medical malpractice claim, Rizk v. Cohen. Here, the concealment claim was without merit, as there was no subsequent act of concealment following the act of malpractice. The court pointed out:

In support of his claim that there was a fraudulent misrepresentation, plaintiff relies on the same act which forms the basis of his negligence claim—Dr. Cohen’s alleged improper advice to plaintiff that there was nothing wrong. Thus, plaintiff’s allegations do not establish that Dr. Cohen, acting with knowledge of prior malpractice, made subsequent misrepresentations in an attempt to conceal his earlier negligence.

In a subsequent legal malpractice action, La Brake v. Enzien, the Appellate Division, Third Department, emphasized that there is no separate cause of action for fraud based upon the same concealment as that upon which the equitable estoppel argument is based, if the damages are the same as those for the negligence claim that would be lost through the running of the Statute of Limitations. In another legal malpractice action, Mangno v. Mangno, the Appellate Division, Fourth Department, considered the equitable estoppel doctrine but held that the plaintiff had failed to meet its requirements, as he had not alleged that the defendant lawyer had made subsequent misrepresentations in an attempt to conceal his earlier negligence. The import from these cases is clear—there must be some additional deliberate activity by the defendant to conceal his earlier negligence, and even then there is still only the negligence claim, absent some discrete damages specifically attributable to the fraudulent concealment.

2. Id. at 448–449, 406 N.Y.S.2d at 262.
3. Id. at 450, 406 N.Y.S.2d at 263.
5. Id. at 105, 538 N.Y.S.2d at 233 (emphasis in original; citation omitted).
8. See infra, § 28.17.
§ 28.16 The Duty of Care—Defenses—Standard Negligence Defenses of Lack of Foreseeability and Supervening Act

The reported cases involving legal malpractice do not place special emphasis on the standard negligence defenses. However, there is no reason why, in the right factual setting, such defenses should not apply. For example, in the appropriate situation, an ordinary foreseeability argument could be a valid and persuasive defense to a claim that the lawyer was negligent.

In a standard negligence case, in order for a defendant to be liable, the plaintiff’s injury must have been a reasonably foreseeable consequence of the defendant’s conduct. In other words, negligence is gauged by the ability to anticipate, and the risk must be within the range of apprehension.

The appropriate factual setting for such an argument is one where the injury to the plaintiff was caused by something that the lawyer could not have reasonably anticipated and prevented. While the decision does not deal with a malpractice claim, the facts of Abramson v. Abramson provide a good example. There, the plaintiff husband, himself an attorney, who had already been sworn in as a witness at his divorce trial, retained new counsel who was otherwise engaged. When the court refused to grant a further adjournment, the plaintiff walked out of the courtroom, defaulting at the trial. On appeal, the Appellate Division, First Department, refused to open the default. On these facts, it is apparent that counsel could not have anticipated that the client, himself a lawyer, would bolt out of the courtroom and default.

The related standard negligence defense of “supervening act” should also be considered for the defense of a legal malpractice case. A defendant is relieved of liability for negligence where an unforeseeable superseding event intervenes, which breaks the chain of causation and itself becomes the proximate cause of injury. The unforeseeable superseding force that intervenes to cut off a defendant’s liability can be the act of the plaintiff himself. Again, the factual scenario set out above provides an example.

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§ 28.17 The Duty of Care—Defenses—Concealment of Malpractice Not a Separate Cause of Action

An attorney’s concealment of his malpractice, in and of itself, is not actionable as a separate cause of action for legal malpractice. This rule has its basis in the rationale that the damages for the attorney’s failure to disclose is the value of the underlying suit.

In *La Brake v. Enzien*, the plaintiff was a passenger in the back seat of an automobile which was run off the road and overturned in October, 1967. While still in the hospital recovering from serious injuries sustained in the accident, the plaintiff hired the defendant attorney on a contingent fee basis to prosecute all claims arising from the accident. The defendant advised his client that he had investigated the accident and found that there were claims against not only the owner and driver, but also that there was a “very strong case in regard to the road” against the governmental bodies responsible for the condition of the road where the accident occurred. The plaintiff alleged that the defendant lawyer had showed him what the defendant described as a “notice of claim” against the state and county.

In 1971, the claims against the owner and driver were settled for $20,000. The plaintiff claimed that the defendant had assured him that his claims against the state and county were still pending. However, in the spring of 1987, the defendant disclosed that there was no lawsuit pending against any governmental entity. When the plaintiff then requested that the defendant give him his file, he was told that it was lost.

In 1988, the plaintiff commenced an action against the defendant for legal malpractice. The first cause of action alleged negligence and malpractice in failing to file a notice of claim and prosecute the plaintiff’s meritorious claims against the state and county. The second cause of action alleged that the defendant had fraudulently misrepresented the status of the case against the state and county and, as a result of his reliance on these false representations, the plaintiff had detrimentally refrained from employing other counsel.

The defendant filed a pre-answer motion challenging the complaint as time-barred or, alternatively, to dismiss the second cause of action for failure to state a claim and for failure to plead fraud with specificity. The plaintiff cross-moved for, *inter alia*, an order that would equitably estop

1989). However, the supervening act does not cut off a defendant’s liability where that act was a natural and foreseeable consequence of a circumstance created by the defendant. Kush v. City of Buffalo, 59 N.Y.2d 26, 432 N.Y.S.2d 831, 449 N.E.2d 725 (1983). See also, Ulysse v. Nelsk Taxi, 135 A.D.2d 528, 522 N.Y.S.2d 162 (2d Dep’t 1987).

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the defendant from asserting any Statute of Limitations defense. The lower court denied the defendant's motion and also denied that part of the plaintiff's motion seeking the equitable estoppel order. Only the defendant appealed.

The Appellate Division, Third Department, reversed, holding that the second cause of action was dismissible since it did not state a cause of action separate and distinct from the customary cause of action for malpractice. The court reasoned as follows:

The measure of damages in each case is the same, i.e., the value of plaintiff's claim for negligence against the governmental ... bodies responsible for the alleged unsafe condition of the road ... [A] defendant's concealment or failure to disclose his own malpractice without more does not give rise to a cause of action for fraud or deceit separate and distinct from the customary malpractice action.

The court went on to say that a separate cause of action for fraud may be established where exposure to liability is not based on errors of professional judgment, but is predicated on proof of the commission of an intentional tort. As the La Brake court saw it, the problem related to proof of additional damages in the fraud cause of action. Here the damages for the failure to disclose were merely the value of the claim lost, i.e., the negligence claim.

Library References:
West's Key No. Digests, Executors and Administrators ⇑433.

§ 28.18 The Duty of Care—Defenses—Need for Consistent Positions

In defending a malpractice suit, an attorney must take positions which are reasonable in light of the underlying case which precipitated the suit. For instance, in Gerard Lollo & Sons, Inc. v. Stern, a claim for malpractice committed in the course of litigation was brought. The court placed the burden on the attorney to present convincing proof in support of his motion for summary judgment, especially where the position he

2. Id. at 711, 562 N.Y.S.2d at 1011.
3. Id. Where the substance of the alleged fraud counts is merely the alleged failure to fulfill a promise to perform legal services, the fraud count is dismissible. Affiliated Credit Adjustors v. Carluci & Legum, 139 A.D.2d 611, 527 N.Y.S.2d 426 (2d Dep't 1988). The alleged deceitful procurement of a release by the lawyer from the client is not a separate cause of action from the malpractice claim to which the release is asserted as a defense. Brown v. Samalin & Bock, 155 A.D.2d 407, 547 N.Y.S.2d 80 (2d Dep't 1989).
4. 167 A.D.2d at 711, 562 N.Y.S.2d at 1011.

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was asserting in the malpractice action against him was different from the position he had previously advocated in the underlying case.

The defendant was a litigation attorney sued for improperly handling the prosecution of a prior breach of contract action. He sought dismissal of the malpractice action on the ground that there was no merit to his former client's position in the underlying action, in which he had asserted that a certain supplier's letter containing price quotations relating to a specified construction project constituted a bona fide offer giving rise to a binding contract. In the subsequent malpractice action, the defendant attorney claimed that the letter had not in fact constituted a bona fide offer. The Appellate Division, Second Department, affirmed the lower court's denial of the defendant's motion. The court was obviously unimpressed that the lawyer's motion was based on an affirmation of an attorney who lacked personal knowledge of the circumstances surrounding the transaction in question, and in contrast, the plaintiff had submitted "the affidavit of the individual who was personally involved in the negotiations which ultimately led to the issuance of the disputed letter."²

A lawyer should try to avoid taking a position in a malpractice case which is wholly contrary to the position he took in the underlying action.³ Obviously, a defendant lawyer sued by a previously unsuccessful plaintiff can find himself in the delicate position of having to argue the worthlessness of a claim he had previously championed. Extravagant claims of the client's damages developed by the lawyer in the first case can, of course, come back to haunt the lawyer in the second case.

Where a lawyer who has been sued for malpractice by a former client claims that an affirmative defense asserted by his former client's opponent would have defeated the former client's claim, the defendant attorney has the burden of proof to establish such affirmative defense. Although the former client bears the burden of proving that "but for" the attorney's negligence he would have recovered in the first action, he does not bear the burden of establishing that the underlying case would not have been defeated by any affirmative defense.⁴

Library References:
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§ 28.19 The Duty of Loyalty

Lawyers are considered fiduciaries who are obligated to prefer their clients' interests over their own. Their obligations arise at the time of retention. Therefore, serious consideration has to be given to the terms and conditions of retention, discussing the terms with the client in an

2. Id. at 607, 563 N.Y.S.2d at 443.
informing manner, and then drafting a retainer agreement that not only fairly states the scope and terms of retention but the consequences to both of a breach.

In a case involving retainer agreements, the Court of Appeals specifically addressed the nature of the attorney-client relationship. In *In re Cooperman,*¹ the court stated that the unique fiduciary reliance, “stemming from people hiring attorneys to exercise professional judgment on a client’s behalf—‘giving counsel’—is imbued with ultimate trust and confidence.”² Therefore, noted the court, the attorney’s obligations transcend those prevailing in the commercial marketplace. “The duty to deal fairly, honestly and with undivided loyalty superimposes onto the attorney-client relationship a set of special and unique duties, including maintaining confidentiality, avoiding conflicts of interest, operating competently, safeguarding client property and honoring the clients’ interests over the lawyer’s.”³ The court acknowledged that because the attorney-client relationship is recognized as so special and so sensitive in our society, its effectiveness may be irreparably impaired by conduct which undermines the confidence of the particular client or the public in general.⁴

This unique fiduciary relationship between attorney and client has been crucial in a variety of contexts. In *Dillon v. Dean,*⁵ an attorney who was sued by his clients raised a defense of “unclean hands.” The Appellate Division, Second Department, noted that the attorney-client relationship is by definition a “confidential” one and is presumptively “unequal.” Thus, the attorney who counsels a client to behave illegally or fraudulently is more blameworthy than the client who follows such advice. In a situation of unequal guilt, the clients will not be barred by the doctrine of unclean hands from seeking equitable relief.⁶

In *Raphael v. Shapiro,*⁷ an attorney who had sold his law practice sued the purchaser to recover on a promissory note. In holding that such sale was improper and unethical, the court pointed out that the client’s trust and confidence in his attorney are at the very core of the fiduciary relationship. “Client security in the soundness of the fiduciary relationship is vital to the smooth functioning of our adversarial system of jurisprudence.”⁸

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2. 83 N.Y.2d at 471–472, 611 N.Y.S.2d at 467–468.
3. 4. 4. Id. at 468.
5. Id. at 580, 551 N.Y.S.2d at 549.
7. Id. at 922, 587 N.Y.S.2d at 70.
In fact, as held by the Appellate Division, First Department, in In re Levy's Estate, the lawyer-client relationship is such that where the fairness of a transaction between lawyer and client is questioned by the client, the lawyer bears the burden of proof to show that the transaction is just and fair. As a result, where the attorney is accused of fraud, "representations, otherwise falling far short of sustaining actionable fraud or overreaching, made in the context of a fiduciary or confidential relationship, in which one party possesses superior knowledge, will more readily supply the basis for relief."

The fiduciary relationship between lawyer and client is such that the client always has the absolute right, on public policy grounds, to terminate the attorney-client relationship at any time, with or without cause.

§ 28.20 The Duty of Loyalty—Conflict of Interest

Conflicts of interest arise when the attorney is unable or unwilling to devote his entire loyalty to the client, because either his or her own interests, the interests of his or her firm or partners, or the interests of another client intrude. Most conflicts, at least between clients, are waivable by the clients, and of course such waivers, where appropriate, should always be secured in writing in advance of commencing the otherwise conflicting representation. Obviously, both affected clients should waive the conflict. Potential conflicts are little different from actual conflicts in light of a lawyer’s ethical duty to avoid even the appearance of impropriety.

While serious conflicts can have disciplinary repercussions and allegations of conflict can complicate malpractice claims, conflict in itself is not actionable as a cause of action against an attorney. To recover because of a conflict, the client must still meet the elements of a legal malpractice claim or some other recognized theory against the attorney, proving that the conflicting representation actually caused damage to the client. In the vast majority of cases where such causation can be shown, the elements of legal malpractice are present even apart from the conflict. This is because the conflict must be manifested in particular

9. 19 A.D.2d 413, 244 N.Y.S.2d 22 (1st Dep't 1963).
10. Id. at 417, 244 N.Y.S.2d at 28.

PRACTICE POINTER: It cannot be repeated often enough that to demonstrate fair and equitable dealing with a client, the lawyer should prepare retainer agreements that have clearly and plainly stated terms and conditions which are executed only after candid disclosure that is acknowledged in the agreement itself. The agreements obviously have to be drafted by the lawyer with the thought in mind that they will be strictly construed against the lawyer in favor of the client. Fairness, clarity and candor are always fundamental.

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1. See Code of Professional Responsibility, DR 5–101 (22 NYCRR § 1200.20), DR 5–105 (22 NYCRR § 1200.24), and EC 5–1, et seq.
acts which damage the client, and it is those acts that become the basis of a malpractice claim.

Where conflict does get litigated at length is in the context of motions to disqualify counsel.

Library References:
West's Key No. Digests, Executors and Administrators ☞115.

§ 28.21 The Duty of Loyalty—Disqualification

While disqualification of counsel may be embarrassing for that counsel, it does not, in and of itself, constitute an actionable professional liability claim. Recoverable damages are not necessarily caused by the breach of the counsel’s obligations.

Courts have held that a former attorney need not have acquired confidences to be disqualified. In fact, where there is a substantial relationship between the issues in the two litigations, there is a rebuttable presumption that a conflict exists.¹ In Solow v. W.R. Grace & Co.,² the Appellate Division, First Department, in reversing the supreme court, found that the firm Strook & Strook & Lavan should be disqualified from representing Solow in an action for asbestos contamination in a Grace-constructed building. The law firm had previously represented Grace in an asbestos action. Although the attorneys involved in the former litigation were no longer associated with the firm, the appellate division held that DR 5-108³ mandated that the firm be disqualified. The court held that the question of confidentiality was not controlling and that “the limitation arises simply from the fact that the lawyer, or the firm with which he was then associated, represented the former client in matters related to the subject matter of the second representation.”⁴

However, after having held that there was an irrebuttable presumption that all the firm’s attorneys had knowledge of confidential information, the appellate division certified that issue to the Court of Appeals, which disagreed. The latter held that while the court must presume that the rights of the former client were jeopardized by the firm’s subsequent representation of the plaintiff, the firm was allowed to rebut that presumption.⁵ It carried this burden and was permitted to remain as counsel.

In Hudson River Sloop Clearwater, Inc. v. Cuomo,⁶ the court disqualified an environmental law firm from representing various New

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3. 22 NYCRR § 1200.27.
York State and New York City agencies in the redevelopment of the Hudson River waterfront area known as Westway. The firm's predecessor firm had successfully represented the petitioners, the environmental groups previously opposed to Westway, in federal actions from the late 1970's through the 1980's, successfully challenging under federal statutes, certain approvals granted by state and federal agencies. The petitioners asserted that because the firm's predecessor had represented them in opposing the Westway development in the earlier proceedings, it could not represent the state agencies in the current litigation. The firm argued that it was not privy to any confidences because all the issues were pure public policy matters, which were all part of the public record.

The court found the firm's arguments unpersuasive. It held that if the petitioners established "a substantial relationship between the issues in the litigation and the subject matter of the prior representation or where counsel had access to confidential material substantially related to the litigation," the firm should be disqualified. "Whether or not counsel has confidential information is not controlling," the court held. It was not actual harm resulting from a conflict of interest, but the potential for harm that caused the invocation of the disqualification remedy.

In The Trustees of Columbia University v. Gwathmey Siegel & Assoc. Architects, the law firm had previously represented a construction manager as outside counsel at the time of a project's construction. Then the law firm represented a subcontractor in an action brought by the project owner against both the construction manager and the subcontractor. When the firm cross-claimed on behalf of the subcontractor against the firm's former client, the construction manager, that former client sought to have the firm disqualified. The firm argued that the construction manager knew that the subcontractor had also been a client of the firm and that the firm had not acquired any confidential information from the construction manager at the time of construction. The court held that because the prior relationship had involved the same building project and because the firm had dealt directly with the subcontractors involved in the current litigation, there was a "substantial relationship between the issues." The court held that whether or not the law firm had received confidential information was irrelevant.

These cases relied on three earlier conflict of interest decisions. In Cardinale v. Golinello, the defendant was able to disqualify plaintiff's counsel because he had previously been associated with a law firm that had represented the defendant during a period of time which was

7. Id.
8. Id., citing Solow v. W.R. Grace, 193 A.D.2d 459, 597 N.Y.S.2d 361 (1st Dep't 1993). This articulation may perhaps be read to hold that disqualification will be ordered if either (i) the substantial relationship or (ii) the confidentiality test is met.
relevant to the pending litigation, even though the attorney in question had never rendered any legal services to the defendant and had even been hired after the key time frame. The court disqualified the attorney because his current representation of the plaintiff and his former firm’s representation of the defendant pertained to the same subject matter.

In *Cooke v. Laidlaw*,\(^{11}\) involving breach of an employment contract, the plaintiff was able to disqualify his former employer’s attorney because he had represented the plaintiff in his corporate capacity in a securities transaction. The court held that disqualification is appropriate where a party establishes a substantial relationship between the issues in the litigation and the subject matter of the prior representations, or where counsel had access to confidential material substantially related to the litigation.

In *Catania v. Lippman*,\(^{12}\) the Appellate Division, Third Department, held that disqualification of plaintiff’s counsel was appropriate where counsel could be a successive tortfeasor in an action against the plaintiff’s prior counsel. The defendant lawyer (lawyer number one) had represented the plaintiff in a matrimonial action in which her representation had been taken over by the second lawyer. When the plaintiff lost possession of the marital residence to her husband in the matrimonial action, she sued the first lawyer for malpractice for alleged bad advice leading to that result. In the legal malpractice action, she was represented by the second lawyer, who had taken over her representation in the matrimonial action. Predictably, lawyer number one impleaded lawyer number two.\(^{13}\) The court disqualified the plaintiff’s lawyer (lawyer number two), as it was clear that, at the least, he would be called upon to testify. The court referred to DR 5-102\(^{14}\) of the Code of Professional Responsibility, which requires that if, after undertaking employment as counsel, it is apparent that an attorney ought to be called as a witness on behalf of his client, he shall withdraw from the representation. Conclusory assertions by the plaintiff that she could not find another attorney were insufficient to establish the substantial hardship required to fall within the hardship exception to the rule.

Disqualification motions are best avoided by proper inquiries and disclosures to the client at the outset of retention, an appropriate and meaningful system of conflict checks, and above all, an individual and

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14. 22 NYCRR § 1200.21.
collective sensitivity to a client's perception of the lawyer's standard of fair and equitable dealing.\(^{15}\)

**Library References:**
West's Key No. Digests, Executors and Administrators \&-18.

§ 28.22 The Duty of Loyalty—Misappropriation of Client Funds

In 1981, the New York State Legislature created the Clients' Security Fund.\(^1\) Funded by the registration fees required of New York attorneys and governed by a board appointed by the Court of Appeals, it has the discretionary power to reimburse clients whose funds have been misappropriated by their lawyers. In *Clients' Security Fund v. Grando*,\(^2\) the Court of Appeals held that the Fund, which has statutory subrogation rights against the lawyers who have misappropriated funds, likewise has subrogation rights against those lawyers' innocent partners, to recover based upon their vicarious liability.\(^3\)

*Majer v. Schmidt*\(^4\) addresses many of the issues that arise when an attorney misappropriates funds. The litigation came about as a result of a series of frauds committed against several clients by one of the defendant attorneys, a partner in a law firm that later dissolved. In order to settle a pre-dissolution action brought against the attorney and the law firm in the U.S. District Court for the Southern District of New York on the grounds of breach of an escrow agreement, breach of fiduciary duty, fraud and conversion, this attorney converted $1,800,000 of the funds of an unrelated estate after the dissolution of the law firm. The estate then commenced a state court action against the law firm in dissolution and its former partners for fraud and conversion of the estate's funds. In addition, the estate sued the federal plaintiffs, claiming that, in spite of the general release given in settlement of the federal action, the estate was subrogated to the rights of the federal plaintiffs with respect to those plaintiffs' additional causes of action against the attorneys.

15. **PRACTICE POINTER:** The law in this area is not so unfathomable that workable measures cannot be developed to avoid conflicts, criticism, disqualification, motions and claims of breach of fiduciary duty. A historical list of clients should be made and maintained, and the matters should be summarized so that the content of new matters can be evaluated to determine whether they have a substantial relationship to prior engagements. A system must be instituted to check all new matters against the historical cases to determine in "short order" if a conflict exists. Where an attorney is practicing in a firm, procedures must be implemented to provide for quick circulation of the relevant information for all new matters before the engagement is confirmed to ensure that conflicting matters are not presently pending. In all events, these procedures must be institutionalized to permit them to occur as a matter of course for all new matters.

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1. State Finance Law § 97-t.
One of the law firm's partners, apparently innocent of the conversion of estate funds, moved to dismiss the state court action, alleging that the partnership had been dissolved, thereby relieving him of personal liability. The Appellate Division, First Department, sustained the lower court's ruling that "conversion of the Estate's funds, after dissolution of the partnership, was an act 'appropriate for winding up partnership affairs or completing transactions unfinished at dissolution' within the meaning of New York Partnership Law § 66 and therefore binding on the partners."  

The appellate division further held that the lower court had erred in dismissing the subrogation claim. The appellate court imposed a constructive trust on the $1,800,000 received by the federal plaintiffs in settlement, since "[a] constructive trust may be imposed where 'property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest.'"  

The court went on to identify the relevant factors to consider in imposing a constructive trust. These include: 1) the existence of a confidential or fiduciary relationship; 2) a promise, express or implied; 3) a transfer in reliance on that promise; and 4) unjust enrichment. The court then applied these factors to the case and held as follows:  

Here there is no question that there was a fiduciary relationship between the Estate and defendant ... attorney. Moreover, implicit in that relationship was an implied promise by ... [defendant attorney] to deal honestly with the Estate's assets. While the transfer involved was effectuated by means of a forgery rather than induced by ... promise, it is clearly within the type of misconduct which calls for the imposition of a constructive trust, which "will be erected whenever necessary to satisfy the demands of justice [and is] limited only by the inventiveness of men who find new ways to enrich themselves unjustly by grasping what should not belong to them."  

The court concluded that a case which involves allegations of outrageous fraud perpetrated by an attorney, "who was able to prolong his career of fraud only by settling with one client with funds stolen from another, is one which calls for the intervention of equity."  

When lawyers are engaged in non-traditional services, they must be especially careful to police the receipt and use of client funds to guard against theft and misappropriation. As to investment and financial services that are not legal services, firms should set up separate organizations through which these services are rendered. Most importantly, there should be appropriate disclosures, including potential conflicts of  

5.  Id. at 502, 564 N.Y.S.2d at 724.  
6.  Id. (citation omitted).  
7.  Id. at 502–503, 564 N.Y.S.2d at 724–725 (citation omitted).  
8.  Id. at 503, 564 N.Y.S.2d at 725.
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interest and investment risk factors at the outset of any such relationships with clients, apprising clients that these services are not legal services and that the law firm is not being engaged to perform those services. Such non-legal services are most unlikely to be covered by the firm’s professional liability insurance.

Library References:
West’s Key No. Digests, Executors and Administrators ☼=117.

§ 28.23 Liability for Negligence of Independent Contractors

An attorney has a non-delegable duty of due care to the client. As held by the New York Court of Appeals in Kleeman v. Rheingold, the retention of an independent contractor to carry out a service for which the attorney was engaged does not relieve the attorney of that non-delegable duty. In Kleeman, a patient retained the defendant law firm on November 2, 1978, only days before the Statute of Limitations was to expire, to prosecute a medical malpractice action against his former doctor. On November 5, 1978, after preparing the summons and complaint, the law firm hired its usual process server to effect the necessary service. The law firm explained that service had to be effected immediately because the Statute of Limitations would expire on November 7, 1978, but it did not discuss how service would be made.²

In due course, the law firm received the affidavit of service executed by an employee of the process server, showing on its face that timely service had been made on the doctor. In fact, the summons and complaint had been served on the doctor’s receptionist, and at the traverse hearing, the referee held the service invalid and recommended dismissal. The trial court consequently dismissed the action. The plaintiff sued the law firm, alleging that it was liable for the process server’s negligence in effecting improper service. The trial court granted the defendant firm’s motion for summary judgment, holding that a process server is an independent contractor rather than an agent of the attorney who engages the process server to serve process. The First Department affirmed, holding that the attorney is not liable for the process server’s negligence when the process server is an independent contractor and the attorney receives an affidavit of service in proper form.³

The Court of Appeals reversed and broadened the scope of attorneys’ liability, holding that attorneys have a non-delegable duty to the client and, accordingly, they cannot evade legal responsibility for the negligent performance of that duty by assigning the task of serving process to an

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2. Kleeman predates CPLR 304, which changed the method for the commencement of civil actions.

independent contractor. Judge Titone, writing for the court, stated the traditional rule that retention of an independent contractor, as opposed to a mere servant or employee, does not subject the lawyer to liability for the mistakes of the independent contractor. However, he pointed out that exceptions have developed where the employer was negligent in selecting, instructing or supervising the contractor, where the work was "inherently dangerous," and where "the employer is under a specific nondelegable duty," the latter being the reason for the exception in the instant case. He explained that "a duty will be deemed nondelegable when 'the responsibility is so important to the community that the employer should not be permitted to transfer it to another.'" Because service of process is an integral part of the task that the attorney undertakes, the duty was deemed to fit "squarely and neatly within the category of obligations that the law regards as 'nondelegable.'" As noted in a concurring opinion, the court's ruling forces attorneys to assume the role of process servers and may oblige firms to hire in-house process servers so they can be properly supervised.

A similar result, though not contemplated by the decision, occurred in Hirsch v. Weisman, where trial counsel retained by the plaintiff's regular counsel was let out of the case on the basis that he was not in privity with the plaintiff, even though that trial counsel had committed the acts alleged to constitute malpractice. Since regular counsel remained in the case, it was apparent that he would bear responsibility for what trial counsel had done.

§ 28.24 Statutory Liability Under Judiciary Law § 487

In 1965, the State Legislature passed a seemingly sweeping statute providing for a private civil cause of action for treble damages against lawyers who deceive any party or the court. In application, the statute's

5. Id. at 274, 598 N.Y.S.2d at 152.
6. Id. at 275, 598 N.Y.S.2d at 153.
7. Id.

9. PRACTICE POINTER: The lesson to be learned is that when a lawyer is involved in the selection of an expert and monitoring of the expert's tasks, he or she should document these activities in the case file. This is particularly true in the litigation context, where the lawyer's knowledge and judgment are presumed to be paramount. Liability for failing to supervise, though typically not "insurer" liability, arises where the delegating attorney fails to take reasonable steps to ensure that assigned tasks are carried out.

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1. Judiciary Law § 487 reads in full as follows:

§ 487. Misconduct by attorneys

An attorney or counselor who:

1. Is guilty of any deceit or collusion, or consents to any deceit or collusion, with intent to deceive the court or any party; or,

2. Wilfully delays his client's suit with a view to his own gain; or, wilfully receives any money or allowance for or on account of any money which he has not laid out, or becomes answerable for,

Is guilty of a misdemeanor, and in addition to the punishment prescribed there-
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breadth has been substantially curtailed by the cases. The section “must be carefully reserved for the extreme pattern of legal delinquency, which falls within the restrictive contemplations of that statute.” Actual deceit by the attorney is a requirement for a recovery under this statute, and it must be pleaded \(^5\) and shown. \(^4\) Further, the plaintiff must prove a causation element—that he or she was caused damages by the deceit or collusion. \(^5\) A six year fraud Statute of Limitations applies. \(^6\) While there may be no cases on the subject, it would appear that the treble damage cause of action falls within CPLR 4018, stating that where increased damages are granted by statute, the decision, report or verdict shall specify the sum awarded as single damages, and then judgment shall be entered for the increased amount.

It is important to note that the statutory cause of action cuts right through any notion of privity; “the party injured” has a cause of action for treble damages, whether the deceitful lawyer represented that party or not. However, the courts do not appear to be quite so willing to award treble damages where one party in litigation sues his opponent’s counsel under the statute. In Lazich v. Vittoria & Parker, \(^7\) the Appellate Division, Second Department, affirmed the dismissal of a pro se husband’s complaint against his wife’s matrimonial counsel, holding that “all the statements and conduct complained of were well within the bounds of the adversarial proceeding and were not outrageous or egregious in any way.” In other words, the statute does not guarantee you a “nice time” while litigating. In another case, the court refused to allow the statute to for by the penal law, he forfeits to the party injured treble damages, to be recovered in a civil action.


8. Id. at 754, 592 N.Y.S.2d at 419. See also, DiPrima v. DiPrima, 111 A.D.2d 901, 490 N.Y.S.2d 607 (2d Dep’t 1985).
be used by a party to sue his own attorney for wilfully delaying in bringing suit against himself for malpractice.9

§ 28.25 Vicarious Liability for Partner's Misdeeds

Various disciplinary cases have held that a partner claiming to be innocent of his partner's misdeeds still bears responsibility and possible liability, which can even result in disbarment.1 In Clients' Security Fund v. Grandeau,2 the Court of Appeals applied the same principle to a partner's civil vicarious liability for damages based upon the misdeeds of his partner for which he was completely innocent. The defendant, Grandeau, was disbarred for misappropriation of clients' funds and failing to keep records, but his partner Dahowski was only censured for misconduct, not disbarred. After the Clients' Security Fund had paid over $500,000 to 373 clients whose funds had been misappropriated by Grandeau, it sought to subrogate against Dahowski, the innocent partner, based on that innocent partner's vicarious liability.

The Court of Appeals held:

Traditional principles of partnership law dictate that, ordinarily, one member of a partnership is liable for the tortious conduct of another, and any member of a partnership may be liable for a conversion of property committed by a member of the firm, even where the other members of the firm had no knowledge of the offending partner's action (see generally, 16 N.Y.Jur.2d, Business Relationships, §§ 1407-1408; Annotation, Vicarious Liability of Attorney for Tort of Partner in Law Firm, 70 A.L.R.3d 1298). In the circumstances of this case, each client victimized by Grandeau's misappropriation of funds acquired a viable cause of action against Dahowski as well.3

Thus the Clients' Security Fund had subrogation rights against Dahowski for Grandeau's misappropriations. What the case does not discuss is the obvious fact that, while Grandeau's stealing of clients'


PRACTICE POINTER: Although not the typical malpractice claim, the cause of action for violation of Section 487 is grounded on a clear deviation from the minimally appropriate practice standard of candor. This is also a fundamental aspirational norm for all lawyers, which if observed, can give the lawyer confidence that he or she will not be subjected to liability under Section 487.

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3. 72 N.Y.2d at 67, 530 N.Y.S.2d at 778.
funds would not be covered by professional liability insurance, the innocent Dahowski's vicarious liability therefor might well be. Although the decision is silent as to any insurance aspects, it may be read as a way of trying to provide for insurance coverage where clients have been stripped of their assets.

Heine v. Colton, Hartnick, Yamin & Sheresky and Newman,4 involved litigation stemming from the activities of a former partner of a New York law firm who had been dismissed from the firm in 1990 for engaging in "a large pattern of financial transactions appearing to be lacking in substance."5 The plaintiff, who had invested in several of these schemes, filed suit for over $1.5 million in damages against the dismissed partner's firm. In January 1986, under unspecified circumstances, the partner had proposed to the plaintiff that the plaintiff invest through the partner personally in "a profit making venture, such as real estate development and sales or fast food operations."6 In return, the partner would give the plaintiff a series of post-dated checks payable over two years, written and guaranteed by him both personally and as a partner in the law firm, to cover both a return on investment and return of principal. The plaintiff alleged that he had asked the partner whether the deal was lawful and was told by him, "as his attorney and as a partner" of the firm, that the deal met all legal requirements. Additional similar "investments" followed, until the plaintiff had allegedly provided the partner with over $2 million, of which more than $1.5 million was never returned.

The court found that the complaint stated a cause of action for breach of fiduciary duty. The firm owed a fiduciary duty to the plaintiff based on the allegations of a prior attorney-client relationship in a 1985 matrimonial proceeding and of the running by the partner of an investment business at and through the law firm's facilities with the apparent knowledge and acquiescence of other members of the firm. Based on their conduct, the firm's attorneys could reasonably have foreseen that the plaintiff would rely on the firm as a professional organization, not merely as a business acting at arm's length.

Although investment counseling and broker-dealer activities were outside the traditional scope of the law firm's activities, the court held that the allegations were sufficient to create vicarious liability on the part of the partnership. It was alleged that the partner had used the firm's facilities in offering his deals, that the firm had known that he was engaging in this course of conduct, and that other partners of the firm had also invested. The facts sufficiently pleaded an inference that the firm's actions vested the partner with apparent or actual authority sufficient to impose liability upon the firm for those transactions.7

5. Id. at 362.
6. Id. at 363.
7. PRACTICE POINTER: Claims of breach of fiduciary duty arising from non-traditional services usually occur where the
With the rise of multi-state and international law firms in recent years wherein partners do not even necessarily know each other, coupled with some spectacular large firm failures, the notion that partners should be their ‘partners’ keepers’ has come to be viewed as too harsh, resulting in a new statutory provision for the formation of limited liability partnerships in which one partner’s strictly vicarious liability for his or her partner’s acts does not exist. While the protections of New York’s LLP statute are not automatic and must be implemented by certain registration and publication requirements, the LLP form of doing business goes a long way toward ameliorating the harshness of partners’ liabilities for each others’ misdeeds.

Firms should be aware of measures which allow attorneys to “supervise each other.” Not only are supervision and the development of internal controls essential for modern practice, but documenting the preventive and remedial steps taken is essential as well to avoid disciplinary and malpractice liability.

§ 28.26 Liability for Indemnity and Contribution

A lawyer’s liability based upon a theory of indemnity or contribution, although arising out of an act of malpractice, is treated differently than a direct claim for malpractice, particularly when it comes to applying the Statute of Limitations. A cause of action for indemnity accrues, and thus the statute starts running, only when the party seeking indemnification makes payment to the plaintiff. As stated by the Court of Appeals in McDermott v. City of N.Y.:1

Indemnification claims generally do not accrue for the purpose of the Statute of Limitations until the party seeking indemnification has made payment to the injured person. This principle stems from

lawyer and his firm hold themselves out as being able to provide those services. Many of the other partners and associates of the firm often do not know of, or are not sensitive to, the special aspects of their colleagues’ practice or activities. When this occurs, it is imperative that the firm only hold itself out as a legal service organization. For those partners and associates who wish to engage in such activities, separate entities should be established that will not be confused with the law firm. In such cases, the clients of both organizations should clearly be made aware that neither organization assumes the responsibilities or liabilities for activities of the other. Fidelity or surety bond coverage should be considered in respect to the handling of funds and securities.

8. See Partners at Peril: Joint and Several Liability Can Sometimes Spell Financial Ruin, The National Law Journal, 4/23/90, p.1, discussing the 1988 bankruptcy of Finley, Kumble, Wagner, Underberg, Manley, Myerson & Casey and the demise of other firms. In the Finley, Kumble matter, contract partners in the New York office of the firm were startled to discover that they, too, were jointly and severally liable for their firm’s debts along with the equity partners, even though they were paid on the level of senior associates and had no equity in the firm. Simply being held out to the world as a partner results in such joint and several liability.


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1. 50 N.Y.2d 211, 428 N.Y.S.2d 643, 406 N.E.2d 460 (1980). The legal theory underlying the indemnity claim was products liability.
the nature of indemnification claims and does not vary according to
the breach of duty for which indemnification is sought.\textsuperscript{2}

The indemnity claim was held to be a separate substantive cause of
action, independent of the cause of action for the underlying wrong.

A number of legal malpractice cases have been reported wherein the
defendant lawyer impleads successor counsel for the plaintiff on a
contribution theory. The leading case is \textit{Schauer v. Joyce},\textsuperscript{3} in which the
Court of Appeals reversed the appellate division and reinstated just such
a third party complaint. In the underlying matrimonial case, lawyer
number one had represented the plaintiff wife in obtaining a default
decree of divorce against her out-of-state husband. The wife discharged
the lawyer after the husband vacated the default based upon that
lawyer’s false moving affidavit of regularity by which the default judgment
had been obtained. Her matrimonial action was concluded by her
second lawyer. She then retained a third lawyer and sued her first
lawyer for malpractice, alleging that the outcome of her divorce would
have been more favorable if the first lawyer had not filed the false
affidavit. Lawyer number one then impleaded lawyer number two, alleging
that he had failed to take appropriate steps then available to
ameliorate the problems caused by lawyer number one’s acts. Lawyer
number two (the third-party defendant) resisted, asserting that there
was no cause of action as he was not in privity with lawyer number one,
and therefore he could not be a joint tortfeasor.

The Court of Appeals pointed out that CPLR 1401 applies not only
to joint tortfeasors, but also to concurring, successive and even
intentional tortfeasors. It was irrelevant that lawyers number one and two
were not in privity—the relevant question was not whether lawyer
number two owed a duty to lawyer number one, but whether both
lawyers owed a duty to the plaintiff, and by breaching their respective
duties had causally contributed to her ultimate injuries. The court saw
no need to find that a “legal relationship” existed between the alleged
wrongdoers.\textsuperscript{4}

The same point was made by the Court of Appeals in \textit{Rosner v. Paley},\textsuperscript{5} where defendant lawyer number one impleaded lawyer number
two. However, here the third-party complaint was dismissed for failure
to adequately allege malpractice by lawyer number two as the basis for a
contribution claim. As a matter of law, the advice given by lawyer
number two to the plaintiff, about which lawyer number one was

\textsuperscript{2} \textit{Id.} at 216, 428 N.Y.S.2d at 645. Accord \textit{Muscio v. Conte}, 22 A.D.2d 121, 254
N.Y.S.2d 589 (2d Dep’t 1964) (medical malpractice case).

\textsuperscript{3} 54 N.Y.2d 1, 444 N.Y.S.2d 564, 429 N.E.2d 83 (1981).

\textsuperscript{4} \textit{Id.} at 5, 444 N.Y.S.2d at 565 (citation omitted). \textit{See also}, \textit{Catania v. Lippman}, 98
A.D.2d 826, 470 N.Y.S.2d 487 (3d Dep’t 1983).

complaining, was not erroneous and could not constitute malpractice. Lawyer number two had not breached a duty to the plaintiff by reason of such advice. The moral here is that, while the contribution claim may be an independent one, it can still be overcome by attacking the underlying malpractice basis at its core.

The liberality of pleading indemnity and contribution was stretched nearly to its limit in *Corva v. United Services Automobile Ass'n*. In this case, the plaintiff, who had been injured in an automobile accident, settled her claim with the defendant's insurer for a small amount on the advice of her lawyer that such was the amount of available insurance. Her lawyer had relied upon the representation of the insurer's counsel as to the limits of available coverage. When the plaintiff learned that indeed more insurance had been available, she sued both lawyers. The insurer's lawyer then cross-complained against the plaintiff's former lawyer for contribution on the theory that, despite the insurer's lawyer's own misrepresentation, the plaintiff's former lawyer was liable to the plaintiff for not having properly investigated the amount of available coverage. While finding the result "unappealing," the appellate division allowed the cross-claim as a matter of pleading.

§ 28.27 Fee Disputes

Lawyers, at the hands of their disappointed clients, experience both legal malpractice and fee dispute litigation. Sometimes they are plagued with both at the same time, and the nightmare takes on a double twist when unscrupulous clients seek to avoid hard-earned fees by counter-claiming with concocted malpractice allegations. A proper analytical framework and a creative approach to separate the two types of disputes and handle them in a manner that is suitable to the particular characteristics of each can avert the nightmare.

Today's legal system seemingly desires that there be a joinder of all claims and a consolidation of all controversies so that all claims and defenses are resolved together at one time. Analytically, however, legal malpractice and fee disputes should be separated. Practically, they precipitate very different consequences, and, therefore, notwithstanding the wisdom of the system's fundamental joinder precept, they need to be dealt with differently.

A legal malpractice claim triggers participation of an insurance defense firm assigned to represent the lawyer, a need to advise and cooperate with the lawyer's professional liability insurer and assigned counsel, and if a pay-out is made by way of settlement or judgment significant in amount, a risk that next year there will be no insurance or insurance at a substantially higher cost. Since the costs of defense often erode the limits of malpractice coverage, the status of the lawyer and his or her law firm is also very much affected by the insurer's litigation

However, if a fee dispute arises in spite of an attorney’s best efforts to communicate with the client and the dispute cannot be resolved face to face, ADR is probably the best solution.

While ADR may not currently be the first choice of many attorneys when trying to resolve a fee dispute, it is ideally suited to resolving fee disputes between attorneys and their clients for several reasons. First, traditional litigation often takes too long and is too expensive. Second, ADR enables both parties to settle their dispute amicably, perhaps avoiding the frequently interposed counterclaim for malpractice once the attorney has filed suit to collect fees owed by the client. Such a “backfire” malpractice claim triggers a defense under the lawyer’s professional liability insurance policy and may have a significant impact on future coverage and premiums. Third, ADR can avoid adverse publicity that can arise from traditional litigation. Finally, willingness to use ADR helps to foster a good public image for the legal profession.

Obviously, neither the attorney nor the client begins the attorney-client relationship expecting to engage in a future fee dispute. One effective means of communication to avoid fee disputes is the use of a written retainer agreement that specifically sets forth the material terms of the attorney-client relationship. This agreement may also include a provision for resolving fee disputes if they cannot be resolved otherwise. It is desirable that such a provision should include not only the agreement to resolve any fee dispute using ADR, but also the choice of the arbitration/mediation forum, where appropriate, e.g., the American Arbitration Association (“AAA”) or a bar association-sponsored program.\footnote{1}

While arbitration is the best known and most widely used form of ADR, mediation is being used increasingly. In arbitration, one or more arbitrators hear the evidence and decide the case using a procedure akin to that of a trial. The number of arbitrators and rules for discovery and admission of evidence vary depending on the nature of the dispute and the terms of the parties’ agreement to arbitrate. The parties usually agree beforehand that the decision will either be final and binding on both sides or nonbinding. If the latter, either party is free to seek a trial de novo if he or she finds the ruling of the arbitrator(s) unsatisfactory.

In mediation, the parties, with the help of a mediator, are encouraged to come to a mutually agreed resolution. The proceedings are generally less formal than arbitration, and unlike the typical arbitration, mediation is non-binding.

Participation in ADR is voluntary and arises from the parties’ agreement to participate, either contractually or, less commonly, after-the-fact, after a dispute has arisen. Even in the latter situation, partic-
ipation is by agreement; so that conceptually, ADR is always essentially a creature of contract.

In New York, an attorney is generally not required to submit to fee arbitration or mediation.\(^2\) The Lawyer’s Code of Professional Responsibility, under Canon 2, Ethical Considerations, urges that “a lawyer should be zealous in efforts to avoid controversies over fees with clients and should attempt to resolve amicably any differences on the subject.”\(^3\) In Manhattan and the Bronx, fee disputes can be handled in at least two different forums: one jointly sponsored by local bar associations, the other by the AAA.

The Joint Committee on Fee Disputes and Conciliation, consisting of The New York County Lawyers’ Association, The Association of the Bar of the City of New York, and the Bronx County Bar Association, sponsors a fee dispute resolution program which includes arbitration, conciliation and mediation. Most disputes are resolved through mediation.

Once client fee complaints are received by the Joint Committee, an information form is sent to the client who returns it to the Joint Committee. The Joint Committee then contacts the attorney to request a response. In general, most attorneys so contacted respond and participate willingly. Thereafter, the case is assigned to an attorney on the Joint Committee who acts as a mediator for the parties. All proceedings and outcomes are confidential. The fact that the program is utilized makes it likely that the process is viewed by the parties as a good one.

The AAA also has a mediation program. Mediation is seen as the first step to resolving an issue. If mediation does not work, then the parties can proceed to arbitration. An advantage to mediation over arbitration, at least at the AAA, is its brevity—a mediation often can be taken care of in one day as opposed to two or more days for many arbitrations.

The AAA appoints the mediator but allows the parties to review his or her qualifications. If either party objects, the AAA will then submit another name for the parties’ review. The mediation can be held at the

2. Beginning November 30, 1993, a statewide rule was adopted requiring matrimonial lawyers to submit to arbitration of fee disputes. See Wise, Divorce Lawyers Win Most Fee Disputes, N.Y.L.J., 12/14/95, p.1, col.3, discussing the requirements and experiences under the rule. In November, 1995, the Committee on the Profession and the Courts, appointed by Chief Judge of the Court of Appeals Judith Kaye to make recommendations for improving the profession, recommended that mandatory arbitration be imposed on all lawyer fee disputes. See Spencer, Panel Urges Reforms on Fees, Discipline, N.Y.L.J., 11/13/95, p.1, col.3; Spencer, Rule on Sale of Law Business Endorsed, N.Y.L.J., 1/29/96, p.1, col.3. Thereafter the Office of Court Administration put the recommendation out for a 90 day comment period. See News Update, N.Y.L.J., 11/17/95, p.1, col.1. As of this writing, mandatory arbitration of fee disputes in non-matrimonial matters has not been implemented.

AAA's offices or elsewhere if the parties so decide. Again, all proceedings and outcomes are kept confidential.

In those cases where mediation does not work, binding arbitration, in accordance with the Commercial Arbitration Rules of the AAA, is another alternative that should be considered, particularly where the fee dispute involves business and commercial transactions or sophisticated or institutional clients.

§ 28.29 Fee Disputes—Alternative Dispute Resolution—Retainer Agreements Given Strict Scrutiny

While the law in New York clearly promotes a policy of arbitration once there is an agreement to arbitrate,1 retainer agreements are given strict scrutiny by the courts, favorably construed in favor of clients, and invalidated where the full consequences of such agreements are not appreciated by the client. To that extent, the policy of promoting arbitration may conflict with and be limited by the policy of allowing the client to properly pursue a valid legal malpractice claim in court.

In Estate of Suleiman,2 the surrogate's court espoused the fundamental principle regarding retainer agreements as follows:

Contracts between an attorney and client as a matter of public policy are of special interest and concern to the courts. They are not enforceable in the same manner as ordinary commercial contracts. The burden of proving that the arrangement for compensation was fair and reasonable and fully comprehended by the client rests with the attorney.... It is well established that agreements as to fees between attorneys and clients must be viewed in the light most favorable to the client.3

Similarly, the New York Court of Appeals, in Greene v. Greene,4 held:

[A]n attorney may ... contract with a client ... in addition to legal services ... [F]urther[,] a contract between an attorney and his client is not voidable at the will of the client. However, the relationship between an attorney and his client is a fiduciary one and the attorney cannot take advantage of his superior knowledge and position. The basic rule ... is that "an attorney who seeks to avail himself of a contract made with his client, is bound to establish

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1. See CPLR 7503.
3. Id. at 337, 496 N.Y.S.2d at 921. See Matter of Muccini's Estate, 118 Misc.2d 38, 460 N.Y.S.2d 680, 683 (Surr.Ct., Queens County, 1983) ("where an agreement for compensation prepared by an attorney is capable of more than one construction it should be construed most strongly in favor of the client"). See also, In re Cooperman, 83 N.Y.2d 465, 611 N.Y.S.2d 465, 633 N.E.2d 1069 (1994).
affirmatively that it was made by the client with full knowledge of all the material circumstances known to the attorney, and was in every respect free from fraud on his part, or misconception on the part of the client, and that a reasonable use was made by the attorney of the confidence reposed in him." Under this rule it is not necessary for the client to show that the agreement was obtained by fraud or undue influence on the part of the attorney . . . although, of course, that would make the agreement unenforceable if it were proven. Even in the absence of such misconduct the agreement may be invalid if it appears that the attorney "got the better of the bargain" unless he can show that the client was fully aware of the consequences and that there was no exploitation of the client's confidence in the attorney.\(^5\)

Since an arbitration provision would be an inextricable part of a retainer agreement, the foregoing principles, requiring necessary disclosures and construction in favor of the client, would automatically apply. The selection of arbitration as a method to avert "back-fire" legal malpractice claims should therefore be accompanied by appropriate disclosures and used only with appropriate clients. It also follows that the arbitration should only be designated to occur in a forum where there is no hint of bias against the client in favor of members of the legal profession. Therefore, lawyers contracting with clients for arbitration of fee disputes should make sure that the conditions for, as well as the context of, the arbitration are grounded in fundamental fairness, to wit, material disclosures regarding possible waiver of rights to bring malpractice litigation and selection of an unbiased forum.

Medical malpractice cases provide some useful analogies. In *Miner v. Walden*,\(^6\) notwithstanding the explicit recognition of the public policy of promoting arbitration in New York, the court declared as unconscionable the attempt to require a patient having a decided disparity of education, knowledge and understanding, as compared to his doctor, to submit a medical malpractice claim to arbitration. *Sanchez v. Sirmons*\(^7\) similarly vitiated an arbitration agreement that would have prevented a patient from instituting a medical malpractice action after elective surgery. Arbitration of medical malpractice claims was not deemed offensive to public policy, *per se*. However, the court pointed out that "it [had] not been demonstrated that the petitioner made an informed and knowledgeable waiver of her constitutional rights to trial by jury."\(^8\)

5. *Id.* at 92, 451 N.Y.S.2d at 49 (citations omitted).

6. 101 Misc.2d 814, 422 N.Y.S.2d 335 (Sup.Ct., Queens County, 1979).

7. 121 Misc.2d 249, 467 N.Y.S.2d 757 (Sup.Ct., Bronx County, 1983).

8. *Id.* at 252, 467 N.Y.S.2d at 760. The court recognized that "... the manifest objective of a medical entity in including an arbitration clause [was] to avoid a jury trial and thereby hopefully minimize losses for any medical malpractice and correspondingly ... hold down the amount of any recovery by the patient."
Brook Plaza Ophthalmology Associates v. Fink illustrates that attorneys can effectively protect themselves by properly drafting retainer agreements in order to prevent unrealistic client expectations. The court, noting that the retainer agreement had clearly delineated the parameters of the lawyer's engagement, held as follows:

As to the breach of contract claim, there were no express promises in the retainer agreement which defendants breached. Indeed, the very reasons for the delay in filing the application were specifically addressed in the retainer agreement. Finally, the written retainer agreement is unambiguous. Plaintiff cannot defeat the summary judgment motion with conclusory assertions that the written agreement does not properly express the oral agreement reached during negotiations.

Some general New York contract rules may be helpful, where a retainer agreement has been specific regarding a point in dispute. Where the expressed intention of the contracting parties is clear, a contrary intent will not be created by implication. A contract must be construed according to the expressed intent of the parties, and where the intention of the parties is clearly and unambiguously set forth, effect must be given to the intent as indicated by the language used. The best evidence of what parties to a written agreement intend is what they say in their writing. A party to a written contract will not be heard to assert terms belied by the explicit provisions of the contract.

§ 28.30 Fees Disputes—Alternate Dispute Resolution—Arbitration Clause in Retainer Agreement May Waive Other Client Rights

The rationale for inserting a material disclosure of possible waiver of malpractice litigation in a legal fee dispute arbitration provision with the sophisticated and suitable client is apparent from a reading of John Grace & Co., Inc. v. Tunstead, Schechter & Torre. In that case, the Appellate Division, First Department, discussed the collateral estoppel effect of fee dispute litigation where the client has asserted an affirm-

10. Id. at 171, 569 N.Y.S.2d 26.

PRACTICE POINTER: Attorneys should always, on an ongoing basis, discuss with their clients the reasonable options available in the course of the representation and obtain, where appropriate, the client's knowing consent so that the client cannot be heard to complain later. This is especially the case where an arbitration provision is incorporated in a retainer agreement.

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tive defense of legal malpractice. The preclusive effect of the fee dispute litigation on a malpractice claim was manifest, since in contesting defendants' fee claim in plaintiffs' action, plaintiffs asserted legal malpractice as an affirmative defense. The court stated that plaintiffs had placed the matter of defendants' alleged legal malpractice in issue and lost. "Therefore, in fixing the value of defendants' services, the court necessarily concluded that there was no malpractice."²

In addressing plaintiffs' arguments against collateral estoppel, the court demonstrated the almost certain preclusive effect of fee dispute arbitration on subsequent malpractice litigation, but such applies only if the arbitration satisfies the essential condition of a full and fair opportunity to be heard. The court stated:

Plaintiffs argued to the motion court (1) that the fee claim hearing was informal and did not afford an opportunity for the full and fair litigation of the issue; (2) that the issues considered and decided by the fee claim court were not identical to the issue before this court; and (3) that there was a statement placed on the record at the fee claim hearing, without objection, that the hearing would not affect the merits of the legal malpractice action. However, these arguments are mere bald allegations by counsel, unsupported by any proof. . . . Thus, the record before this court establishes (1) that there is identity between the parties and of the key issue, (2) that there was a full and fair opportunity to litigate the issue because plaintiffs raised the issue as an affirmative defense in the fee claim hearing, and (3) that since the fee claim and the legal malpractice claim arose from the same transaction, the decision to award fees necessarily included the finding of no malpractice. Accordingly, plaintiffs' legal malpractice claim based upon the same services at issue before the fee claim court is barred by collateral estoppel and res judicata.³

The Appellate Division, Second Department, in Altamore v. Friedman,⁴ validated the concept of the arbitration of legal fee disputes.

². Id. at 19, 588 N.Y.S.2d at 265 (emphasis added). See also, Altamore v. Friedman, 193 A.D.2d 240, 602 N.Y.S.2d 894 (2d Dep't 1993) (there is an identity of issues between a malpractice action and an action for fees, which results in a res judicata holding). There are cases indicating that attorneys may be entitled to their fees even in cases where they have breached a fiduciary obligation and/or retainee agreement. See Mar Oil S.A. v. Morrissey, 982 F.2d 830, 840 (2d Cir. 1993) (attorney who intentionally obscured contingency fee provision in contract with client was permitted to recover on a "time spent" basis); Petition of Rosenman & Colin, 850 F.2d 57, 63-64 (2d Cir. 1988) (billing provision of retainer agreement breached by attorney, but fees awarded on quantum meruit basis). These results occur in cases where a retainer agreement has been rendered unenforceable by the attorney's actions, but there was no detrimental effect on the services rendered. However, attorneys have been denied compensation or reimbursement where they have been negligent in their representation of their clients. See Senftner v. Kleinhaus, 80 Misc. 519, 141 N.Y.S. 533 (1st Dep't 1913).

³. 186 A.D.2d at 19-20, 588 N.Y.S.2d at 265-266.

Where there is informed consent by the client, the legal fee will not only be upheld by the courts, it will be given preclusive effect where there is an award for the lawyer and, as a result, subsequent legal malpractice litigation will be cut off. The client, in an underlying arbitration for wrongful termination against his employer, had proceeded to an arbitration hearing, paid his counsel $19,962, lost the arbitration, and then demanded a refund of the legal fee, claiming counsel "did not deserve or earn his fee." Under the auspices of the Nassau County Bar Association, there was binding arbitration of the fee dispute with the client, whose current lawyer, allowed to testify as an expert, asserted that the former attorney had been "unprepared, misdirected, wasteful, and inadequate." In short, he placed the lawyer's competence directly in issue. The client lost, and two months later, he filed an action for legal malpractice, which neither the supreme court nor the appellate division would permit to go forward on grounds of collateral estoppel. The Second Department held:

[The] claim, and ... supporting expert testimony before the arbitration panel embraces the foundation of [plaintiff's] malpractice action and fatally undermines [plaintiff's] contention that the panel lacked authority to render a decision that would legally bar a subsequent malpractice suit.

Under established case law "[a] judicial determination fixing the value of a professional's services necessarily decides that there was no malpractice." ... The issue of [the lawyer's] competence was reasonably and plainly comprehended to be within the scope of the dispute submitted to arbitration.

The New York Legislature, through the enactment of CPLR 7503, and the judiciary both recognize that "[a]rbitration is designed to achieve a just determination of the matters in dispute and finally to dispose of them in a rapid and inexpensive manner, thus avoiding litigation between the parties.... The policy of the State favors and even encourages arbitration as a means of conserving time and resources." While arbitration of fee disputes is decidedly possible, it should be set in a context of complete fairness, entailing a waiver of court proceedings only by a sophisticated client in an unbiased forum. Fee dispute arbitration at the American Arbitration Association should disabuse even the appearance of a pro-profession bias. Unsophisticated personal injury, trust and estate, matrimonial, and criminal case clientele may not be suitable clients for arbitration of fee disputes. Better candidates may be business and commercial clients who are sophisticated in a business and commercial sense. An institution having its own in-

5. Id. at 243, 602 N.Y.S.2d at 895.
6. Id. at 246, 602 N.Y.S.2d at 898 (emphasis added) (citations omitted).
house counsel is an example of a client well suited to this dispute resolution mechanism.⁹

Effective communication with clients, particularly with regard to billing matters, can go far in avoiding fee disputes. Further, where accompanied by full and fair disclosure to a sophisticated client, fee dispute arbitration grounded in fundamental fair play should be sustained in court. Such arbitration can effectively eliminate the costs and pains of “backfire” malpractice litigation and its detrimental impact on the scope and costs of lawyers professional liability insurance. If properly utilized, ADR, in the form of mediation or arbitration, can accomplish very important objectives for lawyers’ professionalism in our society.

§ 28.31 Fees Disputes—Statutory Limitations

Fee dispute litigation places considerable emphasis on basic documentation such as the retainer agreement, contemporaneous time records, and contemporaneous billing statements. In addition, the court may, in appropriate cases, look at certain statutory limitations.

For example, in In re Estate of Clinton,¹ an application was made to the Surrogate after the compromise of a wrongful death action based upon medical malpractice. As a result of a structured settlement of $979,697, counsel sought a fee of $226,829, the maximum contingent fee allowable in a medical malpractice action by the applicable section of the Judiciary Law,² plus an additional $4,987.50 that counsel had paid to appellate counsel regarding an appeal of the outcome of a motion for change of venue. The surrogate held that the lawyer had to absorb the appellate lawyer’s fee; it was not the equivalent of an out-of-pocket

8. PRACTICE POINTER: A suggested arbitration provision, with the disclosure provision highlighted, is as follows:

In the event of a dispute concerning fees, we agree to attempt, in the first instance, to resolve the dispute by non-binding mediation, and if such procedure fails, to finally resolve the dispute through arbitration rather than court action. You [the client] expressly acknowledge your understanding that, by law, such arbitration may preclude any later litigation of alleged legal malpractice in connection with the services which are the subject of the fee dispute.

Accordingly, the parties to this retainer agreement agree initially to attempt to settle their fee dispute by mediation under the Commercial Mediation Rules of the American Arbitration Association (“AAA”) or through the mediation facilities of the Joint Committee on Fee Disputes and Conciliation supervised by the New York County Lawyers’ Association, the Association of the Bar of the City of New York, and the Bronx County Bar Association.

In the event such dispute cannot be resolved by mediation, the controversy concerning legal fees and expenses shall be submitted to arbitration in accordance with the Commercial Arbitration Rules of the AAA. Unless you object in writing, within five business days after receiving written notice of arbitration, the AAA shall serve as the arbitration forum. If you do object, in writing, within that time period, then your choice of a recognized and appropriate arbitration forum, as specified in such written objection, shall govern. Judgment upon the award rendered by the arbitrator(s) may be entered in any court of competent jurisdiction.

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2. Judiciary Law § 474-a(2).
disbursement, but rather comparable to a fee for an expert witness. Nor was there a showing of "extraordinary circumstances" or compensation authorized in a contract of engagement beyond that provided for by statute. In short, the statutory maximum fee controlled.

Library References:
West's Key No. Digests, Executors and Administrators ◄489.

§ 28.32 Fees Disputes—Account Stated

Frequently, an action for an account stated is one form in which a lawyer seeks recovery of unpaid fees. Such a cause of action, where successful, essentially cuts off defenses to the claim for unpaid fees that might otherwise be stated by the client.

The standard is simple and clear. As the court held in Dreyer & Traub v. Rubinstein, an action based on an account stated may exist where the defendant has received a statement of account from a law firm without objecting to it within a reasonable time. Further, the client's being "economically constrained" is not an acceptable objection or excuse. Summary judgment is appropriate and not viewed as drastic.

However, where a client has submitted letters in response to the lawyer's statements regarding the client's concerns about the legal fees being charged and objecting to the amount charged within a reasonable time after receiving the statement, summary judgment will be denied. Obviously, a series of statements received by the client without objection makes for a stronger account stated case.

§ 28.33 Fees Disputes—A Standard of Reasonableness

Lawyers have a duty both to act reasonably and to effectively communicate with their clients before recovery of their fee can be assured. In Kramer, Levin, Nessen, Kamin & Frankel v. International

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2. Id. at 236, 594 N.Y.S.2d at 258.
3. "Recovery premised upon an account stated will fail where a dispute about the account can be shown to have existed." See Shamberg Marwell Chernoff & Hocherman, P.C. v. Laufer, 193 A.D.2d 664, 597 N.Y.S.2d 471 (2d Dep't 1993); Farley v. Proumision Video Displays Corp., 198 A.D.2d 122, 603 N.Y.S.2d 476 (1st Dep't 1993).

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1. PRACTICE POINTER: Billing practices and procedures must not only be fair but perceptibly fair in the first instance to the client and ultimately to the arbitrator or court. In addition to contemporaneously and accurately documenting time expended, bills should be reviewed by senior lawyers to determine whether the amounts charged are reasonable and fair. Consideration should also be given to flat fee or task-related billing, discussed in advance with the client, so that petty disputes over discrete increments of time, i.e., interoffice conferences with juniors, can be avoided.

A well drafted retainer agreement may avoid confusion and disagreements between clients and their attorneys over billing. See infra, § 28.47 for a drafting checklist and §§ 28.50 and 28.51 for sample retainer agreements.
800 Telecom Corp., the court sustained a default judgment and an award of attorneys fees of $149,956.41 after an inquest because the law firm had met its burden of proof. “[I]t’s fees were fair, reasonable and fully known and understood by defendant.”

In contrast, in Burke v. Crosson, a claim for attorneys fees pursuant to 42 U.S.C.A. § 1988 was asserted. The court denied the claim because counsel had not provided a clear explanation for the amount of the fee awarded, and the fee application was “not supported by adequate documentation.” The court noted that counsel had not submitted contemporaneous time sheets detailing the number of hours reasonably expended and differentiating between the time expended in court, out of court, and in connection with clerical tasks as opposed to professional services. No specific documentary proof was submitted as to the hourly rate (e.g., in the form of a retainer agreement) or showing that the requested hourly rate was the customary fee charged for similar services by lawyers in the community with like experience and comparable reputation.

While there is no precise yardstick for a determination as to whether a fee is reasonable, the factors utilized are, in large part, based on common sense and basic equitable principles. The criteria were well stated in Smith v. Boscou’s Dept. Store. In deciding whether a discharged attorney who had previously entered into a contingent fee arrangement was entitled to compensation and in what amount, the court held that in New York, the attorney was entitled to compensation “measured by the fair and reasonable value of the services rendered whether that be more or less than the amount provided in the contract or retainer agreement.” The court stated that while the percentage agreement was one factor that may be taken into account in determining the value of the services rendered, it was not to be considered the dispositive factor. “Other factors, such as the nature of the litigation, the difficulty of the case, the time spent, the amount of money involved, the results achieved and amounts customarily charged for similar services in the same locality, for example, should also be considered.”

Library References:
West’s Key No. Digests, Executors and Administrators ⇾ 488.

§ 28.34 Limited Liability Companies and Limited Liability Partnerships

In July, 1994, New York enacted the “New York Limited Liability

2. 190 A.D.2d 538, 593 N.Y.S.2d 211 (1st Dep’t 1993).
3. Id. at 539, 593 N.Y.S.2d at 212.
5. Id. at 998–999, 595 N.Y.S.2d at 275.
7. 192 A.D.2d at 950, 596 N.Y.S.2d at 576.
Company Law," which became effective on October 24, 1994. The law authorizes businesses, including professions, to organize as Limited Liability Companies ("LLC's") and authorizes professional partnerships to elect to become registered Limited Liability Partnerships ("LLP's"). The LLP provides general partnerships with individual partner asset protection.2

A member of a professional LLC or LLP limits his or her personal liability for both tort and contract exposure of both the firm and his or her partners. The individual partner's assets are exposed only in the event of personal guarantees of firm obligations (just as a stockholder in a corporation) or for the individual's own professional acts, errors or omissions constituting malpractice, and for such acts of those people whom the individual directly supervises and controls while they are performing professional services. Most importantly, the individual will not be responsible for the independent malpractice of a fellow partner or the firm.3

Under prior partnership law, the assets of the firm were exposed first, but if they proved insufficient, then a creditor of the firm could reach the personal assets of the partners to satisfy a firm liability. As an LLP, the firm's assets are still exposed, but the partners' personal assets are not, assuming they or those under their supervision are not directly responsible for the liability. The firm's professional liability policy is a firm asset and remains exposed either way to the extent that it provides coverage.

The purpose of the LLC or LLP is to provide protection of individual partners in the event the firm dissolves, enters bankruptcy or suffers a substantial malpractice judgment. A dissolving firm might even want to reorganize as an LLP prior to dissolution. The LLP would be in effect while the attorneys are focused on future individual careers rather than entirely on the firm and its clients' matters.

The LLP law provides an interesting issue—does it violate Disciplinary Rule DR 6-201 of the Code of Professional Responsibility? That rule provides that a lawyer shall not seek, by contract or other means, to limit prospectively the lawyer's individual liability to a client for malpractice. Formal ethics opinions of the Association of the Bar of the City

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1. NYLLCL §§ 1201, et seq. As recently as 1978, a limited liability partnership was "an entity unfamiliar to American law." Cuban Cigar Brands N.V. v. Uppmann Int'l., Inc., 457 F.Supp. 1090, n. 7 (S.D.N.Y.1978).


3. See NYLLCL § 1205.
of New York and the New York County Lawyers' Association have opined that it does not.\textsuperscript{4}

\section*{§ 28.35 Lawyers Professional Liability Insurance}

Lawyers professional liability coverage is almost universally written on a “claims made” basis.\textsuperscript{1} For such coverage, the insuring clause provides that coverage under the policy is invoked when the claim is (first) made against the insured during the policy period.\textsuperscript{2} This “attachment point” is informally called the coverage “trigger.”

Such coverage is to be contrasted with “occurrence coverage,” for which the coverage trigger is not the making of a claim against the insured, but rather the insured’s actual or alleged commission of an act, error or omission during the policy period which later results in a claim. Thus occurrence policies can respond many years after an act has occurred, as claims can occur many years after the operative act creating liability was committed. Obviously, such policies should not be discarded upon expiration, since they are subject to what is known as a “long tail,” potentially providing coverage for many years after they have expired.

A typical “claims made” insuring clause reads as follows:

To pay on behalf of the Insured all sums which the Insured shall become legally obligated to pay, resulting from a Claim which is first made against the Insured during the Policy Period as shown in Item 2 of the Declarations, caused by an act, error, or omission of the Insured or any other person for whose acts, errors, or omissions the Insured is legally responsible, and arising out of the rendering or failure to render professional services for others (1) in the Insured’s capacity as a lawyer or Fiduciary (as defined herein), and in the name of the Named Insured stated in Item 1 of the Declarations or the Named Insured’s Predecessor Firm (as defined herein); or (2) in the Insured’s capacity as a Notary Public (as defined herein);

PROVIDED ALWAYS THAT such act, error, or omission happens:

(1) During the Policy Period; or

(2) Prior to the Policy Period but subsequent to the Retro-active Date shown in Item 6 of the Declarations.\textsuperscript{5}


\textsuperscript{1} Regulation 121, 11 NYCRR §§ 73.0, \textit{et seq.}, governs “claims made” coverage for lawyers in New York.

\textsuperscript{2} See Chapter 31 “Insurance Law,” infra.

\textsuperscript{3} Section I, Insuring Clause, Lawyers Professional Liability Policy of Gulf Insurance Company, for New York County Lawyers’ Association sponsored program.
Many "claims made" policies are subject to what is known as a "double trigger," in which the insuring clause requires two events during the policy period for policy coverage to be invoked: (1) the making of a claim against the insured; and (2) the giving of notice to the insurer. The relevant language from an insuring clause for such a double trigger policy reads in pertinent part as follows:

The Company will pay on behalf of the Insured all sums which the Insured shall become legally obligated to pay as Damages for Claims first made against the Insured and reported to the Company during the Policy Period or Extended Reporting Period, as applicable, arising out of any negligent act, error, omission or Personal Injury in the rendering of or failure to render Professional Services by an Insured covered under this policy.\(^4\)

Since the second part of the double trigger (the notice requirement) can happen during the automatic extended reported period,\(^5\) a claim that is made during the closing days of the policy can still be reported to the insurer within the following sixty day period of the automatic extended reporting period ("tail" coverage).

Many "claims made" policies also have a "front end" limitation called a "retroactive date." When a claim is made, it is covered only if the acts complained of occurred after the specified retroactive date.\(^6\) Sometimes the same result is effected with a "prior acts" exclusion or limitation built into the insuring clause or elsewhere in the policy.

§ 28.36 Lawyers Professional Liability Insurance—Extended Reporting Period

Occurrence policies for lawyers have not been commercially available for lawyers in New York for many years. For professional liability, insurers much prefer to write "claims made" policies, as such policies essentially "die" once they expire. However, since that can work a hardship upon insureds, Regulation 121\(^1\) in New York requires the insurer to offer extended reporting period coverage, or what is informally known as "tail" coverage.

Such coverage is analytically occurrence coverage, providing coverage for claims made during the specified "tail" period following the normal policy termination date, for acts that occurred prior to that date.


5. See infra, § 28.36.

6. See, e.g., 30 W.15th Street Owners Corp. v. Travelers Ins. Co., 165 A.D.2d 731, 563 N.Y.S.2d 764 (1st Dep't 1990). See Regulation 121, 11 NYCRR §§ 73.1(b), 73.3(b), the latter forbidding the insurer to change a retroactive date as long as coverage is in force with that insurer. See retroactive date language in Gulf Insurance Co. Insuring Clause set out in text above.

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1. 11 NYCRR §§ 73.0, et seq.
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(i.e., during the policy period, as with an occurrence policy).\(^2\) Tail coverage allows for transition to another carrier without coverage gaps and allows for “overhang” coverage when a firm goes out of business or a solo practitioner retires.

Regulation 121 provides for two types of “tail” coverage: (1) automatic 60 day tail coverage, which is mandatory and free to the insured, and (2) optional tail coverage for a period of time thereafter, for an additional premium, at the insured’s option.\(^3\) Note that these provisions apply even when a policy is non-renewed or canceled (or even where there is a decrease in limits or reduction of coverage),\(^4\) except where the insured has been continuously covered by the involved carrier for less than one year and the policy is canceled because of the insured’s non-payment of premium or fraud.\(^5\)

The automatic sixty day tail coverage serves several functions. First, it allows for a smooth transition to a policy with another carrier or to an optional extended reporting period, making sure that no insured is “caught short” by failing to timely renew, creating a coverage gap. Second, it ameliorates some of the stringency of a “double trigger” policy for those few days at the end of a policy period where it becomes less reasonable to require notice to be given to the insurer very quickly after a claim has been made against the insured.

A by-product of the sixty day tail is that, where the insured has changed to a new carrier, there can be overlapping coverage under both policies for that sixty day period. The benefit is that the insured has more limits available, for no additional cost, for a claim made during that overlap period; the disadvantage may be that the insured is subjected to a disagreement between the carriers as to which carrier has primary liability.

The purchase of optional tail coverage, which costs some specified fraction of the original premium, is definitely recommended if for any reason an insured knows or believes that he or she will not be covered by a new policy after the old one has terminated. Such can happen where the individual insured attorney is retiring, where the firm is going out of business, or where an attorney makes a “lateral move” to a new firm whose carrier does not provide “prior acts” coverage for such “lateral hires” (many do not, as otherwise an insurer is “picking up” all kinds of unknown risk).

Within thirty days of cancellation or nonrenewal, the insurer is generally obligated to advise the named insured in writing of the

\(^2\) If the policy is subject to a “retroactive date” or “prior acts” limitation on the “front end,” whereby claims arising from acts occurring prior to policy inception are covered only if those acts occurred after a specified date, the acts covered by tail coverage must generally occur after that retroactive date.

\(^3\) 11 NYCRR § 73.3.

\(^4\) 11 NYCRR § 73.2(n).

\(^5\) 11 NYCRR § 73.3(k).
automatic sixty day period and that optional tail coverage is available for specified time periods at specified premiums. For lawyers professional liability coverage, an insurer must offer the insured a three-year optional tail period. To accept the carrier's offer of extended reporting period coverage, the named insured must respond within the later of sixty days from policy termination or thirty days from the insurer's written notice.

Where the named insured is a corporation, partnership or other entity, the Regulation also permits an individual insured who is covered under the policy to purchase "tail coverage" if: the named insured entity is placed in liquidation or bankruptcy or permanently ceases operations, the entity or its trustee does not purchase tail coverage, and the person requests the individual tail coverage within 120 days of the termination of the policy. However, note that the insurer is not obligated to provide written notice of this option to purchase tail coverage to individual insureds. This individual option to purchase tail coverage is very important, because the demise of a firm may coincide with significant claim activity against its constituent professionals, who can otherwise be left "high and dry" if the firm policy is simply allowed to expire without the purchase of tail coverage.

§ 28.37 Lawyers Professional Liability Insurance—What Is a "Claim" and When Is It "Made"?

Since it is the making of a claim against the insured that triggers coverage under a policy, one must know what qualifies as a "claim," and when a claim is "made." The answer to the first of these important questions is most often found in the policy definition of the word "claim." Absent such a definition, the answer is supplied by case law.

The essence of a claim is a demand for money. Many policies require that such demand be made in writing, to avoid assertions of undocumented oral claims first made during the policy period for lawsuits plainly brought after the policy has expired. Note that policies rarely require that the claim be made in a complaint; a simple letter will fully suffice to trigger coverage if it meets the requirements of the definition of "claim." In addition, where the claim is first made in a complaint, there is generally no requirement that such be actually served

6. 11 NYCRR § 73.3(e)(1).
7. 11 NYCRR § 73.3(f).
8. 11 NYCRR § 73.3(e)(3).
9. 11 NYCRR § 73.3(n)(1).
10. 11 NYCRR § 73.3(e)(2).

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2. "The term 'Claim' shall mean a demand for money by a third party, made in writing against the Insured and actually received by the Insured, including the service of a Suit on the Insured." Section IV(4), Lawyers Professional Liability Policy of Gulf Insurance Company, for New York County Lawyers' Association sponsored program.
on the insured to constitute a "claim." Receipt of a "courtesy" copy in
the mail, unserved, will generally trigger coverage.

As for when the claim is "made," this issue is generally just a
matter of common sense. The issue can arise in "file and serve"
jurisdictions, which New York now is and federal courts have always
been, where a complaint is filed with the court first, before it is served
on the insured, and the dates of filing and service span a policy inception
or termination date. For a claim to be "made" against the insured, the
"common sense" rule of thumb is that the insured must at least know
about it. If the insured is unaware of the claim, such as with a filed but
unserved complaint of which the insured has no knowledge prior to
service, such claim has obviously not been "made" against the insured.

§ 28.38 Lawyers Professional Liability Insurance—Professional Capacity and Typical Exclusions

Lawyers professional liability policies are limited to claims made
against an insured in his or her professional capacity, i.e., a lawyer
acting as a lawyer. Policies typically extend this covered capacity to cover
certain fiduciary roles, such as acting as a trustee, guardian, etc., or
acting as a notary public. A lawyer’s actions serving as an investment
advisor, carrying on a business enterprise other than the practice of law,
or serving as a director of a client corporation are generally excluded
from coverage.

Other typical exclusions are:

- Dishonest, fraudulent, malicious and criminal conduct;
- Claims by one insured against another insured;
- Claims arising from alleged discrimination based on race,
  creed, age, sex, etc.;
- Non-pecuniary relief, punitive damages (which are not insur-
  able under New York law), fines, sanctions, and penalties;
- Matters covered by prior insurance;
- Claims arising out of bodily injury, sickness, disease or death
  of any person, or injury to or destruction of any tangible
  property or loss of use resulting therefrom (to eliminate
  overlapping with comprehensive general liability coverage);
  and
- Liability for acting as a fiduciary under ERISA.

Where a claim is made which could result in liability which would be
eliminated by an exclusion, but the insurer cannot deny coverage out-

Goldfarb, 53 N.Y.2d 392, 442 N.Y.S.2d 422,
right because there is a mix of covered and non-covered allegations, the insurer is required to give the insured a complete statement of the coverage issues. This is done in what is called a “reservation of rights letter.” Such a letter can often cause confusion because it appears to resemble a denial letter. However, the distinction is crucial; a reservation of rights letter signals that the insurer is not denying coverage but is instead providing coverage, subject to the stated reservations.

A reservation of rights is not appropriate for issues as to which the insurer already has all the information it needs to “make up its mind” as to the applicability of a particular coverage defense. If the insurer reserves rights where it has all the information it needs to deny coverage, it may actually waive the coverage defense altogether. Further, if an insurer assumes the defense of a claim without reserving rights for a particular coverage defense, such coverage defense is generally waived. An insurer may sometimes choose to waive a coverage defense by not raising it, in order to maintain control over the defense.

§ 28.39 Lawyers Professional Liability Insurance—Limits, Deductibles and Defense

Policies generally have a “per claim limit,” which is the maximum that the company will pay for any one claim (including related claims), and an “aggregate limit,” which is the maximum the company will pay for all claims under the policy. Note that a “claim” is as defined in the policy and is not synonymous with a cause of action generally or the alleged acts involved in a claim.

Most lawyers professional liability policies offered in New York provide for what is known as a “full defense.” In other words, when an insured is sued, the company has the right and duty to retain defense counsel for the insured and maintains the right to control the defense thereafter (although policies also generally give the insured the right to consent to any settlement). In New York, where the insurer has reserved its rights to deny coverage in the future due to the existence of a possible coverage defense, the insured then has the right to select his or her own defense counsel and control his or her own defense, with the insurer paying the reasonable costs thereof. Where the policy does not provide a full defense, it covers only defense expenses, and the insured has the right and duty to retain defense counsel and controls his or her defense from the outset.


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The erosion of policy limits by defense expenses is strictly governed by regulation in New York. However, an insurer always has the option to provide for a defense totally "outside the limits," meaning that the costs of defense never erode the limit of liability, and several lawyers professional liability insurers do write such coverage.

The regulation provides that for lawyers professional liability policies having limits of less than $500,000, defense costs cannot erode limits. For policies with limits of $500,000 up to $5,000,000, no more than one half of the limits can be eroded by defense costs, and for policies having limits of $5,000,000 and up, defense costs may fully erode limits. For the middle category, the insurer must give the insured the option to purchase a policy with the defense totally outside the limits.

This issue of erosion of limits by defense expenses is an important one, because a lengthy litigation with several appeals can literally exhaust the coverage, leaving little or nothing left for payment of a judgment or settlement "at the end of the day." In this situation, the insurer must keep the insured well apprised of the progressive exhaustion of limits.

Deductibles often apply to defense expenses, and again such application is governed by regulation in New York. For full defense policies, if the limits are below $500,000, the deductible cannot apply to defense costs; if limits are from that amount up to $5,000,000, no more than one half of the deductible can be applied to defense costs, and if limits are $5,000,000 or more, the entire deductible can apply to defense costs.

Note that the defense obligation is owed for a covered claim no matter what the merits of that claim are. Liability insurance is, after all, "litigation insurance." If a complaint contains even one allegation invoking coverage, the carrier must provide a defense for all of the allegations of the complaint, as the duty to defend is broader than the duty to pay. Only if the insurer can demonstrate that none of the allegations in the complaint could result in coverage, can the insurer avoid providing a defense.

2. Regulation 107, 11 NYCRR §§ 71.0, et seq.
3. 11 NYCRR § 71.3(d).
4. 11 NYCRR § 71.3(d), (e).
5. 11 NYCRR § 71.3(d).
6. 11 NYCRR § 71.3(b), (e).
7. Id.
§ 28.40  Lawyers Professional Liability Insurance—Notice of Claim and Notice of Occurrence

Notice to the insurer can be of two types. First, the insured must give the company prompt notice of an actual claim made against the insured. The policy should specify to whom notice is to be given, and such directions should be followed.¹

The second way is called “notice of occurrence” or “notice of circumstance.” This protects the insured where he or she has learned that something has happened which could result in a claim, but no claim has been made yet. By giving such notice under the policy, the insured “triggers” the policy then in effect, no matter when the claim is later made. In other words, the policy will cover any claim that materializes from the “noticed” events, even if the policy has long expired.

A policy should be carefully examined to see whether or not notice of occurrence is mandatory when the insured discovers a matter that could reasonably be expected to result in a claim (i.e., that a Statute of Limitations has been missed, or someone has threatened to sue the insured for malpractice). Some policies require such notice and for others it is purely optional with the insured. It will be observed that for the acts for which notice was given, the “claims made” policy works just like occurrence coverage.

Where notice of claim is not timely according to the policy requirements, the insurer may attempt to deny coverage for late notice, and late notice in reporting a claim can result in the loss of coverage.² In many states, to avoid coverage on this basis, the insurer must demonstrate that it has in fact been prejudiced by the lateness. In New York however, the rule is still that, for direct primary insurance, no prejudice need be shown by the insurer to avoid coverage on the basis of late notice.³

§ 28.40

1. Notice to any licensed agent of the insurer in New York State is, by statute, deemed notice to the insurer. Insurance Law § 3420(a)(3).

2. See Security Mutual Ins. Co. v. Ackerman-Fitzsimons, 31 N.Y.2d 436, 390 N.Y.S.2d 293, 293 N.E.2d 76 (1972); Commercial Union Ins. Co. v. International Flavors & Fragrances, Inc., 822 F.2d 267 (2d Cir.1987). However, by statute in New York, failure to give notice within the time required by a policy does not invalidate coverage “... if it shall be shown not to have been reasonably possible to give such notice within the prescribed time and that notice was given as soon as was reasonably possible.” Insurance Law § 3420(a)(4).

3. Gizzi v. State Farm Mutual Ins. Co., 56 A.D.2d 973, 393 N.Y.S.2d 107 (3d Dept' 1977). There are signs that this long-standing rule may be eroding in New York. Decisions have held that prejudice must be shown for reinsurance matters (Unigard Security Ins. Co. v. North River Ins. Co., 79 N.Y.2d 576, 584 N.Y.S.2d 290, 594 N.E.2d 571 (1992)), and more recently, by an excess insurer (American Home Assurance Co. v. International Ins. Co., 219 A.D.2d 143, 641 N.Y.S.2d 241 (1st Dept' 1996)). Despite the arguments set forth in the cases, these exceptions to the general “no prejudice” rule cannot be rationalized except as an erosion of that rule. In addition, a bill was introduced in the New York State Legislature to change the “no prejudice” rule legislatively, but as of this writing no such bill has been passed (NYS Assembly Bill No. 3719, 1995-1996 Regular Sessions, 2/14/96).
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Where the insurer must show prejudice, such can be difficult to show. It must generally be shown that, had the insurer known about the claim sooner, it could have taken some steps that might have prevented or lessened its liability.

§ 28.41 Lawyers Professional Liability Insurance—Cancellation

New York has strict rules governing when a policy can be canceled or non-renewed by an insurer, and for what reasons. Generally, during the first 60 days of a policy which is not a renewal with the same company, the insurer has broad cancellation rights, on 20 days notice. However, thereafter, the reasons are enumerated by statute, and include such things as the insured's loss of license to practice; nonpayment of premium; the insured's conviction of a crime arising out of acts increasing the hazard insured against; the insurer's discovery of fraud or material misrepresentation in the obtaining of the policy or in the presentation of a claim thereunder; discovery of an act or omission or violation of the policy that substantially and materially increases the hazard insured against, which occurred subsequent to inception of the current policy period; determination by the Superintendent of Insurance that the insurer's present premium volume jeopardizes its solvency; etc. Complex timing rules for the giving of notice of non-renewal or cancellation are provided, the violation of which leaves the policy in effect.

§ 28.42 Lawyers Professional Liability Insurance—Innocent Partner Coverage

Under the wording of many policies, an innocent insured does not lose coverage in certain circumstances, even though the "guilty" lawyers do not receive coverage. A typical "Waiver of Exclusion and Breach of Conditions" section reads as follows:

Whenever coverage under any provision of this policy would be excluded, suspended or lost:

1. because of [an exclusion] relating to any judgment or final adjudication based upon or arising out of any dishonest, deliberately fraudulent, criminal, malicious or deliberately wrongful acts or omissions by any Insured; or

2. because of noncompliance with [a condition] relating to the giving of notice to the Company with respect to which any other insured shall be in default solely because of the default or concealment of such default by

§ 28.41

1. Insurance Law § 3426(b).

2. Insurance Law § 3426(c).
one or more partners or employees responsible for the
loss or damage otherwise insured hereunder,

the Company agrees that such insurance as would otherwise be
afforded under this policy shall apply with respect to each and every
Insured who did not personally commit or personally participate in
committing one or more of the acts, errors, or omissions described in
any such exclusion or condition; provided that if the condition be
one with which such Insured can comply, after receiving knowledge
thereof, the Insured entitled to the benefit of the Waiver of Exclu-
sions and Breach of Conditions shall comply with such condition
promptly after obtaining knowledge of the failure of any other
Insured or employee to comply therewith.

With respect to provision [1] above, the Company's obligation to pay
in the event of such waiver shall be in excess of the deductible and
in excess of the full extent of any assets in the firm of any Insured
who is not a beneficiary to the waiver.¹

§ 28.43 Lawyers Professional Liability Insurance—Ap-
application for Coverage and Rescission of
Policy

When first purchasing a policy, the insured will be required to fill
out an application which asks detailed questions about the firm, its
personnel and its practice. When renewing the policy upon expiration, a
"renewal" application, often less detailed, will generally be required.
Care must be exercised because these applications can be the basis of a
rescission action by the insurer if it has been materially misled.

The firm submitting an application should make sure that due
diligence is performed in order to discover all known circumstances that
could result in claims. Disclosure of such information is the basis of the
contract with the insurer.¹ A material misstatement or omission gives
the insurer a right to rescind the policy.² Rescission of the policy cancels

§ 28.42
1. Section IX(C), Lawyers Professional
Liability Claims—Made Insurance Policy of
Chicago Insurance Company, for New York
State Bar Association sponsored program.

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1. A typical policy provision reads:
By acceptance of this Policy, the Insured
expressly warrants that the Application
upon which this Policy is based is true
and accurate in all respects. It is further
agreed that the Application shall be
deemed fully incorporated in this Policy,
and it is acknowledged that the Company
has relied upon the Application in agree-
ting to issue this Policy.

Section XI(12), Lawyers Professional Liabil-
ity Policy of Gulf Insurance Company, for
New York County Lawyers' Association
sponsored program.

2. See INA Underwriters Ins. Co. v.
(W.D.N.Y.1985) (accountant's professional
liability policy); Shapiro v. American Home
1984) (directors & officers liability policy);
(E.D.Pa.1972) (directors & officers liability
policy). In New York it is also a 'crime to
knowingly defraud an insurer by filing a
false application for insurance or statement
of claim. Insurance Law § 403.
it as of inception, and the insured gets the premium back (but no policy coverage).³

Accordingly, the best course is for the law firm to perform due diligence with regard to all known circumstances that could result in claims by making specific inquiry of all professional personnel and to disclose all such circumstances on the application. The insurer is then on notice to negotiate a specific exclusion for any disclosed matter, or be obligated to cover it if no exclusion is issued.

The most common alleged misrepresentation for attempted rescissions is a negative response to a question on the application inquiring as to the insured’s knowledge of any acts or circumstances which could reasonably be expected to result in a claim. The insurer asks such a question to avoid writing a policy for an insured who already knows that he or she has a bad problem; no insurer intends to write a policy covering known loss situations.

To succeed on a rescission claim, the insurer must prove that the insured’s misrepresentation was material to the risk. “Material” means that had the insurer known the truth, it would not have written the policy, or at least not for the premium charged.⁴ This materiality requirement generally means that the insurer’s underwriting file and personnel are exposed to discovery in a rescission action, as there is generally no other way to prove materiality.⁵

Material non-disclosure of potential claims in an application may void the policy as to all insureds whether or not they have knowledge of or involvement in any wrongdoing. In addressing this issue with regard to a directors and officers liability policy, the court in Shapiro v. American Home Assurance Co.⁶ stated:

The language in the application form, which was part of the insurance contract, is straightforward. The form, in Question No. 14, inquires about knowledge of any officer or director concerning facts which might give rise to claims under the policy. Because of the likelihood of joint and several liability being imposed on all directors for the wrongdoing of one, the facts known by Shapiro [the applicant] were highly material not only to his potential liability, but to that of all other[s].... Since Shapiro’s answer misrepresented the risk incurred in insuring all those covered by the policy, it follows that American Home can avoid responsibility to all the insureds on the

³. See CPLR 3002(e), 3004.
basis of that misrepresentation. Nothing in the application indicates that the parties intended a different result.\textsuperscript{7}

Some policies, however, do protect innocent insureds in these circumstances, by express language negating the insurer’s right to rescind as against such insureds.\textsuperscript{8}

In \textit{American Home Assurance Co. v. Morris J. Eisen, P.C.},\textsuperscript{9} a professional liability insurer instituted an action against a law firm, a professional corporation, to rescind five lawyers’ professional liability policies for the years 1985–1989 on the ground that there were false responses to questions in the applications seeking the firm’s knowledge of any “claims or suits” for the five years and “any circumstances which may result in a claim being made.” The insured’s negative responses had concealed the wrongful activities leading up to the 1991 racketeering convictions of the principal shareholder of the firm and six associate employees for bribing witnesses and manufacturing evidence in twelve personal injury cases in the years 1981–1990.

The firm sought to preserve its coverage and avoid summary judgment, arguing that the convictions had not occurred until after the submission of the insurance applications, and that the principal and sole shareholder of the firm had not known of the illegal activities of his employees. The court rejected these arguments as to all the corporate employees, including its principal shareholder, who had been criminally convicted of “willfully and knowingly combin[ing], conspir[ing], confederat[ing] and agree[ing] together,”\textsuperscript{10} and granted summary judgment in favor of the insurer. The court ruled that the doctrine of collateral estoppel was properly invoked so as to preclude denial of the facts underlying the convictions, and the interests and knowledge of the principal shareholder were merged into, as well as imputed to, the professional corporation.

In its review of New York law and that of other jurisdictions, the court stated:

Misrepresentations or omissions by an insured, even if innocently made, may result in rescission if such misrepresentations were material to [the] insurer’s assessment of the risks in issue on the policy ... The test is whether the insurer has been induced to accept an application it might otherwise have refused ... “[T]he question of materiality is not limited to the knowledge that would

\textsuperscript{7} \textit{Id.} at 1252 (emphasis added). This Massachusetts federal decision was followed in \textit{INA Underwriters Ins. Co. v. D.H. Forde & Co.}, 630 F.Supp. 76 (W.D.N.Y.1985).


\textsuperscript{9} \textit{N.Y.L.J.}, 9/4/92 at 22 (Sup.Ct., N.Y. County, 1992); \textit{see also, Home Insurance Company v. Dunn}, 963 F.2d 1023 (7th Cir. 1992) (innocent lawyer deprived of coverage for negligence claim against him where policy was rescinded due to non-disclosure on application of the unrelated embezzlement of client funds by firm’s principal shareholder).

\textsuperscript{10} \textit{N.Y.L.J.}, 9/4/92 at 22.
have been gained by the insurer from disclosure of the particular suppressed fact alone; it extends to any information that might have been revealed had further inquiry followed the initial disclosure of the suppressed facts."\(^{11}\)

It is important for all law firms, regardless of size, to engage in a due diligence review of past activity to assure coverage for future potential lawsuits. Firms must, of necessity, honestly reveal past acts which could create liability.

Once a rescission has been asserted by an insurer, one of the most effective ways of defeating it is to show conduct by the insurer after the insurer had full knowledge of the misrepresentation, that is inconsistent with the rescission position. In other words, once the insurer has reason to know that it has been defrauded, it is obligated to take steps to protect itself or it will waive the rescission argument.\(^{12}\)

§ 28.44 Lawyers Professional Liability Insurance—Bad Faith

There is an implied covenant of "good faith" in every insurance policy. New York allows a cause of action to an insured for breach of that covenant.\(^{1}\) Such a cause of action accrues whenever, in the context of a liability insurance claim, the insurer puts its own interests ahead of those of its insured.

§ 28.45 Lawyers Professional Liability Insurance—Cautions for Dissolving Law Firms

It is common in today's world for partners to leave law firms, law firms to dissolve, and firms and individual partners to be sued for malpractice in response to efforts to collect receivables in such circumstances. Partners will often leave a firm prior to the firm's decision to dissolve, taking clients and matters with them to more viable firms. Lawyers and firms in transition must takes steps to protect themselves against claims in these vulnerable moments.

\(^{11}\) Id. (citations omitted).


§ 28.44

The best means of protecting against claims is putting professional liability insurers on notice as soon as possible of all potential claims, especially before dissolution of a firm. The notice should be as complete as the firm’s information will allow. Dissolving firms should also purchase “tail” coverage, and individuals should consider purchasing individual tail coverage when available, or individual professional malpractice policies covering their past exposure.

Prior to dissolution, a firm should designate one partner who will remain in charge of future litigation and notices to the insurer. The insurer will then correspond with the firm through this designated person.

When a lawyer moves to a new firm from a dissolving firm, the new firm’s malpractice policy typically will not cover the new lawyer for work done at the former firm (or vicarious liability for other partners’ acts at the prior firm), absent a special endorsement. Partners who join new firms and have not purchased “individual tail coverage” may be surprised to learn that they are uninsured for such prior activity because the professional liability coverage of their new firms is limited to claims arising out of work only at the new firm. By law, as long as the prior firm maintains its coverage, the lawyer who moved remains an insured under the prior firm’s coverage for acts committed while at that prior firm, but that is no help where the prior firm does not maintain its coverage.

§ 28.46 Conclusion

The most important “practice pointer” for any committed lawyer is to recognize that no other profession provides as much opportunity to exemplify the best of human values as does the practice of law. Benjamin Cardozo, Chief Judge of the New York Court of Appeals for many years and then Associate Justice of the United States Supreme Court, once expressed to a graduating law school class:

How it lies with you, to uplift what is low, to erase what is false, to redeem what has been lost; till all the world shall see, and seeing shall understand, that union of the scholar’s thought, the mystic’s

§ 28.45

1. See supra, § 28.36.
2. 11 NYCCR § 73.3(m).
3. PRACTICE POINTER: The foregoing sections on lawyers professional liability insurance issues highlight several areas of major concern for lawyers and their firms. For all firms and groups of practitioners, a designated lawyer or committee should be appointed to be responsible for obtaining and maintaining cost-effective professional liability insurance sufficiently broad to cover all aspects of the firm’s practice. In connection with the insurance application and periodically thereafter, due diligence reviews should take place to identify matters that should be reported to the carrier to ensure that coverage is preserved. Reviews of the firm’s insurance status should also take place in the face of such events as partner withdrawals, the firm’s dissolution, a change of insurers, and possible coverage gaps. If a non-covered claim is asserted, the designated lawyer or committee should take steps to make sure there is effective assistance of defense counsel.
yearning, the knight’s arder, and the hero’s passion, which is still in
the truest moments of self expression, the spirit of the bar!

The authors hope that by defining what is legal malpractice, identi-
fying some of the core issues that arise, and suggesting practice stan-
dards fundamentally premised on diligence and candor, the incidents of
legal malpractice can be reduced to the absolute minimum, and we will
achieve for ourselves and society the truest expression of Benjamin
Cardozo’s values.

§ 28.47 Drafting Checklist—Retainer Agreement

A well drafted retainer agreement may avoid confusion and dis-
agreements between clients and their attorneys which might ultimately
lead to fee disputes and malpractice suits. The following checklist dis-
cusses elements of a retainer agreement which clarify the relationship
between client and attorney and define the relevant duties in an attempt
to avoid unreasonable expectations and resulting disappointment.

The following items should generally be considered when preparing
a retainer agreement:

1. The scope of the attorney’s engagement, clearly defining any
   limitations of that engagement;
2. Specific exclusion of any performance not anticipated by the
   retained attorney (e.g., handling appeals);
3. The parties’ understanding of the fee arrangements, including
   the hourly or transaction rate, billing of expenses, method of
   billing, and time for payment;
4. Terms regarding any retainer amount paid by the client (e.g., is
   the retainer “evergreen”—to be kept paid up to a certain
   amount? Note that retainers cannot be made nonrefundable);
5. Methods of fee dispute resolution, where appropriate;
6. If alternative dispute resolution is contemplated, an advisory
   that a client’s right to judicial review of malpractice issues may
   be waived thereby;
7. Statement that no result is guaranteed; and
8. For particular matters (e.g., plaintiff’s personal injury or matri-
   monial), a statement regarding what personnel (or categories of
   personnel, including outside trial counsel) are anticipated to
   work on the matter, to negate the notion, often alleged in
   malpractice suits, that a particular attorney has promised to
   handle all aspects of the matter.

§ 28.47


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§ 28.48 Drafting Checklist—Malpractice Complaint Against Attorney

Legal malpractice complaints should generally contain the following allegations:

1. An attorney-client relationship existed between the plaintiff and the defendant;
2. The defendant's acts fell below the ordinary and reasonable skill and knowledge commonly possessed by members of the legal profession, in
   - giving advice to the plaintiff; and/or
   - undertaking specified action on the plaintiff's behalf;
3. The defendant failed to disclose material facts and risks (where appropriate);
4. Breach of contract allegations, that the defendant failed to perform a duty that he or she had specifically undertaken to perform, or failed to achieve a promised result;
5. The defendant's acts resulted in actual damages to the plaintiff; and
6. The underlying litigation would have had a more favorable outcome to the plaintiff but for the defendant's acts (where appropriate).

Library References:
West's Key No. Digests, Attorney and Client ⇔64.

§ 28.49 Drafting Checklist—Answer to Malpractice Complaint on Behalf of Attorney

Answers must, of course, respond to the specific allegations of the complaint, so no checklist can apply for purely responsive matter. In drafting responses, the pitfall of CPLR 3018(a) should be borne in mind—any allegations not denied are deemed admitted.

As a general rule of drafting answers, it can be inadvisable to assert affirmative defenses that are merely the converse of essential elements that the plaintiff has the burden to plead and prove. Such practice could arguably shift the burden of proof to the defendant, who has the burden of proof for affirmative defenses. Such a burden-shifting argument by the plaintiff might not succeed for the basic elements of a claim, but there is no purpose served by having to litigate the issue. That said consideration should be given to the possibility of raising (or at least
developing, if they need not be pleaded as affirmative defenses) the following defenses:

1. There was no attorney-client relationship between the parties (lack of privity); *(See §§ 28.11, et seq.)*

2. The breaches of duty complained of were outside the express scope of the parties' retainer agreement; *(See §§ 28.29, et seq.)*

3. The plaintiff's injuries were not proximately caused by the defendant lawyer's acts *(i.e., “but for” test not satisfied; plaintiff would have suffered the same injuries regardless of defendant's acts); (See § 28.8)*

4. Defendant disclosed all material facts and risks that would affect the plaintiff's interests, and chose one among several reasonable actions (lawyer's judgment rule); *(See § 28.12)*

5. Plaintiff is estopped from raising malpractice issues because they have already been adjudicated in another forum in a fee dispute context; *(See §§ 28.27, et seq.)*

6. The claim is barred by the Statute of Limitations; *(See §§ 28.13, et seq.)*

7. The claim is barred due to a prior settlement not compelled by the lawyer's acts; *(See § 28.9)* or

8. The injury was not foreseeable or was caused by a supervening act of someone other than the lawyer. *(See § 28.16)*

Library References:

West's Key No. Digests, Attorney and Client ⇒ 129(2).

§ 28.50 Forms—Retainer Agreement With ADR Clause

This Agreement is entered into between Responsible & Prudent ("R & P"), referred to in this agreement as "the Firm," and Klein Tell, South Street Seaport, New York, New York 10004, referred to in this agreement as "Client."

Client retains the Firm to render services in connection with [insert description of engagement].

Client understands that this Retainer Agreement and any sums paid to the Firm pursuant hereto do not cover any services which are not specifically set forth above. Client expressly understands that this Retainer Agreement (and any sums paid to the Firm pursuant to it), does not cover any services relating to (i) any appeal, or (ii) any other services following the entry of a final judgment, including, but not limited to, such matters as enforcement or modification of the judgment and possible future litigation to enforce or modify a settlement *(or separation agreement).*
The Firm's assignment of work to attorneys and staff may include, but is not limited to, preparation of pleadings, motions, disclosure demands and responses, settlement negotiations, preparation of agreements, preparation and conduct of examinations before trial, court appearances, trial work and any other matter deemed by the Firm to be appropriately delegated. No representation is made that any particular attorney of the Firm will handle any particular task.

Client agrees to cooperate fully with any attorney, paralegal, clerk, or other member of the staff of the Firm in the administration of the case. Such cooperation shall include, but is not limited to, providing the Firm with complete and accurate information. In the event that Client unreasonably fails or refuses to provide such information or follow the advice of the Firm, Client agrees that such failure shall be good cause for the Firm to withdraw from further representation of Client, and Client hereby agrees that the Firm may move to withdraw as Client's counsel under such circumstances.

The Firm will keep Client informed of the status of his case, as well as the results of any court appearances in his case.

Client agrees to provide the Firm with a retainer of ______ dollars ($_______) in connection with the above services, which will be applied to the charges incurred on Client's behalf, with any excess to be promptly refunded. Client agrees to pay the Firm for the actual time expended by its attorneys at an hourly rate of $_______ for partner time and $_______ for associate time, beyond the initial consultation, which is provided without charge. Statements for services and out-of-pocket disbursements incurred by the Firm on Client's behalf (for such things as photocopying, messenger service, deposition transcripts, expert witness fees, computerized legal research, etc.) shall be rendered to Client monthly and, to the extent not covered by the retainer, paid by Client within thirty (30) days of receipt.

Although the Firm is hopeful that Client will be satisfied by the outcome of this retention, Client understands that the Firm makes no representations or guarantees that any specific result can or will be obtained.

In the event of a dispute concerning fees, the parties hereto agree to attempt, in the first instance, to resolve the dispute by non-binding mediation, and if such procedure fails, to resolve the dispute through arbitration rather than court action. Client expressly acknowledges his understanding that, by law, such arbitration may preclude any later litigation of alleged legal malpractice in connection with the services which are the subject of the fee dispute.

Accordingly, the parties to this retainer agreement agree first to attempt to settle their fee dispute by mediation under the Commercial Mediation Rules of the American Arbitration Association ("AAA") or through the mediation facilities of the Joint Committee on Fee Disputes.
§ 28.50 LEGAL MALPRACTICE

and Conciliation supervised by the New York County Lawyers' Association, the Association of the Bar of the City of New York, and the Bronx County Bar Association.

In the event such dispute cannot be resolved by mediation, the controversy concerning legal fees and expenses shall be submitted to arbitration in accordance with the Commercial Arbitration Rules of the AAA. The AAA shall serve as the arbitration forum, if Client does not object in writing within five business days after receiving written notice of arbitration. If Client does object, in writing, within that time period, then his choice of a recognized and appropriate arbitration forum, as specified in such written objection, shall govern. Judgment upon the award rendered by the arbitrator(s) may be entered in any court of competent jurisdiction.

Library References:
West's Key No. Digests, Attorney and Client ©64.

§ 28.51 Forms—Retainer Agreement Without ADR Clause

Mr. Klein Tell, Esq.
South Street Sea Port
New York, New York 10004

Re: Estate of Mother Tell, etc., sua sponte complaint
Docket No. 8888/97
9/15/97 opinion of Westchester Surrogate's Court

Dear Mr. Tell:

You have requested that Responsible & Prudent ("R & P") assist you with regard to the sua sponte complaint served upon you by the Departmental Disciplinary Committee, Supreme Court, Appellate Division, First Judicial Department, concerning the opinion of the Westchester County Surrogate dated September 15, 1997 in Estate of Mother Tell (#8888/97, Westchester County), and with regard to the possible reargument and/or appeal from that decision.

The purpose of this letter is to clarify for you the scope of this firm's engagement and the firm's billing practices with respect to this matter. By doing so we hope to solicit at the outset any questions you may have concerning our engagement and our billing procedure and to assure that we have agreement on these matters.

In order to enable R & P to effectively represent you, and in connection with such representation, you agree promptly to provide R & P with any and all information and documents which R & P may reasonably require or request and to otherwise provide R & P with your full cooperation.

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R & P's charges shall be based upon actual time charges plus reimbursement of all actual out-of-pocket disbursements incurred by us on your behalf in the course of the representation.

Should a question arise regarding any billing practice or any particular charge, you will immediately raise your concerns with us and we will provide you with supporting documents and attempt to resolve any dispute.

You acknowledge that this represents the entire agreement between you and R & P and that you have not relied upon any inducement, promises or representations made by R & P which are not included in this agreement, and that the scope of R & P's responsibilities are fully encompassed herein.

If the foregoing accurately sets forth the terms of our agreement, please sign the accompanying copy of this letter where indicated below and return it to the undersigned.

Library References:
West's Key No. Digests, Attorney and Client 864.

§ 28.52 Forms—Complaint for Malpractice: Commercial Transaction

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF _______

[FORMER CLIENT],

Plaintiff,

-against-

[ LAW FIRM, LLP],

Defendant.

Index No:

COMPLAINT

Plaintiff [FORMER CLIENT], as and for his Complaint, alleges as follows:


2. Defendant [LAW FIRM, LLP] is a limited liability partnership engaged in the practice of law with its offices located in [New York], New York.

3. On or about January 1, 1996, Plaintiff retained Defendant as his attorneys in connection with Plaintiff's sale of certain business propert/
located at [555–557 Candyland Lane, New York], New York ("the property").

4. Defendant's engagement was documented by a retainer agreement which implicitly provided that the Defendant would, *inter alia*: 1) undertake all actions necessary to legally complete the closing on the sale of the property, 2) file the necessary documents relating to the closing in the appropriate public records, and 3) give Plaintiff legal advice relating to the closing and specifically advise Plaintiff as to the legal ramifications of the closing and filings related to the closing.

5. Defendant failed to file certain closing documents consisting of __________, the filing of which would have avoided adverse tax consequences to Plaintiff.

6. By reason of Defendant's said actions, Defendant committed professional malpractice and breached the terms of the retainer agreement by failing to perform its duty to exercise due care according to the ordinary and reasonable skill and knowledge commonly possessed by a member of the legal profession, and by failing to perform its duties specified in the retainer agreement.

7. As a result of Defendant's said actions, Plaintiff has been damaged by incurring tax liability that he would not otherwise have incurred in the amount of $[85,000].

8. Defendant is liable to Plaintiff for damages in the amount of $[85,000] by reason of Defendant's malpractice and breach of the retainer agreement.

    WHEREFORE, Plaintiff demands judgment against Defendant in the amount of $[85,000], plus interest thereon from date of injury, with costs.

Dated: New York, New York

[October 1, 1997]

[Responsible & Prudent]  
Attorneys for Plaintiff  
[999 Justice Street  
New York, New York 10005]  
(212) ______

Library References:

West's Key No. Digesta, Attorney and Client ⊑=129(2).
§ 28.53 Forms—Complaint for Malpractice: Personal Injury Action

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF 

[FORMER CLIENT],

Plaintiff,

-against-

[LAG FIRM, LLP],

Defendant.

Index No: COMPLAINT

Plaintiff [FORMER CLIENT], as and for his Complaint, alleges as follows:


2. Defendant [LAW FIRM, LLP] is a limited liability partnership engaged in the practice of law with its offices located in New York, New York.

3. On [January 5, 1991], Plaintiff retained Defendant as his attorney to represent him in a litigation against three tortfeasors, [X, Y and Z], who had negligently injured plaintiff in a four-car automobile accident that occurred on [January 1, 1991], causing damages to Plaintiff in the amount of $[2,000,000].

4. Defendant commenced the action on Plaintiff’s behalf, seeking damages in excess of $[2,000,000], and represented plaintiff through the completion of the jury trial of the action.

5. In his answer to the complaint in said action, Defendant [Z] pleaded lack of jurisdiction over the person as an affirmative defense.

6. Upon information and belief, unknown to Plaintiff, Defendant made no inquiries of [Z] as to the basis of that defense and directed no discovery toward any issue regarding that affirmative defense.

7. At trial, [Z] offered proof on his said affirmative defense that service of process on him had been insufficient.

8. Defendant offered no proof to the contrary on Plaintiff’s behalf, except an affidavit of service which was shown by [Z] to be defective on its face.

9. As a result of [Z]’s affirmative defense, [Z] was dismissed from the action for lack of jurisdiction over the person, and by the time of trial the
three year Statute of Limitations for Plaintiff's claim against [Z] had expired.

10. The trial proceeded against [X] and [Y], and the jury returned a verdict in their favor since [Z] had been solely responsible for the accident.

11. By reason of Defendant's said actions, Defendant committed professional malpractice and breached its contract of retention by failing to perform its duty to exercise due care according to the ordinary and reasonable skill and knowledge commonly possessed by a member of the legal profession.

12. As a result of Defendant's said actions, Plaintiff has been damaged by having lost his claim against [Z] having a value of $[2,000,000], which Plaintiff would have recovered but for Defendant's said malpractice.

13. Defendant is liable to Plaintiff for damages in the amount of $[2,000,000] by reason of Defendant's malpractice.

WHEREFORE, Plaintiff demands judgment against Defendant in the amount of $2,000,000, plus interest thereon from date of injury, with costs.

Dated: New York, New York
[October 1, 1997]

[Responsible & Prudent]
Attorneys for Plaintiff
[999 Justice Street
New York, New York 10005]
(212) ______

Library References:
West's Key No. Digests, Attorney and Client 8=129(2).

§ 28.54 Forms—Answer: Commercial Transaction

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF ______

____________________________________
[FORMER CLIENT],

Plaintiff,

-against-

[ILLAW FIRM, LLP],

Defendant.

____________________________________

Index No:

ANSWER

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Defendant [LAW FIRM, LLP], as and for its Answer, alleges as follows:


2. Denies each and every allegation contained in paragraphs [6, 7 and 8] of the Complaint.

3. Denies knowledge or information sufficient to form a belief as to the allegations contained in paragraph [1] of the Complaint, and therefore denies same.

4. With respect to the allegations of paragraph [3] of the Complaint, Defendant admits that Plaintiff retained Defendant as his attorney in connection with particular business properties located at [551-553 and 559-561 Candyland Lane, New York], New York, and otherwise denies the allegations of said paragraph 3.

5. With respect to the allegations of paragraph 5 of the Complaint, Defendant admits that he did not file any closing documents in connection with 555-557 Candyland Lane, New York, New York, as Defendant was not retained to do so, and otherwise denies the allegations of said paragraph 3.

AS AND FOR A FIRST AFFIRMATIVE DEFENSE

6. The Complaint fails to state a claim for which relief may be granted.

AS AND FOR A SECOND AFFIRMATIVE DEFENSE

7. The duties that Plaintiff alleges have been breached were outside the scope of the retainer agreement between Plaintiff and Defendant.

WHEREFORE, Defendant demands judgment dismissing the Complaint, with costs.

Dated: _______, New York
[November 3, 1997]

[Level Headed LLP]
Attorneys for Defendant
[998 Justice Street
New York, New York 10005]
(212) ________
Defendant [LAW FIRM, LLP], as and for its Answer, alleges as follows:

1. Admits the allegations contained in paragraphs [2, 4, 5, 7, 9 and 10] of the Complaint.

2. Denies each and every allegation contained in paragraphs [6, 8, 11, 12 and 13] of the Complaint.

3. Denies knowledge or information sufficient to form a belief as to the allegations contained in paragraph [1] of the Complaint, and therefore denies same.

4. With respect to the allegations of paragraph [3] of the Complaint, Defendant admits that on [January 5, 1989] Plaintiff retained Defendant as his attorney to represent him in a litigation against [X, Y and Z] in connection with [an accident that had occurred on January 1, 1989], and otherwise denies the allegations of said paragraph [3].

**AS AND FOR A FIRST AFFIRMATIVE DEFENSE**

5. The Complaint fails to state a claim for which relief may be granted.

**AS AND FOR A SECOND AFFIRMATIVE DEFENSE**

6. Plaintiff's claims are barred by the Statute of Limitations because the attorney-client relationship which existed between Plaintiff and Defendant terminated more than three years prior to the filing of Plaintiff's Complaint, when final judgment was rendered in the underlying action.

**AS AND FOR A THIRD AFFIRMATIVE DEFENSE**

7. Plaintiff is collaterally estopped from asserting this claim because it has previously been adjudicated in an arbitration proceeding relating to Defendant's fees for legal services.
AS AND FOR A FOURTH AFFIRMATIVE DEFENSE

8. Defendant offered clear and credible proof at the trial that service of process on [Z] was sufficient, but such proof was rejected by the court through no fault of Defendant.

9. Defendant’s actions were reasonable and did not violate the standard of ordinary and reasonable skill and knowledge of the legal profession.

AS AND FOR A FIFTH AFFIRMATIVE DEFENSE

10. The allegations set forth in paragraphs [8 and 9] hereof are repeated and realleged, as if fully set forth herein.

11. Defendant offered to represent Plaintiff with respect to an appeal on the issue of sufficiency of service of process on [Z], which was erroneously decided by the court, but Plaintiff discharged Defendant and retained new counsel (who also represents plaintiff in this action) who then allowed the time to take an appeal to lapse by filing and serving a Notice of Appeal one day late.

12. If Plaintiff has suffered any injury, such was the fault of either Plaintiff himself and/or subsequent counsel, and not due to any fault of Defendant herein.

WHEREFORE, Defendant demands judgment dismissing the Complaint, with costs.

Dated: New York, New York
[November 3, 1997]

[Level Headed LLP]
Attorneys for Defendant
[998 Justice Street
New York, New York 10005]
(212) ____-______
In December 2000 an article was written for this column which addressed the professional liability risks for auditors and the lawyers who are asked to report to auditors on litigation that had a material impact on the financial statements subject to audit. [FN1] In such contexts lawyers, restrained by applicable evidentiary privileges and the client confidentiality obligation, cannot always effectively inform the auditor. Even where the lawyers' reports are both consistent with professional standards and not affected by privilege or confidentiality obligations, the auditor does not generally review with counsel prior to the publication of the financial statements the accounting determinations that have significant legal implications and the footnote disclosures. Audit failure in this context, therefore, can be more effectively prevented when such a pre-release review by the lawyer handling or managing the litigation does take place. Enron's professional intersection, while not identical, is quite similar in that the audit failure resulted from the ineffective coordination and focus of legal and auditing expertise. The accounting treatment of certain transactions and relationships that had significant legal implications and the attendant disclosures were, in the last analysis, ultimately left to the auditor without the benefit of an independent legal determination and review. By understanding the material risks of this professional intersection in the audit process, we can here, too, take the right path to reform.

'U.S. v. Simon'

In 1969 the United States Court of Appeals for the Second Circuit with Judge Henry Friendly writing the opinion of the Court, in the context of a criminal prosecution of auditors for their responsibility for a false and misleading financial statement footnote, addressed issues similar to the ones in Enron [FN2]. The court noted, almost as a preface to its opinion, "[w]hile every criminal conviction is important to the defendant, there is a special poignancy and a corresponding responsibility on reviewing Judges when, as here, the defendants have been men of blameless lives and respected members of a learned profession." [FN3] The trial focused on transactions between two affiliated companies that had a single office and were dominated by the same chief executive officer and principal shareholder.

Funds were advanced by one affiliate to the other and as a result the principal-shareholder caused the issue of negotiable notes which were endorsed in blank so that the principal could obtain cash to effect securities transactions for his own account and meet related margin calls. In a five and a half year time span the company whose financial statements were in issue loaned to its affiliate $16 million and in turn the affiliate loaned $13 million to the principal. By the "certification" date the auditors learned the affiliate was not in a position to repay its debt and accordingly, it was arranged that the principal post collateral, eighty (80%) percent of which was the lending company's securities. When cash became stringent and the transactions problematic, corporate counsel listed the securities as collateral and at the auditors request the securities were assigned to counsel as trustee. There were errors in the list furnished by counsel and the auditors also did not check the list by any verification.
procedures. Third party commercial lenders had prior liens on many of the securities. After the completion of the audit and before the mailing of the financial statements to public shareholders, the securities collateral also significantly declined in market value. Shortly thereafter a check to the IRS "bounced" and bankruptcy ensued.

The core case against the auditors was premised on the fact that the footnote did not disclose the make-up of the collateral and the fact of the post audit market decline. Eight defense expert witnesses, described by the court as "an impressive array of leaders of the profession" testified that except for the erroneous netting of accounts receivable owed by each company to its affiliate, the footnote treatment of the accountants receivable from the company's affiliate was consistent with both Generally Accepted Auditing Standards (GAAS) and Generally Accepted Accounting Principles (GAAP). Further these experts testified additional disclosures of the collateral's make-up and post-audit decline in market value was not necessary and its absence did not defeat a fair presentation of the company's financial position. Nor did the experts believe the borrowings of the principal from the affiliate to finance his stock transactions had to be disclosed. The Court of Appeals in reviewing the criminal conviction, nonetheless, significantly held literal compliance with GAAS and GAAP did not insulate the auditors from criminal liability. The court in a message to all professionals in the capital markets and financial services industries that lasts to and through this day, articulated the proposition that professionals are responsible to get to and state the truth, especially when they know or should know the real facts. The court held:

It is quite true that there was no proof of motive in the form usual in fraud cases. None of the defendants made or could make a penny from ... putting out false financial statements.... Ordinary commercial motivation is thus wholly absent.

Even if there were no satisfactory showing of motive, we think the Government produced sufficient evidence of criminal intent. Its burden was not to show that the defendants were wicked men with designs on anyone's purse, which they obviously were not, but rather that they had certified a statement knowing it to be false. As... [the Court] said ... long ago, 'while there is no allowable inference of knowledge from the mere fact of falsity, there are many cases where from the actors' special situation and continuity of conduct an inference that he did know the untruth of what he said or wrote, may legitimately be drawn. [FN4]

Thus professional liability risk exists even when there is literal compliance with professional standards.

The Powers Report

A Special Investigative Committee of the Board of Directors of Enron Corporation headed by William C. Powers Jr. rendered a written report Feb. 1, 2002. The report discussed the partnerships that served as Special Purpose Entities (SPE) which kept liabilities off of Enron's balance sheets, generated significant income for Enron which was subsequently restated, and the conflicting ownership and controlling interests of Enron's CFO and other personnel in the SPE and off-balance-sheet partnerships. The respective roles of Enron's internal accountants, Arthur Andersen, Enron's in house counsel, Vincent and Elkins, Enron's outside counsel, and most significantly the related party transaction disclosure issues presented by the footnotes and the proxy statements, are also addressed.

Enriching Enron's CFO
The Powers Report emanated from the Special Committee's mandate to conduct an investigation of related party transactions. The investigation turned up information such as the significant enrichment of Enron's CFO and other employees by reason of their participation in the SPE and non-compliance with Enron's Code of Conduct of Business Affairs, not previously disclosed. Further the report significantly noted that "[m]any of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve bona fide economic objectives or to transfer risks." [FN5] In reference to these related party transactions that the legal and audit professionals had to confront the Special Committee also found:

Enron's publicly-filed reports disclosed the existence of the ... partnerships. Indeed, there was substantial factual information about Enron's transactions with these partnerships in Enron's quarterly and annual reports and in its proxy statements. Various disclosures were approved by one or more of Enron's outside auditors and its inside and outside counsel. However, these disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships.... The disclosures also asserted that the related party transactions were reasonable compared to transactions with the third parties, apparently without any factual basis.... There was an absence of forceful and effective oversight by Senior Enron Management and in-house counsel, and objective and critical professional advice by outside counsel at Vincent and Elkins, or at Andersen. [FN6] (Emphasis added)

The Report also noted Andersen's consulting roles and the fees earned from those services included advice on the structuring of the partnerships so that it would meet the SPE non-consolidation rules, i.e., essentially the sine qua non was an outside investor with a minimum ownership interest of three (3%) percent who had control of the entity. It was also noted "Vincent and Elkins, as Enron's longstanding outside counsel, provided advice and prepared documentation in connection with many of the transactions ... [and] also assisted Enron with the preparation of its disclosures of related-party transactions in the proxy statements in Enron's periodic SEC filings." (Emphasis added) Further the Report, which discussed corporate governance as well professional responsibility issues noted that "[m]anagement and the Board relied heavily on the perceived approval by Vincent and Elkins of the structure and disclosure of the transactions." [FN7]

Auditor-Legal Issues

AU 336, Using the Work of a Specialist, sourced in SAS (Statement on Auditing Standards) No. 73, makes permissible and appropriate auditor reliance on the work and analysis of specialists including lawyers. Management or the auditors can engage a specialist and rely on that work as evidential matter in performing substantive tests to evaluate material financial statement assertions. The standard states,

[T]he auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation.... During the audit, however, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgement require using the work of a specialist to obtain competent evidential matter.

... Examples of the types of matters that may... require... using the work of a specialist include... [i]nterpretation of technical requirements, regulations, or agreements (for example, the potential significance of contracts or other legal documents or legal title to property.) [FN8]
Where specialists are to be engaged the auditors are to assess their qualifications. Further, they are to evaluate the relationship of the specialist to the client, especially circumstances that might impair the specialists' objectivity. They are to obtain an understanding of the specialist's methods and assumptions, although the appropriateness and reasonableness of the methods and assumptions used and their applications are stated to be the responsibility of the specialist. However, if the auditor believes the specialist's findings are unreasonable additional procedures have to be employed, including obtaining another opinion. An unresolved matter should also cause the auditor "to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient competent evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation." [FN9]

The standard also goes on to state that generally the auditor should not refer to the work or findings of the specialist in that it might be misunderstood to be "a qualification of the auditors' opinion or a division of responsibility neither of which is intended." This is to be avoided as "...there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference." AU 9336

AU 9336 provides guidance with respect to Financial Accounting Standards Board (FASB) Statement No. 125 Accounting For Transfers and Servicing of Financial Assets and Extinguishment of Liabilities. Utilization of this standard is to assist in interpreting transactions similar to those that occurred between Enron and its off-balance sheet partnerships. The auditor is to give consideration to whether an asset transfer can be revoked, whether a transfer of financial assets would likely be deemed to be a true sale at law, whether the transfer and transferee are affiliated, whether transferred assets are beyond the reach of a bankruptcy trustee, and whether entities truly qualify to be an SPE making remote the possibility that they would enter bankruptcy or receivership. Significantly the section states "...determinations about whether the isolation criterion has been met to support a conclusion regarding surrender of control is largely a matter of law ... [t]his aspect of surrender of control, therefore, is assessed primarily from a legal perspective." [FN10] (Emphasis added)

This section also gives some guidance to auditors as to when to rely on the legal opinion furnished or when it is inadequately premised on hypothetical transactions and/or qualified to limit the scope of the opinion so that reliance cannot be placed upon it. The accounting standard, however, is not definitive and carries with it the material risk of the auditor stepping beyond the scope of his expertise and ultimately making a legal judgement.

For Reform

In the context of the Enron bankruptcy there is now a temptation to jump to easy criticism of both Arthur Andersen and Vincent and Elkins in respect to the related party transactions addressed by the Powers Report. This is anything but a sound approach. A closer look at both the facts and the current authoritative accounting literature relating to auditors interacting with lawyers in the audit process demonstrates there are systematic flaws which could lead to other financial disasters with other public companies served by other law and auditing-accounting firms. To avoid future recurrences we should develop insights from the events such as those that occurred in United States v. Simon and Enron and thereby enhance professional standards for both lawyers and auditors, especially when those professionals are required to coordinate their
respective expertise and disciplines in the audit process. In this way we will be able
to best serve the securities laws' core-remedial purpose, and follow a correct path to
reform.

Points for Discussion

Points to consider and to discuss are the following: (1) accounting-auditing firms do
not have to divest themselves of their consulting arms, but should adhere to a strict
rule that the same company should not be both an audit and consulting client; (2) fiduciary
duty codes should be promulgated for accounting-consultants, which would include
reporting obligations to audit committees and the auditors of accounting irregularities
and internal control problems discovered and not corrected in their engagements; (3)
in respect to public companies meeting certain defined criteria established by the SEC
and other self-regulatory organizations, accounting treatments that have to be "assessed
from a legal perspective" should be addressed by independent counsel - counsel not
regularly engaged by the company - that will make the required legal judgement and also
do a legal review of the footnote disclosures; and (4) in respect to other public companies
whose financial failure may not have such a devastating impact as Enron, the auditor
as well as the audit committee should jointly select legal counsel for the legal judgement
and review, who may or may not be counsel regularly engaged.

Independent legal counsel will have inquiry power and authority to get to the facts
that will support his judgement. Lawyers will have ultimate responsibility to make legal
judgments. In situations where independent legal counsel will make the legal judgment
and review, auditors also will not be placed in the position of having to shop around
for another opinion after having found the first lawyer's opinion to be unreasonable.
Nor will the auditor be placed in the position of having to qualify or disclaim where
a conflict remains unresolved; the issues will be resolved by independent counsel.

Further the fact of the utilization of this legal judgement and review procedure,
including who legal counsel is and the circumstances of his appointment should be
disclosed. Not only will the responsibilities of the company and its professionals be
identified, but if the procedures are correctly applied there will be a higher comfort
level for the user of the financial statements and a corresponding strength in our capital
markets.

Conclusion

Woodrow Wilson wrote "the whole purpose of democracy is to take counsel with one another
so as not to depend upon the judgement of any one man but upon the common counsel of
all." [FN11] The points for consideration addressed hopefully will be part of a collective
and meaningful discussion leading to the best path for reform of our professional
standards so to avoid the material risks of Enron's Professional Intersection.

Norman B. Arnoff is a lawyer in New York City. He is a member of the professional liability
committee of the New York County Lawyers' Association. Ted Felix and Moshe Levitan,
certified public accountants of the firm of Lazare Levine & Felix, assisted in the
preparation of this article.

FN1. N.Y.L.J., Dec. 12, 2000, "Professional Intersection: Lawyers' Responses to
Auditors' Letters," by Norman B. Aronoff and Sue C. Jacobs. See, also for discussion of
issues related to the article, the following: N.Y.L.J., Aug. 8, 2000, "Professionalism's
First Principle: Fiduciary Responsibility," by Norman B. Aronoff and N.Y.L.J., Apr. 25,

FN3. Id. at 425 F.2d 798-799.

FN4. Id. at 425 F.2d 809.


FN8. Statement on Auditing Standards 73, Using the Work of the Specialist, AU 336 at 292.


FN10. Id.

FN11. Woodrow Wilson, "The New Freedom." The authors wish gratefully to acknowledge the contribution of Ted Felix and Moshe Levitan, Certified Public Accountants of the firm of Lazare Levine & Felix, for their assistance in the preparation of this article.

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THE NEW CODE OF PROFESSIONAL CONDUCT FOR ATTORNEYS

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The New Code of Professional Conduct for Attorneys

By Norman B. Arnoff and Sue C. Jacobs

Effective April 1, 2009 New York will have in effect Part 1200 – Rules of Professional Conduct. All lawyers practicing in New York should make a comparative study of the Lawyer's Code of Professional Responsibility Effective January 1, 1970 and the New Code. With the New Code, this analysis should be done in a straightforward manner as to what provisions remain constant and which ones differ. The focus of this article will be to address confidentiality, competence, conflicts, client relationships, fees and professional misconduct in that context.

Definitions

The constants are the following: Differing Interests, Domestic Relations, Firm, Fraud, Person, Professional Legal Corporation, State, Tribunal, and significantly Confidential Information.

“Confidential Information” is defined in Rule 1.6 and “Confidence” and “Secret” were defined in DR 4-101 [1200, 19]. The Rules are comparable. A lawyer cannot use confidential information of the client to the advantage of a person other than the client or to the client’s disadvantage. “Confidential information” is defined as follows:

...[I]nformation gained during or relating to the representation of a client, whatever its source, that is (a) protected by the attorney-client privilege, (b) likely to be embarrassing or detrimental to the client if disclosed, or (c) information that the client has requested be kept confidential...

“Confidential information does not ordinarily include (i) a lawyer's legal knowledge or legal research or (ii) information that is generally known in the local community or in the
trade, field or profession to which the information relates.” Further “Confidential Information” may be used and/or disclosed “to prevent reasonably certain death or substantial bodily harm; (2) to prevent the client from committing a crime; to withdraw a written or oral opinion “based on materially inaccurate information or is being used to further a crime or fraud”; to secure compliance with the Rules for the lawyer or another lawyer associated with the lawyer’s firm; defend the lawyer when accused of wrongful conduct or to collect a fee and ‘when permitted or required under...[the] Rules, other law or court order.” (Emphasis added)

What differs is while DR 4-101 prescribes the scope of “Confidential Information”, Rule 1.6 is more educative in what is and is not “Confidential Information.” Rule 1.0 terminology is also more helpful in respect to certain definitions.
Competency

The terminology "reasonable," reasonably, "reasonable belief," "reasonably believes," and "reasonably should know" has significant import in testing the lawyer’s judgment when a competency or ethical issue is presented. Rule 1.0(q), (r) and (s) provide the definitions of “reasonable” or “reasonably” as “the conduct of a reasonably prudent and competent lawyer” and in the context of conflict determinations, it denotes “a lawyer acting from the perspective of a reasonably prudent and competent lawyer who is personally disinterested in commencing or continuing the representation.” “Reasonable belief” or “reasonably believes,” in reference to the matter in question, is when the circumstances are such that the belief is reasonable.” (Emphasis added) “Reasonably should know” occurs when “a lawyer of reasonable prudence and competence would ascertain the matter in question.” The definitions comport with the Lawyer’s Judgment Rule that lawyers are protected from civil liability and professional discipline when the lawyers, after obtaining the client’s informed consent in respect to the matters being handled, exercise good faith and not unreasonable judgment; albeit in error. In Rubinberg v. Walker, the First Department articulated the Lawyer’s Judgment Rule as follows:

Attorneys are not liable in negligence for errors of judgment or the exercise of appropriate judgment that leads to an unsuccessful result where it is clear that the attorney exercised his or her judgment reasonably as to how to proceed, summary judgment should be granted dismissing the action.”

The Lawyer's Judgment Rule protects the lawyer who acts reasonably and in good faith in contexts where duties are not specifically mandated by statute, court or agency rules. This can be particularly true in situations where a second-guessing client is looking to avoid his or her obligation to pay legal fees. The litigation context is where the Lawyer’s
Judgment Rule is most suitable for application and where the lawyer has broad discretion. In Bernstein v. Oppenheim & Co. P.C., the Court held in the context of a lawyer erroneously advising his client to start a lawsuit that a judgment of legal malpractice cannot be based on dissatisfaction with strategic choices.

DR 6-101 addressed competency issues. The Rule that a lawyer should decline to handle a matter he or she is not competent to handle without associating with a lawyer competent to handle it; handle a matter without preparation adequate in the circumstances,” or “[n]eglect a legal matter entrusted to the lawyer.” It is obvious from a comparison of the foregoing with Rules 1.1 and 1.3 “Competence” and “Diligence” respectively, that the New Code in importing an express standard of reasonableness gives better recognition to the realities of present day law practice that, while the lawyer should be held to high standards of competency and ethics, there is also a degree of fair flexibility in making professional and ethical judgments in respect to the lawyer’s conduct. Rule 1.1 (a) provides “[c]ompetent representation requires the legal knowledge skill, thoroughness and preparation reasonably necessary for the representation” and Rule 1.3(a) provides “[a] lawyer shall act with reasonable diligence and promptness in representing a client.” (Emphasis added)

The pervasive use of the terminology “reasonable” enhances the New Code, because the Lawyer’s Judgment Rule strikes a fair balance between the lawyer’s responsibilities and what clients can reasonably expect of the legal profession and that has added value. They should not expect the impossible of the lawyer, only what is fair, honest and reasonable.

**Conflicts**
DR 5-101 §1200.20 Conflicts of Interest – Lawyer’s Own Interests reads:

“A. A lawyer shall not accept or continue employment if the exercise of professional judgment on behalf of the client will be or reasonably may be affected by the lawyer’s own financial, business, property, or personal interests unless a disinterested lawyer would believe that the representation of the client will not be adversely affected thereby and the client consents to the representation after full disclosure of the implications of the lawyer’s interests.

Rule 1.7 is essentially the same but with slightly different wording than DR 5-101. Lawyers cannot represent clients where “the representation will involve the lawyer in representing differing interests; or there is a significant risk that the lawyer’s professional judgment on behalf of a client will be adversely affected by the lawyer’s own financial business, property or other personal interests.” In order for the conflict to be waived, the lawyer has to “reasonably believe that the law that the lawyer will be able to provide competent and intelligent representation…; the representation is not prohibited by law; the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation…; and such affected client gives informed consent confirmed in writing.” (Emphasis added) The two key language changes that may affect the interpretation of the New Rules are that the risk of conflict has to be “significant” and informed consent has to be “confirmed in writing.”

Client Relationships

Rule 1.2, Scope of Representation and Allocation of Authority between Client and Lawyer, and 1.4, Communication, are the key rules. Rule 1.2 provides “a lawyer shall abide by a client’s decisions concerning the objectives of presentation” and “shall consult with the client as to the means by which they are to be pursued.” Further, “[a] lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances, the
client gives informed consent and where necessary notice is provided to the tribunal and/or opposing counsel.” (Emphasis added) Other provisions of the Rules permit the lawyer to “discuss the legal consequences of any proposed course of conduct with a client...exercise professional judgment to waive or fail to assert a right or position of the client...when doing so does not prejudice the rights of the client...[and] refuse to aid or participate in conduct that the lawyer believes to be unlawful, even though there is some support for an argument that the conduct is legal.” The foregoing gives the practicing attorney greater discretion when being ethically challenged by the client.

Rule 1.4, Communication, requires and facilitates full disclosure and informed consent. The lawyer has to “reasonably consult with the client about the means by which the client’s objectives are to be accomplished; keep the client reasonably informed about the status of the matter;...[and] explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.” (Emphasis added)

In dealing with a client in an advisory role, Rule 2.1 also gives significant recognition to the practical reality of giving legal advice that is, on many occasions, not purely legal advice. Rule 2.1 provides:

In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. in rendering advice a lawyer may refer not only to law but to other considerations such as moral, economic, social, psychological and political factors that may be relevant to the client’s situation.”

However, a lawyer should be cautious that to the extent non-legal advice or support for overall advice to the client is predicated upon factors outside of the legal compass there is also a more uncertain risk for a potential professional liability claim from the client.
**Legal Fees**

In today’s currently charged environment, legal fees and the other costs of litigation more often than not implicate ethical issues and present ongoing problems especially for smaller law firm practitioners. The key operative Rules heretofore were DR 2-106, Fees for Legal Services, and DR 2-107, Division of Fees among Lawyers. DR 2-106 describes an excessive fee “when, after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee.” There are eight (8) factors for consideration. They are as follows: (1) the time, labor, novelty and difficulty of the issues presented, and the skill requisite skill necessary to perform the service; (2) the likelihood that the particular engagement precludes other employment; (3) the fee customarily charged in the locality for such services; (4) “the amount and results obtained” (5) “the time limitations imposed by the client or by circumstances”; (6) “the nature and length of the professional relationship with the client”; (7) “[t]he experience, reputation, and ability of the lawyer or by lawyers performing the services”; and (8) whether the fees are fixed or contingent. Rule 1.5, Fees and Division of Fees, of the New Code rearticulate the same eight (8) factors and the same prefatory language as DR 2-106. Rule 1.5 also addresses fee sharing that was addressed previously by DR 2-107, but to a greater degree.
What adds to the clarity of the New Rule is subparagraph (b) that states:

“A lawyer shall communicate to a client the scope of the representation and the bases or rate of the fee and expenses for which the client will be responsible. This information shall be communicated to the client before or within a reasonable time after commencement of the representation and shall be in writing where required by statute or court rule. This provision shall not apply when the lawyer will charge a regularly represented client on the same bases or rate and perform services that are of the same general kind previously rendered to and paid for by the client. Any changes in the scope of the representation or the bases or rate of the fee or expenses shall also be communicated to the client.” (Emphasis added)

This subparagraph addressing the scope and variance of ongoing representation and the terms of the retainer agreement are helpful. The initial writing clearly should state that the terms of the representation and it should be further stated and understood as the Rule provides that acceptance of the terms continues through the representation unless expressly communicated to the client. This creates mutual responsibility for both lawyer and client. Once the terms of retention are reduced to writing and in clear terms, they continue without variance, and the client also clearly has a responsibility to raise and specifically voice issues regarding the billing or other matters. If the scope and terms of the retention change, it is the lawyer’s duty to communicate the changes expressly to the client, and preferably as a matter of best practice, this should be done in writing.

Subparagraph (g) of the New Rule mirrors DR 2-107. It, however, states:

“A lawyer shall not divide a fee for legal services with another lawyer who is not associated in the same law firm unless:

(1) the division is in proportion to the services performed by each lawyer or, by a writing given to the client, each lawyer assumes joint responsibility for the representation;

(2) the client agrees to employment of the other lawyer after a full disclosure that a division of fees will be made, including the share each lawyer will receive, and the client's agreement is confirmed in writing; and
(3) the total fee is not excessive...”

(Emphasis added)

While DR 2-107 specifies that fee-sharing arrangements between independent attorneys be fully disclosed, it does not extend, at least expressly, to “including the share each lawyer will receive, and the client’s agreement is confirmed in writing.” Obviously, this puts the New Code on a firmer foundation for best practices, because when key agreements are memorialized, especially in an ongoing attorney-client relationship where fee disputes are interwoven with legal malpractice claims, this avoids misunderstandings. Client fee claims are used as the offensive-defense when the client does not want to pay his or her bill. The Rule will also be more prophylactic by enhancing the professional responsibilities of lawyers who, when putting together groups of independent practitioners to serve the clients cause they will fairly compensate each of the lawyers for what they actually do as opposed to inflating the fees because those not working on the case also have to be compensated, i.e., the “rainmaker” has to get his due. When the client knows the true split, he will both be better able to understand the true costs of the representation and know who is doing what work to actually earn a share of the fee.

**Professional Misconduct**

DR 1-102, Misconduct, and Rule 8.4, Misconduct, are comparable. In any analysis of Misconduct Rules, the best focus is always the responsibilities of supervising attorneys and the non-delegable duties of all lawyers in whatever level they are positioned in their firm, whatever the latter’s size. The key phraseology in the Rule is “A lawyer with management responsibility in a law firm shall make reasonable efforts to ensure that the supervised lawyer conforms to these Rules.” Rule 5.1(d) fixes supervising responsibility
and accountability and subjects the lawyer to sanction when “the lawyer orders or directs the specific...[impermissible] conduct or, with knowledge of the specific conduct ratifies it.” The Rule also extends supervisory responsibility to “a lawyer who individually or together with other lawyers possesses comparable managerial responsibility in a law firm in which the other lawyer practices or is a lawyer who has supervisory authority over the other lawyer,” i.e., supervisory responsibility can now extend from one independent lawyer to another independent lawyer.

Supervisory Responsibility and being subject to a disciplinary sanction for the misconduct of another lawyer requires (a) knowledge at the time that the conduct could be prevented or remedial steps taken to correct the situation and (b) by the exercise of “reasonable management or supervisory authority...[the lawyer] should have known of the conduct so that reasonable remedial action could have been taken at a time when the consequence of the conduct could have been avoided or mitigated.” (Emphasis added). Here against the Lawyer’s Judgment Rule is a factor in the mix.

Rule 5.2, Responsibilities of a Subordinate Lawyer mandates that all lawyers have responsibility for compliance with the Rules “notwithstanding that the lawyer acted at the direction of another person” but the subordinate lawyer “does not violate these Rules if that lawyer acts in accordance with a supervisory lawyer’s reasonable resolution of an arguable question of professional duty.” (Emphasis added) Here, too, assessing the reasonableness of conduct in the light of pragmatic factors makes the Lawyer’s Judgment Rule come seriously into play.

The foregoing Rules are comparable to DR 1-104, Responsibilities of a Partner or Supervisory Lawyer and Subordinate Lawyers. While substantively the Rules are not
materially different, stylistically there are differences that make for more clarity in the New Rules in the authors' assessment.

**Conclusion**

This article is not intended to be a definitive comparison of the two codes but an illustration that the comparative approach will facilitate transition and pragmatic insights that can be employed by the Bar to improve even the New Code. By reviewing professional conduct rules and standards for ethics and competency, we, as lawyers, can more readily comply with the New Code because we will then be able to internalize it and certainly with that understanding proceed to act as Officers of the Court. The standards for competency and ethics of our profession are not merely outside of ourselves but within each of us.
COLLECTING OUR ATTORNEY FEES JUSTLY DUE

By Norman B. Arnoff

The most difficult litigation for any lawyer to engage in is the litigation involving attorney fees, especially where former clients assert breach of fiduciary duty causes of action for excessive fees and legal malpractice, either as counterclaims or as an anticipatory suit brought by the former client’s new lawyer who thinks that by taking the offensive the lawyer and his or her professional liability insurance carrier will throw in the towel on the fee claim, legitimate or not. Lawyers should be entitled to collect legitimate fees in a time and cost effective manner, and there are means to accomplish this objective that this article will review. The tools are informed consent letters, detailed and descriptive billing, account stated, retaining liens and charging liens.

Account Stated

When the client gives informed consent to a strategy pursued by counsel and the bills rendered are sufficiently descriptive of the services and the charges, unless the client timely and specifically objects to the bills and charges, the client is obligated to pay the bills. Paul Weiss Rifkind Wharton & Garrosen v. Jeffrey Koons makes it clear that informed consent, detailed billing, continued rendition of legal services, and failure to timely and meaningfully object by the client constitute an account stated that the client cannot overcome to avoid the payment of legal fees. The Court held:

In the present case, plaintiff has established a prima facie claim under the account stated doctrine and has established that defendant has no valid defenses to the claim. “An account stated is an agreement between the parties to an account based upon prior transactions between them with respect to the correctness of the separate items composing the account and that balance due, if any, in favor of one party or the other.”

“In order to establish an account stated, there must be a debtor and creditor relationship...[between] the parties as to the items forming the account. Thus, an
account stated may exist between an attorney and client."

An implicit agreement to pay, warranting summary judgment, will arise from either the absence of any objection to a bill within a reasonable time or a partial payment of the outstanding bills.

Of course, an account stated may also be an explicit promise to pay the outstanding bills.

Here, as plaintiff argues in its moving papers, it is entitled to summary judgment on all three grounds. Specifically, defendant never objected to the bills within a reasonable time, made partial...payments, and even explicitly promised to pay the outstanding balance of the debt. Indeed, defendant does not contest the validity of the account stated doctrine. Instead, defendant argues that the account stated in this case should not be upheld by this court because the gross excessiveness of the fees makes the agreement illegal and, therefore, unenforceable.

In support of his position, defendant cites Code of Professional Responsibility DR 2-106 (22 NYCRR 1200.11), which states that a lawyer shall not charge an illegal or excessive fee. Thus, in Chisholm-Ryder Co. v. Sommer & Sommer, defendant notes, the Court held that...the agreement implied under the account stated doctrine is conclusive “[i]n the absence of fraud, mistake or other equitable consideration.”

It is undisputed that defendant told plaintiff law firm, in essence, to do whatever it had to do to achieve the desired result. While plaintiff is not relieved of its ethical obligation to charge a reasonable fee, the fact is that no such issue has been raised. Defendant is not alleging that plaintiff charged an unreasonable hourly fee... Instead, defendant is asking this court to make a policy determination that the amount incurred as a result of this litigation was unethical as a matter of [law]... This court, however, will not police the conduct of wealthy litigants who choose to... share their wealth with counsel through extravagant litigation.

... While Monday morning quarterbacking may lead to... questions of tactic and utilization of staff by plaintiff, the fact is that defendant never objected to the bills nor the tactics which generated such hefty bills. Indeed, defendant encouraged such tactics. Nor, does defendant’s belated oral complaints (that he told a Paul Weiss partner that the bills were “too much” and were “wiping” him out) raise an issue of fact inasmuch as defendant’s own written letters and actions refute his current recollection. [in deposition testimony, defendant made no specific objections of any kind about the invoices, but instead proffered a general complaint that the bills were mounting and that she could not afford to pay them.]

Under these circumstances, this court will not ignore the account stated doctrine. Defendant never objected to the bills, acknowledged in writing that they were fair.
and reasonable, and explicitly promised to pay them. Defendant,...is no novice. Accordingly, plaintiff's request for summary judgment is granted. (Emphasis Added)

_Rosenman Colin Freund Lewis & Cohen v. Neuman_ recognizes that “fraud, mistake, or other equitable considerations,” if they are actually shown, prevent the application of an account stated. Informative disclosures, however, both with respect to the strategies elected and pursued as well as specific and descriptive billing allow this species of estoppel to operate without interruption.

**Retaining Liens**

The second best means to secure payment of the lawyer’s fees is the retaining lien. The retaining lien attaches to all papers, securities, or monies belonging to the client which come into the possession of the attorney in the course of his professional engagement and is a general lien for the entire balance of the account, dependent exclusively on possession. The attorney may secure payment for the services rendered by asserting a general or retaining lien on books and papers of the client in the lawyer’s possession. In the absence of possession, the lawyer’s security for payment of attorney fees is limited to a special or charging lien upon the proceeds resulting from the lawyer’s services in the litigation. If the lawyer obtains possession, the lien is obviously possessory; if, however, the lawyer does not, then the attorney is relegated to a charging lien that attaches only to the proceeds created by the lawyer’s services.

Unless there is a judicial determination that the attorney was discharged and no attorney fees were warranted, the retaining lien attaches to papers, funds and other property in the lawyer’s possession, and the Courts will not direct their turnover absent extraordinary circumstances or the posting of adequate security for payment of the attorney’s fees. Where
exigent circumstances exist such that the client needed the papers to prosecute counterclaims for legal malpractice, courts can and do order the turnover of the papers. When exigent circumstances present themselves a summary determination of the value of the services, however, will be justified and that sum will have to be paid or secured for payment by court order before the papers are turned over.

Retaining liens are most effective when they attach to clients’ funds coming into the possession of the attorney. Funds collected by the attorney in his or her professional capacity are subject to the retaining lien. Retaining liens, however, do not attach to the funds placed in an escrow account intended to pay third parties unless the escrow agreement specifically authorizes payment of the attorney’s fees out of the escrow. In other words, the property has to be the client’s and not a third party’s where the lawyer steps into take possession of and then release and deliver the property to the proper party.

**The Statutory Charging Lien**

Section 475 of the Judiciary Law provides:

From the commencement of an action, special or other proceeding in any court or before any state, municipal or federal department, except a department of labor, or the service of an answer containing a counterclaim, the attorney who appears for a party has a lien upon his client’s cause of action, claim or counterclaim, which attaches to a verdict, report, determination, decision, judgment or final order in his client’s favor, and the proceeds thereof in whatever hands they may come; and the lien cannot be affected by any settlement between the parties before or after judgment, final order or determination. The court upon the petition of the client or attorney may determine and enforce the lien.(Emphasis Added)

The charging lien is not possessory but attaches to the client’s cause of action when the action is commenced. It provides no benefit where the client is successful in having a lawsuit dismissed but no affirmative recovery is made.
The authoritative literature explains the charging lien as follows:

An attorney has the right to have the proceeds of the client’s claim or cause of action applied to the payment of the charges for the attorney’s professional services. By its very nature, such a lien is limited to attorney’s fees representing plaintiffs or defendants with counterclaims. The charging lien is created and governed by statute. It was created to “save the attorney’s rights where he had been unable to get possession” of papers and other property suitable for the retaining lien. The lien is paramount over all other claims on the fund created by the attorney’s efforts.

The charging lien differs from the retaining lien in several important respects. It does not depend on possession, but springs into being at the commencement of an action or proceeding or when notice of representation is given pursuant to Judiciary Law Section 475-a .... Unlike the retaining lien, which may be utilized to compel payment of any or all professional charges whether connected with the action or not, the charging lien is applicable to only charges rendered for the particular action involved. Only the attorney of record is entitled to a charging lien which does not survive after the action has been dismissed. In the absence of any claim of an attorney’s lien, the outgoing attorney’s proper remedy is a plenary action for his or her fee.

The proceeds of a settlement arranged by the parties to the action are also subject to a charging lien but an attorney discharged by a client prior to settlement may not enforce the contingency retainer agreement against the settlement figure. The attorney’s right to compensation is measured in quantum meruit rather than by the terms of the agreement. Because the agreement was not in force at the time of settlement, attorneys are limited to the reasonable value of their services prior to discharge.

Schneider, Kleinick, Weitz, Damashek and Sshoot v. City of New York clearly extends the protection of the statutory charging lien to the attorney discharged without cause, provided notice is given to the defendant,. The Court held “a defendant’s payment of settlement proceeds, while on notice of a charging lien is made at a defendant’s peril.” Further, even when the retaining lien has been extinguished by the surrender of the legal file, the lawyer still can assert a charging lien to assure payment of his or her attorney fees when and if there is an affirmative recovery. In Callaghan v. Callaghan et al. the Court held, “the Supreme Court retains jurisdiction pursuant
to Judiciary Law § 475 to determine … [the lawyer’s] entitlement to a fee based upon his charging lien against any proceeds of … [the] action.”

Even though the charging lien is a creature of statute, attorneys should be cognizant of the fact that courts will make their determinations with equitable considerations in mind. In Cassie Sutton v. New York City Transit Authority et. al. the Second Circuit held:

A charging lien, although originating at common law … is equitable in nature … and the overriding criterion for determining the amount of a charging lien is that it be “fair. There is nothing “fair” about requiring a pro se litigant to be subjected to a charging lien … in favor of the former law firm that urged her to accept a settlement that would have netted it nothing under its retainer agreement.

**Grounds for and Protection against Wrongful Discharge**

Both Account Stated and the Possessory and Charging Liens discussed above are important tools in today’s world where litigation costs seem unreasonable to most laymen and not extraordinary to lawyers who litigate not merely to protect their client’s rights, but to avoid legal malpractice claims and counterclaims resorted to by the clients and their new lawyers to avoid the clients’ legitimate obligations to pay fees justly due. While the foregoing is and should always be part of the attorney’s calculus of thought, however, the avoidance of professional misconduct should always be at the highest level of concern so that the tools to protect and collect our attorney’s fees will be unimpeded. As one court noted, “‘[a]torney-client relationships frequently end because of personality conflicts, misunderstandings, or differences of opinion having nothing to do with any impropriety by either the client or the lawyer.’

Something more than a personality conflict or difference of opinion is required to establish discharge for cause and “[c]ourts typically find a discharge for cause where there has been a significant breach of legal duty’....”
Clients prone to avoid paying legal fees are not unique and will jump many times with the help of their new lawyer to allegations of professional misconduct so that their obligation to pay the legal fees incurred can be discharged. For that reason informed consent every step of the way that is well documented and conduct consistent with Part 1200-Rules of Professional Conduct effective April 1, 2009 should be the way we practice law.

**Conclusion**

Keeping in mind the aspirational norms to conduct one’s practice ethically and in a highly competent manner and steadfastly pursuing such standards and goals is simply not enough to protect one’s fees. Every lawyer and his firm’s practices should include billing practices entailing informed consent by the client in writing for the strategies pursued; detailed and descriptive billing; written and recurring notice to the client that questions and objections to bills or charges need to be raised promptly or waived; and the appropriate assertion of the lawyer’s retaining and charging liens when attorney fee and collection issues surface.
PROFESSIONAL LIABILITY

DR2-106, DR2-107, Attorney Fees, and Professionalism

Norman B. Arnoff and Sue C. Jacobs

The thorn in the side of every attorney and his or her law firm is the fee dispute, and more frequently than not it is the primary trigger for a client's legal malpractice cause of action. It behooves us as lawyers to do more to relieve our profession of these unnecessary and costly disputes and also address the concerns of the public whose trust and confidence is significantly diminished by these suits.

The starting remedial measure should be to achieve greater clarity in the Code of Professional Responsibility, particularly those Ethical Considerations and Disciplinary Rules that address attorney fee issues. Specifically, we need to give consideration to EC2-17, EC2-18, DR2-106 and DR2-107. While there is no question that our profession always strives to achieve the aspirational norms of the Ethical Considerations, there is a significant lack of clarity with respect to DR2-106 and DR2-107 and their inability to give educative notice of clear and basic standards that should not be violated. We need to address these issues so that the higher aspirations of our profession will be achieved.

Absence of Textual Clarity

EC2-17 provides:
The determination of a proper fee requires consideration of the interests of both client and lawyer. A lawyer should not charge more than a reasonable fee for excessive cost of legal service should deter non-lawyers from using the legal system to protect their rights and to minimize and resolve disputes. Furthermore, an excessive charge abuses the professional relationship between lawyer and client.

EC2-18 provides in pertinent part:

(t)he determination of the reasonableness of a fee requires consideration of all relevant circumstances, including those stated in the Disciplinary Rules. The fees of a lawyer will vary according to many factors.... (Emphasis added).

This absence of textual clarity is even more manifest in DR2-106. In pertinent part DR2-106 states:

A. A lawyer shall not enter into an agreement for, charge or collect an illegal or excessive fee.

B. A fee is excessive when after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee.... (Emphasis added).
In regard to the factors to be considered, DR2-106 then states, 'the reasonableness of a fee may include the following' and lists eight factors with a number of subfactors, i.e., the time and labor involved, the degree of complexity of the issues, preclusion of other employment, the customary fee for such service in the lawyer's community, the results achieved, the length of the professional relationship, and the skill and reputation of the lawyer. (Emphasis added) The rule does not make sense since the lawyer is not provided with prospective notice of intelligible standards. The hindsight judgment by which the lawyer is judged is more likely to give the lawyer a free pass for charging unreasonable fees at a time when public perceptions of the legal profession are not the highest.

Fraudulent Billing, Unethical Fees

The stakes for lawyers that become enmeshed in fee disputes are high because charging unreasonable fees raises concerns of serious professional misconduct. It is virtually an automatic trigger for a legal malpractice claim and a disciplinary complaint. As one court has observed, at worst, charging excessive legal fees represents a form of conversion of client monies...at best it represents a careless and shoddy practice and a willingness to abuse the professional relationship between lawyer and client. [FN1]

Sloppy business practices also result in disciplinary proceedings and costly litigation with former clients.

The same court further observed:

Respondent's actions appear closer to the latter and his misconduct might have been avoided had he reached a clear agreement concerning his fees with these clients when they first retained him. Such an agreement probably best serves its purpose when it is reduced to writing and at least sets forth understanding of the attorney and client with respect to the basis for an initial retainer, if any, and the hourly billing rate; the form and frequency of bills to the client, and the provisional nature of any estimate as to the total amount of the fee...

Unreasonable fees are better described as unethical fees and fraudulent billing. The cases should be reviewed to discern what is the evidence for unethical fees and fraudulent billing so that a more intelligible standard can be articulated for the legal profession in the Code of Professional Responsibility.

Most legal fees are time-based because fees for the rendering of professional services are in reality inestimable, especially in the litigation context. There are always variables that cannot be predicted, so lawyers bill on a time basis to assure themselves they will be compensated for the actual time expended. When billing is time-based the likely evidence of impropriety is either false and overstated time and expense charges or the absence of original and contemporaneous time records that sufficiently describe the services that were in fact performed. In a Disciplinary Proceeding in the Third Department, the court sustained findings that the respondent violated DR2-106 by double billing in submitting vouchers to the Albany County Family Court for acting as assigned counsel. The court in the Matter of Robert T. Enton defined double billing in this context as follows:

...[D]ouble billing is 'the practice of rendering legal services on multiple cases in a given period, and then requesting payment for one hour for each case...[this] would be double billing... Time expended on multiple cases must be apportioned among those cases'....
[Respondent]...was engaged in improper billing practices...[that] should have been obvious to any with a law school education' [FN2]

'Charles L. Feely'

In the Matter of Charles L. Feely [FN3] an attorney was disbarred for, among other things, charging a client $41,265 and representing the charge to the client as an out-of-pocket disbursement to a contractor when the lawyer only paid the contractor $7,425. In re: Jonathan A. Weinstein [FN4] was another case where an attorney received both fees and expense reimbursements from different sources because he was representing the clients in multiple proceedings, so, in fact, he was receiving payments for the same time and expense charges twice. The court viewed this as the most serious misconduct requiring disbarment and noted '(r)espondent’s otherwise unblemished record and character evidence, viewed in context, do not warrant leniency.'

In re: Jeffrey M. Jayson [FN5] was a Fourth Department disciplinary case where a lawyer undertook representations in criminal and domestic matters knowing or having reasonable knowledge that he could not perform the services because of severe health problems. In addition to other cited Disciplinary Rule Violations respondent was found to have violated DR2-106 (a) in 'entering into an agreement for, charging or collecting an illegal or excessive fee.'

Unethical and fraudulent time-based billing is also evidenced by an absence of bills and/or bills that are not itemized so that they can be substantiated. In re: H. Roger Hantman [FN6] was another such case where the court imposed the most severe sanction. Referring to a prior arbitration award, the court observed:

The respondent did not present any bills or provide any itemization of his services to...[the client] during his representation. Pursuant to a complaint filed by [the client] the fee issue was heard by an arbitration panel. The arbitration panel determination...directed the respondent to refund the entire ...fee to...the client] and ruled that he is not entitled to any additional monies.

The respondent in the Second Department disciplinary proceeding was also found to have violated DR2-106 A and B and DR9-102, D-5.

The court also held:
Neither the respondent’s belated payments of money owed nor his attempts to gather positive character evidence minimize the egregiousness of his conduct with respect to the handling of the subject matters. Under the totality of the circumstances the respondent is disbarred.

Fraudulent Billing

Other cases manifest other aspects of fraudulent billing and unethical fees. In re: Carl Mathison, [FN7] a Second Department disciplinary proceeding, a lawyer representing a client in a domestic relations matter was sanctioned in part for not providing 'a Statement of Client’s Rights and Responsibilities in violation of Code of Professional Responsibility DR2-
106...' In re: H. Ronald Buttarazzi [FN8] was another disciplinary proceeding arising from a domestic relations matter where the attorney was suspended for failing to disclose in the retainer letter that the retainer was refundable in whole or in part if not earned. Material disclosures up front as to the basis of the billing are essential, and important information when withheld warrant sanction and restitution.

In re: Phillip I. Aaron [FN9] represents a case where the lawyer was disciplined for false statements in bills rendered to the client as the lawyer charged for expenses not incurred and interest on these expenses as well as for unnecessary work. In regard to the latter item, the court picked up on a charge for an affidavit that the court noted '(a) after stage of the foreclosure action before the filing of the bankruptcy petition, there would have been no reason to prepare such an affidavit.' In re: Francis X. Morrissey [FN10] held it was clearly improper for a lawyer to significantly charge for his time and services when other lawyers in fact performed the services. The lawyer also obtained from the client a release and holds-harmless agreement in respect to disbursing the settlement funds including his exorbitant fee. Here, too, the respondent-lawyer kept no time records with the court validating the hearing panel's evaluation of the respondent's conduct; to wit, '(W)e are presented here with a lawyer who over-reached incredibly, who has a most unusual notion of compensable time, and who in a deceptive manner obtained his client's signature on a document aimed at validating his conduct...' Respondent was suspended for two years for dishonesty and charging excessive fees compounded by what the court described as his 'self-help measures.'

Other courts have disciplined lawyers for some of the same species of violations, compounded by two or more instances of the foregoing conduct with additional nuanced behavior that was also subject to sanction. Material nondisclosure is a common theme in respect to virtually all the cases where lawyers are subject to discipline for fraudulent billing and unethical fees. A prime example of a case involving material non-disclosure was In re: Robert H. Harris [FN11] where the Second Department disbarred a lawyer who, along with other professional misconduct, was found to have 'demanded and received unearned referral fees without his client's consent in violation of Code of Professional Responsibility DR2-106(A) and DR2-107.' The disclosure that was required was 'full disclosure.' [FN12] (Emphasis added)

Material nondisclosure in respect to legal fees can also trigger civil liability and/or forfeiture of even the legal fees earned by the lawyer. Dav v. Nadel & Associates, [FN13] the court ordering restitution of the fees held:
The court finds that both parties were responsible in fact for the uncertainties about their fee agreement without...[the client's] signature on the engagement letter. But responsibility in fact is not the same as responsibility in law. 'An attorney has the burden of showing that a fee contract is fair, reasonable, and fully known and understood.... An agreement to pay a legal fee may be invalid if it appears that the attorney got the better of the bargain, unless...[the attorney] can show that the client was fully aware of the consequences and there was no exploitation of the client's confidence in the attorney'...

... Like other contractual relationships, the duration of the relationship should be defined in the first instance by the understanding and expectations of the parties, but unlike other
contractual relationships, the attorney, the party whose specialized knowledge and expertise is the basis of the relationship must bear responsibility for ensuring that the client's understanding and expectations are grounded in the realities of the law and legal process...
The court further addressed the attorney's contention that he was entitled to withdraw because the client refused to make additional advances. The court held:

'An attorney will be permitted to withdraw from employment when a client refuses to pay a reasonable fee... But nonpayment of counsel fees alone will not entitle an attorney to withdraw from representation...

And so, even where the retainer has been fully exhausted, where there is no deliberate violation of a fee agreement by a client, a court may still refuse to allow the attorney to withdraw.... And withdrawal is not permitted when the client refuses to pay additional fees that the attorney is not entitled to collect.
The facts of the case involved the lawyer demanding an additional advance after overbilling the client and when in fact a portion of the retainer remained unused. The court held the lawyer should not have attempted to leave the client in the lurch; the lawyer was not entitled to any further fees; and he was ordered to pay back the initial retainer.

Fair and Reasonable Fees
A lawyer is obligated to charge only a fair and reasonable fee. While the attorney's retainer agreement in the above case disclosed that it would charge the client if the fee payment was not made in 15 days the interest rate charged was exorbitant and arguably in violation of the usury laws. The court held the fairness principle was applicable to interest charged on late fees and awarded the attorney only the 9 percent statutory rate of interest.
Courts also flag nondescriptive billing entries such as unspecified 'internal conferences' as evidence of unethical billing. [FN14] Receiving compensation for serving as a lawyer as well as receiving other compensation by serving simultaneously in another role, especially where the tasks and services overlap, are also highly problematical. [FN15] Fee arrangements in instances of vulnerable clients also receive special attention and scrutiny. Cases involving immigration and matrimonial cases where contingent fees are impermissible as well as Surrogate Court proceedings are good examples of cases warranting special scrutiny. [FN16] Also, where there are statutory procedures and prescribed methods of collection there should be provable compliance with the statute and applicable rules.

The Pollack Standards

In 520 East 72nd Commercial Corp., et al v. 520 East 72nd Owners Corp. [FN17] the late Judge Milton Pollack addressed an issue of whether a fee arrangement was unconscionable and whether the court in the absence of time records would entertain a fee application and to what extent. Judge Pollack held:

After a full exploration of the facts and circumstances of this dispute, the court finds that the contingent retainer agreement demands a fee that is grossly out of proportion to the value of the attorney's modest services. See Gross v. Russo, 47 A.D.2d 655, 655, 364 N.Y.S.2d 184, 186
The fee demanded here is an amount which, with due regard to the contingent nature of compensation is unreasonable and unconscionable factually and large enough to render the retainer agreement unenforceable under the circumstances of the case. See Gair v. Peck, 6 N.Y.2d at 107, 160 N.E.2d at 48, 188 N.Y.S.2d at 498. In the background of an estimate given by...[the lawyer] of $10,000 fee to carry the case to summary judgment on his hourly charge of $225 per hour, the provision for the minimum payment of $375,000, even if only the laundry concession could be terminated with an expected increase in rental income of $2,000 per year, provides a fee which 'ceases to be a measure of due compensation for professional services rendered and makes the lawyer a partner or proprietor in the lawsuit.... Indeed, the fee smacks of a penalty; it is grossly disproportionate to the services rendered or contemplated and is... unenforceable.' At the time...[the lawyer] executed the contingency agreement, he stood in a fiduciary capacity vis-à-vis the Cooperative. He was paid on a flat retainer basis as general counsel. He had a duty to present fairly and fully the nature of what he might be called upon to do in the prospective lawsuit and the nature of his representation, the values at stake, and the likelihood of success with respect to the three leases involved, including the commercial lease. The fees provided for in the agreement were as unreasonable at the time the contract was signed as they later became in retrospect. The agreement is voided as an unconscionable and unreasonable arrangement between attorney and client.

... Asked to detail what time he spent under the contingent retainer in the eighteen days from inception of the suit until the parties agreed to a total standstill of all proceedings,...[the lawyer] replied: [*33] 'We did not keep time records...'

There is a mandatory salutary requirement in this Circuit that 'any attorney...who applies for court-ordered compensation...must document the application with contemporaneous time records' which 'specify, for each attorney, the date, the hours expended and the nature of the work done.' New York State Ass'n for Retarded Children Inc. v. Carey, 711 F.2d 1136, 1148 (2d Cir. 1983); Soliman v. Ebasco Services Inc., 822 F.2d 320, 323 (2d Cir. 1987), cert. denied, 484 U.S. 1020, 98 L.Ed.2d 680, 108 S. Ct. 732, 56 U.S.L.W. 3461 (1988). Under New York law also, in contractual fee cases, the burden is on counsel to keep and present records of time spent, and where adequate contemporaneous records have not been kept, the full amount of compensation requested should not be awarded. See F.H. Krear & Co. v. Nineteen Named Trustees, 810 F.2d 1250, 1265 (2d Cir. 1987).

In the absence of records of time spent it becomes a speculation to assess the scope of the actual services rendered .... (Emphasis added).

Material consistency between the lawyer's time and expense records and the services
contemplated by the retainer as well as the accuracy of the records are important for the lawyer to establish in any fee dispute. Judge Milton Pollack, however, viewed this only as a starting point and not the basis for definitive determination. Judge Pollack noted in Browning v. Peyton [FN18]:

[T]he 'meter approach'...of computing compensation has created a tendency...to obscure the objective value of the particular services to be evaluated in monetary terms. The meter method tends to disregard the fact that a fee for legal services must also bear a proper relationship to the value of the engagement to the client, the amount involved and the importance of the services required. The requirement that time records be kept by counsel...[is] a check against runaway charges on the upside and to put in bold relief the actual time required and spent on a legal task.... In short, time records... highlight unrestrained fee demands. However,...time records...[are] not an invitation for the distortion of the value of the required services or the proliferation of unnecessary unwarranted activity in the light of the overall objective requirements of the case. (Emphasis added)

Conclusion
The late Judge Pollack, was one of the most astute judges on the federal bench whose tenure on the bench was preceded by his practice as one of the most highly respected commercial litigation and trial lawyers. In the above-cited cases Judge Pollack addressed what is and should be required to establish a reasonable legal fee consistent with appropriate professional standards. Judge Pollack's observations should be seriously considered as the fundamental building blocks for a more intelligible and effective Disciplinary Rule both to prevent and to sanction excessive, unethical and fraudulent billing.
Time should never be an absolute yardstick to measure the reasonableness of a fee. Accurate time records, however, specifically describing the services rendered should be the sine qua non before a lawyer's fee is accepted as reasonable, whatever the context. Only when there are accurate and descriptive records can the reasonable value of the attorney fee be established. Judge Pollack's high and workable standards that a lawyer should make and maintain accurate and descriptive time records and only then can reasonable billing be demonstrable; have to be the foundation for professionally responsible and ethical billing.

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FN12. The obvious purpose is to maximize both up front and ongoing disclosure; however, the word 'material' should be substituted for the word 'full' so a minimalist approach to disclosure and the client's informed consent on fees will not become the standard.


also Estate of Sylvester G. Prime, Dec'd, NYLJ Volume 203, Number 108, Surrogates Court, Suffolk County, June 6, 1990.


FN18. 123 FRD 75, 78 (SDNY 1988).
PROFESSIONAL LIABILITY

DR2-106, DR2-107, Fees and Professionalism: Part 2

Norman B. Arnow and Sue C. Jacobs

In Part 1 of this two-part series, 'DR2-106, DR2-107, Attorney Fees, and Professionalism,' NYLJ, March 26, 2008, at p. 3, we addressed issues that included: absence of textual clarity; fraudulent billing; unethical fees; the Matter of Charles L. Feely; fraudulent billing and the Pollack Standards.

Mandate for Reform
In Part 2, we begin with the 'mandate for reform.' In virtually all contexts, lawyers are required to exercise good faith and sound judgment that can vary with individual lawyers and their particular clients.

DR2-106 addresses the factors that are to be considered in determining the reasonableness of the attorney’s fees. However, DR2-106 and DR2-107 as presently drafted are seriously flawed as they invite a subjective and hindsight juggling act by both the courts and the bar when evaluating the reasonableness of fees and how and in what manner fees are permissibly shared by independent lawyers working together.

Further, a rule such as DR2-106 that is violated only when a prudent person, albeit a professional, has his or her conscience shocked is absurd. Not only does the rule lack meaningful educative notice since a fundamental standard requiring universal compliance is lacking. The basis for an objective determination is absent as to when the attorney’s fee crosses the line from an unreasonable fee to an excessive one. DR2-107 also permits a minimalist approach that relieves lawyers of meeting the highest disclosure standards when it comes to billing.

The soft underbelly of DR2-106 can, however, be rectified by incorporating the astute observations of the late Judge Milton Pollack. [FN1] The nonexhaustive factors set forth in DR2-106 can be given meaningful content only if the rule will require that every attorney no matter how the fees are based, whether fixed, contingent, and/or especially time-based, make and keep original and contemporaneous time records with entries specifically and not generically describing the services rendered (i.e., a mere reference to a nonspecific phone conference, research, or a meeting, etc., will be insufficient).

DR9-102, D-9 and 10 with respect to escrow accounts and 'other accounts' where lawyers have care, custody, and control of client funds and property, require that original and contemporaneous records or duplicate original records be made and maintained that 'cannot be altered without detection.'
Arguably, the language of DR9-102 D-9 and 10 applies to time records that serve as the basis for creating the process by which client funds are made payable to lawyers for their fees and by means of which funds from unused retainers are returned. False and fraudulent billing is also conversion or its near equivalent and, therefore, at least with respect to time-based billing, the duty to make and keep such time records exists and certainly should exist if sound policy is to be followed.

It makes eminent sense, therefore, to add the following provisions to the text of DR2-106:
In order to establish the attorney's fees as reasonable, the attorney must make and keep original and contemporaneous time records or duplicate originals where the entries must accurately and sufficiently describe the services rendered to allow for reasonable verification and where the records of original entry or duplicate originals cannot be altered without detection.

Further, the rule should provide:
At the outset of the engagement the attorney should provide the client with a good-faith estimate of what the fees are likely to be and thereafter on a periodic basis report to the client what the time charges and expenses have been to date.

At all times it is the lawyer's duty to the client to disclose all information material to the client's engagement of the lawyer or the exercise of the client's right to discharge counsel. Lawyer and client shall mutually agree as to the frequency of the reports of the attorney's time and expenses incurred and in the absence of such agreement such reports should be rendered on a monthly basis. In the absence of such periodic reporting by the attorney, there is a rebuttable presumption that the fees are unreasonable and in violation of the Disciplinary Rules.

No lawyer should be able to argue that his or her fees are reasonable where, for at least one year after the termination of the attorney-client relationship or other sufficient period including during the pendency of proceedings where professional liability and attorney-client fee issues are before a court or arbitration panel, the lawyer does not have contemporaneous records of original entry or its duplicate originals that cannot be altered without detection. Argument that entries inputted into a computer and printed out on bills are sufficient without records of original entry cannot and should not be accepted. Entries inputted into a computer or taken from other records of original entry that have been destroyed can be altered and do run the clear risk of being deceptive substitutes.

Original, Contemporaneous Records
It is critical that original and contemporaneous records be made at or near the time of the event to record and maintain for a reasonable time the actual billing so as to preserve and protect the client's right to meaningfully challenge a bill after the termination of the attorney-client relationship and certainly during a fee dispute, legal malpractice action, and/or fee application to the court.

Further, the applicable Disciplinary Rules should be construed to give full force and effect to the statement of client's rights appended to the written retainer agreement. There should be no doubt the Code of Professional Responsibility's primary end is to facilitate the lawyer's service to the client.

With the necessary and express adoption of such rudimentary requirements, objective assessments will be substituted for hindsight judgments; the factors' test analysis will be made
meaningful; and the imposition of textually articulated standards of fairness for both lawyers and clients will be more consistently and effectively applied. The analysis and standards by Judge Pollack serve the legal profession and public far better than the most minimalist 'shock the conscience' test.

DR2-107

• Division of Fees among Lawyers. DR2-107 provides in pertinent part:

A. A lawyer shall not divide a fee for legal services with another lawyer who is not a partner in or associate of the lawyer’s law firm, unless:

1. The client consents to employment of the other lawyer after a full disclosure that a division of fees will be made.

2. The division is in proportion to the services performed by each lawyer or, by a writing given to the client, each lawyer assumes joint responsibility for the representation.

3. The total fee of the lawyers does not exceed reasonable compensation for all legal services they rendered the client.

DR2-107 also must be considered in trying to achieve higher standards of professionalism and assuring that legal fees charged by the lawyers and paid for by the clients will be reasonable and understood to be such.

The flaws in D2-106 and DR2-107 are ambiguities that create unworkable standards that lead to a minimalist approach in interpreting and applying the rules. The terminology 'full,' to wit, 'all inclusive' and 'all encompassing,' prescribes a disclosure requiring virtually everything that can have an affect upon billing. The term 'material,' i.e., 'consequential, important, significant, [and] substantial,' is decidedly more workable and will cut out the 'shock conscience' and the 'mere faint' at disclosure approaches.

The other flaw is that the rules frequently serve multiple and conflicting purposes as DR2-107 attempts to address both issues of client disclosure and the potential disputes over fees between lawyers serving the same client when the lawyers are not associates or members of the same firm. Even the best scholars have not worked through these significant deficiencies. Professor Roy Simon writes:

The disclosure about fees is a simple one. The lawyer need not disclose the percentage or amount or conditions of the split. For example, if Lawyer A is billing out Lawyer B’s time at $200 per hour but Lawyer A is paying Lawyer B only $175 per hour, this split need not be disclosed. All that is necessary is for Lawyer A to say, 'our firm will be sharing in the fees billed by Lawyer B,' of course, he may decide not to consent without knowing the precise terms of the division of fees, but Lawyer A can ethically ask for the client's consent disclosing only that there will be a split of fees (a number of other jurisdictions do require that lawyers disclose the precise fee sharing arrangement but New York does not). [FN2]

Informed Consent

Precise disclosure is likely unworkable but disclosure of material facts pertinent to the billing at the outset and on an ongoing basis is and should be workable. Certainly the client should be informed in most circumstances of the percentages of what counsel will be receiving in the engagement to make the best assessment of the time and cost-effectiveness of the services that will be performed by the individual lawyers and the incentive and disincentives for the
different counsel working on the matter. Every client is entitled to know the material information of how he or she will be and is being billed and not merely that the fees will be shared. How else can the client weigh in on how his or her money is or will be spent? The client is entitled to know this information in making the judgment as to whether or not to hire the lawyer and whether to exercise the right to discharge counsel.

Most of the cases addressing DR2-107 issues focus almost exclusively on disputes between lawyers, probably because DR2-107 mechanically requires inter alia that the lawyers be compensated in proportion to the services they render; a 'full' disclosure of the fee arrangement to the client; and the client's written consent to the arrangement. The cases that do address the issues arising in lawyer-client fee disputes, however, seem to require more than nominal disclosure.

A review of the cases show, DR2-107 is a dual purpose rule that seeks to obtain the client's informed consent to fee sharing and to establish a framework for lawyers to work together with reasonable predictability and without disputes. This is not an easy balance. In a case involving a fee-sharing arrangement between lawyers representing a co-op, Excelsior 57th Corp. v. Lerner, [FN3] the court held:

...It is by no means clear...that the co-op knew of the fee-splitting arrangement, or that its board knowledgeably ratified it at any time. Client knowledge of a joint representation agreement between lawyers is the sine qua non of its ethical validity...as well as proof that an attorney who claims part of a legal fee must have shared, to some significant degree, the legal work entailed.

Not only must there be informed consent but the fee sharing must be in proportion to the services rendered or the lawyers must accept in writing joint responsibility for the representation. In Nicholson v. Nason and Cohen PC, [FN4] the court articulated the latter two elements, holding:

...Under DR2-107 (A)(2) (22) NYCRR 1200.12 [a][2]; unassociated lawyers may share in a fee if, among other things, '[t]he division is in proportion to the services performed by each lawyer or, by a writing given to the client, each lawyer assumes joint responsibility for the representation. Neither option avails plaintiff, who admittedly gave no such writing to any of the clients, and whose work, the record establishes was merely that of a finder searching for potential clients and conducting non-investigative interviews...'

While the case articulates the elements of DR2-107, it also at the same time dilutes them to the extent of making the standards highly nebulous. The court goes on to hold:

While a fee-splitting agreement will be enforced where the attorney seeking a share 'performed some work, labor or services which contributed toward the earning of the fee' there being no requirement that compensation be proportioned to the amount of work actually performed..., more is required of the forwarding attorney than the mere recommendation of a lawyer...given the important policy goals underlying DR2-107 and the well-established right of states to regulate the legal profession...we think this is a reasonable restriction on the right to contract.

Protection and Fairness
The policies behind the rule should not be diluted because of apprehensions that standards are not susceptible to clarity and consistent application. Nor does applying the rule mechanically serve the purpose of its valid policies. In Ruskay v. Jensen, [FN5] U.S. District Judge Lee Gagliardi articulated that the primary reason for the rule was to protect against excessive fees and achieve fairness for lawyers and their clients. Addressing DR2-107 the court observed: Although on the face the rule appears to bar fee splitting, subsection (3) would permit such an arrangement provided the initial fee granted is not ‘clearly excessive.’ The American Bar Association in promulgating the rule referred to its Formal Opinion No. 204 (Nov. 24, 1940).... The Formal Opinion prohibited the splitting of fees ‘where a lawyer merely brings about employment of another lawyer but renders no service and assumes no responsibility in the matter’...and allowed a fee division when the referring attorney also rendered services. The opinion further stated that when dividing fees ‘it is obviously desirable that the lawyer should determine in advance whether a joint fee is to be charged and divided, or whether each lawyer is to charge a separate fee for his services.’... [It is clear that the ABA intended to permit fee arrangements among attorneys rendering services, provided that the fees are not excessive. As stated, fee sharing should not be disconnected from measuring whether the fees charged are reasonable, and that end can only be achieved with a more reasonable degree of certainty by insisting upon accurate and descriptive time records coupled with informed consent and ongoing disclosure. In view of the foregoing, it is recommended DR2-107 (A)(1) should now read as follows:

1. The client gives written and informed consent to employment of the other lawyer after disclosure of all material facts pertinent to the prospective and actual costs of the representation as well as those facts that can affect the quality of the legal services. Maximizing the transparency of the fee sharing arrangements between independent lawyers enables the clients to make their best selection of counsel as well as to be more effective and responsible in monitoring their legal representation on an ongoing basis.

Conclusion
Chief Judge Benjamin Cardozo, addressing a law school graduating class, once stated: How it lies with you to erase what is false; uplift what is low; and redeem what is lost; till all the world shall see and seeing understand that union of the scholars thought, the knight’s ardor and the hero’s passion which is in the best moments of self-expression, the spirit of the bar.

We owe it to ourselves as members of a profession with the greatest of aspirations, and to the clients whom we serve to articulate and adhere to the highest standards of ethical billing. Making the Code of Professional Responsibility more intelligible is certainly a good starting point. Enhancing public perceptions of the legal profession is also critical in today’s context as the public perceptions of the legal profession are not now at the highest point. [FN6] Equally significant are the problems virtually every lawyer has faced where the billing has exceeded client expectations; the retainer has been exhausted; and the client has then announced an inability to pay perhaps coupled with a promise to pay down the line if the services are continued. Most ethical lawyers disposed to act decently face a serious conundrum whether or not and when they should withdraw.

A course of sound practices that will consistently require better mutual understanding and responsibility by attorneys and their clients will no doubt minimize if not eliminate the
problems described above. The practice of law is the practice of justice and justice is always served when there is responsibility and fairness for all.

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FN1. The Pollack Standards: In 520 East 72nd Commercial Corp., et al v. 520 East 72nd Owners Corp., the late Judge Milton Pollack addressed an issue of whether a fee arrangement was unconscionable and whether the court in the absence of time records would entertain a fee application and to what extent. Judge Pollack held:

After a full exploration of the facts and circumstances of this dispute, the court finds that the contingent retainer agreement demands a fee that is grossly out of proportion to the value of the attorney's modest services. See Gross v. Russo, 47 AD2d 655, 655, 364 NYS2d 184, 186 (2d Dept. 1975) ('a full exploration of all the facts and circumstances, including the intent of the parties and whether the fee demanded...is out of proportion to the value of the attorney's services, [was] necessary before a determination of unconscionability may be made').

The fee demanded here is an amount which, with due regard to the contingent nature of compensation is unreasonable and unconscionable factually and large enough to render the retainer agreement unenforceable under the circumstances of the case. See Gair v. Peck, 6 N.Y.2d at 107, 160 N.E.2d at 48, 188 N.Y.S.2d at 498. In the background of an estimate given by...[the lawyer] of $10,000 fee to carry the case to summary judgment on his hourly charge of $225 per hour, the provision for the minimum payment of $375,000, even if only the laundry concession could be terminated with an expected increase in rental income of $2,000 per year, provides a fee which 'ceases to be a measure of due compensation for professional services rendered and makes the lawyer a partner or proprietor in the lawsuit.... Indeed, the fee smacks of a penalty; it is grossly disproportionate to the services rendered or contemplated and is... unenforceable.'

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Material consistency between the lawyer's time and expense records and the services contemplated by the retainer as well as the accuracy of the records are important for the lawyer to establish in any fee dispute. Judge Milton Pollack, however, viewed this only as a starting point and not the basis for definitive determination. Judge Pollack noted in Browning v. Peyton:

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(from Capuder & Arnoff, P.C. 10/1/2000)
Engaged to represent registered representatives and securities broker-dealers in arbitration and regulatory matters, give compliance lectures and seminars and to represent claimants, lawyers, accountants and other financial service professionals in professional liability litigation, arbitration and mediation.

March 1991 - April, 1992
Federal Deposit Insurance Corporation (FDIC)
Northeast Regional Office, New York, NY
Counsel, Professional Liability.

January 1977 - March 1991
Arnoff & Siskind, P.C. (and predecessor firms)
Litigation firm specializing in arbitration, securities, commodities, futures and commercial matters, as well as lawyers' and accountants' liability.

October 1974 - December 1976
D'Amato, Costello & Shea
Litigation and trial attorney, specializing in lawyers' and accountants' liability suits in state and federal courts.

October 1972 - October 1974
United States Department of Justice
Office for Drug Abuse Law Enforcement (ODALE)
Organized Crime and Racketeering Section
Special Attorney and Special Assistant United States Attorney.

April 1969 - October 1972
United States Securities and Exchange Commission (SEC)
New York Regional Office
Trial and Enforcement Attorney.

Career Case Highlights:

"Argued before the United States Supreme Court, the first Monday in October 1989 in the case of Pavelic & LeFlore v. Marvel Entertainment Group for the proposition of law firm liability under Rule 11 of the Federal Rules of Civil Procedure, which has now resulted in an amendment to Federal Rules of Civil Procedure 11 establishing such law firm liability.

Argued successfully the *George Muhlstock & Co. v. American Home Assurance Co.* (1986), one of the leading coverage cases under the accountants' professional liability policies in New York State that the selling of tax shelters by accountants does not constitute professional service covered by the policy.

On behalf of National Union Fire Insurance Company of Pittsburgh, PA, conducted professional liability insurance coverage investigation and litigation involving the offer and sale of Boardwalk/Marketplace limited partnerships by John P. Galanis in a major nationwide financial fraud and the law firms involved in the securities offerings (1986-1990).

Served as trial and appellate counsel for a lawyer-defendant in a six-week trial in the United States District Court, Southern District of New York in defense of professional liability and forgery claims against him. After a favorable jury verdict, acted as his counsel in the Second Circuit on the Rule 11 sanction issues in *Calloway v. Marvel Entertainment Group* 854 F.2d 1452 (2nd Circuit 1988).

Served as plaintiff’s trial attorney in *Magnum Corp. v. Lehman Brothers Kuhn Loeb Inc.* in the United States District Court, Eastern District of Texas (1985), 794 F.2d 198 (5th Circuit, 1986). The case reinforced the principle that a broker-dealer firm must promptly and faithfully execute customer orders. It is discussed in Professor Norman S. Poser’s text, *Broker-Dealer Law and Regulation.*

Served successfully as trial counsel to an ophthalmologic surgeon, erroneously believed to have been a drug abuser, in a license restoration proceeding before the Office of Professional Conduct, New York State Department of Health. *In Re: G-G, M.D.* (1984).

Served as one of the trial counsels in *SEC v. Rooney Pace, Inc.* (1984) and *SEC v. First Jersey Securities, Inc.* (1979-80), major and lengthy SEC administrative proceedings.


Served as trial counsel in *Sleebeen v. McKenzie Martin Cambell & Greene* (1976), a legal malpractice action in Supreme Court, New York County, involving a lawyer’s responsibilities in written opinions on the sale of unregistered securities and applicable exemptions Obtained a defendant’s verdict.

Conducted three-year (1969-72) SEC investigation of nominee and fictitious accounts and manipulative trading of new issue securities which resulted in a number of SEC criminal prosecutions and convictions including Steven C. Burns and John Galanis, and administrative proceedings revolving six over-the-counter broker-dealers, the barring of 30 salesmen, and several Rule 2(e) proceedings against lawyer and accounting professionals.

Served as SEC enforcement and trial counsel in *SEC v. J. Bennett Rafter* (1970) in the Southern District of New York, a $750,000 “ponzi” scheme involving 100 investors in eight states and two foreign countries and the first grant of ancillary relief in the context of an SEC injunctive action by a United States District Court.

**Bar Association and Professional Activities:**

2004-Present Mediator/Arbitrator, New York County Law Association, Attorney-Client Fee Dispute Program

1998 Mediator Panel, United States Bankruptcy Court, Southern District of New York

1992-1995 Chairman, NY County Lawyers’ Association Professional Liability Committee
1991-Present  City of New York Bar Association, Professional Liability Insurance Committee
1990-Present  American Bar Association Professional Liability Committee
1991-Present  New York County Lawyers' Association, Federal Courts Committee and Lawyers’ Professional Liability Committee

Education:  
New York University School of Law, JD, February 1969
New York University, Bronx, NY BA, June 1965

Academic Honors:  
Phi Beta Kappa
Founders Day Award for Scholarship
THE CROSS-HAIRS OF ACCOUNTING AND LAW: THE VECTORS OF LITIGATION RISK

By Norman B. Arnoff* and Paul I. Immerman**

INTRODUCTION
The Dodd-Frank Wall Street Reform and Consumer Protection Act is a work in progress. The legislative intent is to recapture by more effective concentration on specific and inherent risks -- as well as more effective coordination among regulators -- the transparency and market integrity lost over the last number of years. There also should be additional methods of addressing and avoiding systemic risks.

Consonant with that is the subject of this article, which is the enhancement of professional responsibility and the necessary coordination of different disciplines when overlapping issues arise in the respective engagements of accountants and lawyers.

In the public or private offering context, law and accounting issues become intertwined in highly challenging ways that present to both professions the difficult objectives of not only making the correct analysis in terms of their own professional discipline, but of their colleague’s discipline as well, so that there is the required transparency. This clearly is essential for the company making a securities offering, whether it is a public or private offering. The capital-raising function cannot be impaired and, therefore, the broadest disclosure is mandated.

To avoid the debilitating threat of litigation costs and regulatory sanctions, the better approach is to make a careful accounting and legal analysis that requires the sophistication and sensitivity of both the legal and accounting professions and the less costly premiums of complete and material disclosure in all documents given to investors and lenders or filed with the regulators. Above all, sound preventive measures must be taken to avoid costly and protracted securities litigation.

ACCOUNTING FOR LITIGATION UNCERTAINTIES
Coordination among litigation and corporate counsel and the company’s accountants in the context of determining contingent liabilities from threatened or pending litigation offers an excellent template for illustrating the opportunities that exist for these professionals to not merely do their jobs, but to serve their corporate client and public investors by advancing market integrity and transactional transparency. Particularly with large securities class actions and other complex litigation, the need to weigh the risks of an unfavorable outcome, to disclose the nature and probabilities of litigation risks, and to quantify those risks for reserve purposes provide the professional with considerable challenges and, at the same time, tantalizing prospects to serve well.

THE PROFESSIONAL ACCOUNTING STANDARDS
Both FAS5: Accounting For Contingencies, promulgated in 1975 by the Financial Accounting Standards Board (“FASB”), and FASB’s promulgation in July 1, 2009 of the Accounting Standards Codification (“ASC”) 450 provide the starting points for analysis when contingent liability issues arise in the litigation context.

FAS5 states, “a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain... or loss... to an enterprise that will ultimately be resolved when one or more future events occur or are likely to occur... When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote... [T] he terms probable, reasonably possible, and remote identify three areas within that range...” (Emphasis Added).

“Pending or threatened litigation” and “actual or possible claims and assessments” are two of the uncertainties where the fundamental distinctions between

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probable, reasonably possible and remote must be given more precise definition and application in the financial reporting process in respect to the accrual of the loss contingency, i.e., reporting it as a liability.

FAS5 provides that “[a]n estimated loss from a loss contingency... shall be accrued by a charge to income if ... information available prior to the issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability had been incurred at the date of the financial statements... [and] [i]t is implicit in this condition that it must be probable that... future events will occur confirming... the loss... {Additionally} [t]he amount of loss can be reasonably estimated... {in respect to an accrual}.” (Emphasis Added)

FAS5 further provides: “Disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.... Even if an accrual is not made... [t]he disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.” (Emphasis Added)

Further “disclosure is not required as to a loss contingency involving an unasserted claim or assessment when there has been no manifestation of a potential claim or assessment... [or] an awareness of... [the] possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.” (Emphasis Added)

In other words, disclosure is required when there is a probability that the claim will be asserted and the reasonable possibility exists of an unfavorable outcome in the period covered by the financial statement. The disclosure is triggered by the “reasonable possibility” of an unfavorable outcome. While “probable” is the standard for liability determinations, disclosure of litigation risks is still appropriate when there is no basis for accrual but there still remains a sufficient threshold of risk.

Disclosure has to take place in virtually all circumstances except when the possibility of liability is remote. FAS5 also sets forth the qualification that the mere “filing of a suit or formal assertion as a claim or assessment does not automatically indicate that the accrual of a loss may be appropriate.”

ASC 450 does not substantially amend FAS5. It merely clarifies it. Whether the governing professional standard was or is FAS 5 or ASC 450, accrual of a liability would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of the financial statements but before those financial statements are issued. Disclosure, however, in this context is appropriate.

Accrual may be appropriate for litigation, claims, or assessments whose underlying
cause is an event occurring on or before the date of an enterprise’s financial statements even if the enterprise does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statement. This may seem nonsensical, but, unlike the immediacy of public disclosures, financial statements are historical renderings, prepared well after the fact and published with the facility and advantage of hindsight. Often, that hindsight is informed by revelations arising after the date of the financial statement.

Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise’s management as to how the enterprise intends to respond to the lawsuit, claim, or assessment.

A decision to contest the case vigorously or a decision to seek an out-of-court settlement will affect whether the liability is to be accrued or merely disclosed. The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss is met.

With respect to unasserted claims and assessments, an enterprise and its professional advisers must determine the degree of probability that a claim may be asserted and the possibility of an unfavorable outcome. An investigation of an enterprise by a regulatory authority such as the SEC is an excellent example of when disclosure is not only required but accrual may be prudent.

If the judgment is that the assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required. If an amount of loss cannot be reasonably estimated, accrual is not appropriate. Disclosure is nonetheless appropriate and more likely than not the soundest course. The disclosure, however, should be grounded in the true facts and applicable law and not merely be a mechanical application to avoid professional liability and liability to the board and management.

**The Cases And The Law**

Accounting standards that deal with litigation uncertainty are easily stated. The challenge is in the application and the variables that come into play in order to distinguish what is probable from what is reasonably possible, and whether the liability or possible liability can be reasonably estimated. Those standards, however, when interpreted and applied in the context of litigation or its anticipation, can be informative tools, both to defend against and to prevent liability in securities and professional liability litigation.

In *SEC v. Guenther*, the Court held: “...to give rise to section §10(b) liability for fraud, the mere second-guessing of calculations will not suffice; the Commission must show that the defendants’ judgment - at the moment exercised - was sufficiently egregious that a reasonable accountant reviewing the facts and figures...should have concluded that the company’s financial statements were misstated and that as a result the public was likely to be mislead. (Emphasis Added)

“GAAP and the anti-fraud rules promulgated under §10(b) of the 1934 Act serve similar purposes, and courts have often treated violations of the former as indicative that the latter were also violated.... Nevertheless, the prohibitions contained in the GAAP and in section 10(b) are not perfectly co-extensive. In some circumstances, courts have found defendants liable for securities fraud under §10(b), despite having complied with GAAP, while in other circumstances, courts have discharged defendants from §10(b) liability, notwithstanding deliberate violations of GAAP.” Discretionary judgment is a constant in dealing with litigation uncertainty and therefore there is a relatively high bar to establish professional and civil liability. The *Guenther* Court recognized, where there is litigation uncertainty, an easy to overcome threshold in order to accrue a liability does not exist. The Court held: “GAAP is a term of art that encompasses a wide range of acceptable procedures.... GAAP are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions.... [GAAP] rather tolerate a range of 'reasonable' treatment, leaving the choice among alternatives to management. Accounting concepts are flexible, (and) circumstances will give rise to fraud only where differences in calculating are the result of a falsehood, 'not merely the difference between two permissible judg...
ments”…. A reasonable accountant may choose to apply any variety of acceptable procedures when preparing a financial statement...” (Emphasis Added)

This forgiving professional judgment rule, however, is not an absolute shield from liability. What cannot and should not be disregarded is that disclosure is virtually always prudent, even when the facts and circumstances would not require it because the possibility of litigation and a successful claim being asserted is remote.

The possibility of falsity and material omission necessitates an evaluation of the total mix of information before liability can be adjudged. The Court held in the cited case: “A misinterpretation is considered ‘material’ if it has been established there is a substantial likelihood that the misrepresentation would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available…. A determination of materiality requires delicate assessments of the inferences that a reasonable shareholder would draw from a given set of facts and the significance of those inferences to the shareholder…. Although materiality generally presents a factual question, the issue may be decided as a matter of law in an appropriate case upon a showing that ‘a reasonable investor could not have been swayed by an alleged misrepresentation, or omission.’ Cautionary language that relates directly to the issue on which plaintiff claims to have been misled can render the alleged misrepresentation or omissions immaterial as a matter of law…” (Emphasis Added)

The Guenther case also stands for the proposition that expert testimony is necessary to inform the adjudicator of the facts with respect to the interpretation and application of professional standards. Qualified experts, however, are not permitted to opine upon ultimate issues that usually are conclusions of law. Issues such as whether the defendant aided and abetted any breach of fiduciary duty by the officers and directors of the issuer are good examples. The latter is both an ultimate legal issue and beyond the scope of expert opinion.

PEC Solutions Inc. Securities Litigation was a class action involving securities fraud allegations, premised upon accounting fraud. The Court held not only was particularity required in the pleading in order to survive a motion to dismiss, but that the allegations of misrepresentations are to be addressed in terms of the materiality of the facts, i.e., “‘a court should not consider each relevant factual allegation solely in isolation... but rather as a part of the overall factual picture painted by the complaint.’” (Emphasis Added)

Not only must the total mix of information be considered but it is also a settled proposition that violations of accounting standards are not in and of themselves violations of the anti-fraud provisions. Further misstatements and omissions are not actionable when they are not considered “material because in light of the quality of the company’s disclosures, any additional disclosures could not have altered the ‘total mix’ of information available to an investor.”

Moreover, in respect to litigation uncertainty there is a threshold of required predictability and certainty when a liability should be accrued. The Court in Alphastar Insurance Group Limited et al. v. Arthur Anderson et al. held: “... the defendants could not have misrepresent the likely outcome of the ... litigation because the outcome could not have been predicted with the type of likelihood required by F.A.S.5.”

Neither general fraud allegations nor allegations of accounting violations, without more, constitute sufficient allegations of accounting fraud. In Local 295/Local 851 Employer Group Pension Trust v. Fifth Third Bancorp, the Court held, however, accounting violations can be indicative of fraud. Specificity is not merely required to state the nature of the error but its magnitude as well. The Court held: “Accounting violations, standing alone, do not create an inference of scienter.... If however, the accounting errors are sufficiently basic and large, their existence in combination with other factors may support the requisite scienter .... ‘In order to establish scienter based on accounting violations.... the complaint must allege ‘extreme’ in your face facts that ‘cry out scienter.’” (Emphasis Added)

The Court also recognized “the estimation of probable losses in a large loan portfolio is more of an art than a science’.... Indeed the complaint cited ... different standards or accounting authorities that address accounting for loss contingencies, much of which in turn contain numerous subparts or considerations....”

In Biver County Retirement BD v LCA Vision Inc., the Court held in order to be sufficient to give rise to an inference of scienter “…[the] allegations of accounting violations…[have to be]... so simple, so basic and pervasive in nature, and so great in magnitude, that they should have been obvious to a defendant.” (Emphasis Added) The accounting violations were not “so simple, basic, or pervasive in nature” as to be obvious to the defendant.

In NVIDIA Corporation Securities Litigation, the Court addressed in the context of a securities class and fraud action the two key issues that must be resolved before a liability can be accrued. Not only must there be ‘probable loss’ but the accounting charges must be “reasonably estimable” before the end date of the period covered by the financial statement.

Further, if the violation of accounting standards are to have any probative value the allegations, especially where the Private Securities Litigation Reform Act (“PSLRA”) is applicable, must have specific and concrete content coupled with the allegation of knowledge or reckless disregard by the wrongdoer that the error will have a material impact on the financial statement and as a result make a likely difference to the investor in regard to his or her investment decision. Nor is there a more liberal standard of pleading or proof for the SEC when it brings enforcement actions.”

Conclusion And A Further Recommendation

Accounting for litigation uncertainty takes lawyers and accountants to a professional intersection that can have serious, unintended consequences unless FAS5 and ASC 450 are understood. This is true in terms of how they are interpreted and
applied as an accounting standard in the financial audit and reporting process, as well as to what legal effect these standards are to be given by the courts. The standards are clear in principle but difficult to apply and therefore require clear, sensitive, and cooperative communication between the legal and accounting professions. An interactive dialogue is not only a means to avoid the pitfalls of professional liability but most importantly best serve the client. (Emphasis Added)

When an event may be reasonably possible to result in a liability, it must be disclosed. When it is probable and reasonably estimable in amount, a liability is accrued if such an event took place within the fiscal year. However, that is not the end of the story. The law is forgiving with respect to professional and civil liability, because in this context the judgment of both the legal and accounting professions must address complex, sensitive and difficult questions. It should be recognized the only real liability exposure occurs when there is a failure to disclose material facts, so opting for disclosure is a given.

Some will view such disclosure as an invitation to litigation. However, non-disclosure can be an even stronger precipitating factor to cause litigation. Again it is good to remember what Justice Louis Brandeis said in this context, i.e., “sunlight is the best disinfectant” and that precept, which should be internalized by the members of both professions, is the best means both to avoid professional and civil liability and to best serve the client and the investing public. Accurate and material disclosure on an ongoing basis is always the soundest and best professional advice to be given, as well as the safest way to avoid the systemic risks that inhere in the professional practices of both lawyers and accountants.

OUT OF THE FIRE, INTO THE FRYING PAN.

Bear Stearns hedge fund managers, Ralph Cioffi and Matthew Tannin, must have considered themselves lucky when they were found not guilty of securities fraud in a criminal trial. Prosecutors in that case accused the two of giving rosy forecasts for the performance of the hedge funds that they knew were on the verge of collapse. However, the two did not escape unscathed by any means; the SEC pursued a civil proceeding against them and reached a settlement in which Cioffi and Tannin, while not admitting to any liability, agreed to be barred from the securities industry for three years and two years, respectively, and to pay a total of $900,000 in disgorgement and $150,000 in penalties. (NOTE: For a summary of the Court’s approval of the settlement, with further details on the background of the case, see SLA 2012-26.)


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Professional Liability

Norman B. Arnoff and Sue C. Jacobs
12-08-2009

"Sunlight is the best disinfectant," declared Justice Louis Brandeis. A lawyer who has internalized the concept of this key principle adopts the best measure for ultimately collecting his or her attorney’s fees and avoiding legal malpractice and breach of fiduciary claims. Obtaining informed consent from the client and confirming it in writing, not merely at the beginning of the representation but at any discrete moment of the representation is the best professional liability insurance and the cheapest. It is a roadblock even to frivolous litigation.

The best way to approach these key concepts for the well being of our professional practices is to review Part 1200, The Rules of Professional Conduct for Attorneys, effective April 1, 2009. Both the definitions in the rules and the emphasis placed upon the concepts of informed consent and confirmed in writing in various rules clearly establish the best foundation of professionalism for our practices.

Definitions

The shift from the Code of Professional Responsibility to the New Code of Professional Conduct for Attorneys requires in the first instance a close reading of the definitions and a textual analysis premised solely upon the language in the rules. Rule 1.0 provides a series of definitions that we should key into any analysis necessary for interpretation and application of the rules. The definitions are as follows:

Rule 1.0(f) states: "Differing interests" are "every interest that will adversely affect either the judgment or the loyalty of a lawyer to a client," i.e., interests that have to rise to a sufficient level to impact the judgment or loyalty of the lawyer.

Under Rule 1.0(i), in order to find "fraud" against an attorney, it is mandatory to have the "element of scienter, deceit, intent to mislead, or knowing failure to correct misrepresentations that can be reasonably expected to induce detrimental reliance by
another."

As stated in Rule 1.0(j), "informed consent" occurs where the lawyer "communicated information adequate for the person to make an informed decision" and "adequately explained to the person the material risks of the proposed course of conduct and reasonably available alternatives."

"Confirmed in writing," according to the rules, occurs either by a writing from the client or the lawyer. A statement on the record before a tribunal is also a separate means to obtain informed consent. If it is "not feasible to obtain or transmit the writing at the time the person gives oral consent, then the lawyer must obtain or transmit it in writing within a reasonable time thereafter." Rule 1.0(e).

Rule 1.0(x) defines "writing" as "a tangible or electronic record of a communication or representation." A "signed writing" includes "an electronic sound, symbol or process attached to or logically associated with the writing and executed or adopted by a person with the intent to sign the writing."¹

The Substantive Rules

After one looks at the key definitions, the next step is to closely read the language in the rules addressing such issues as scope of representation, conflicts with past and current clients, fee sharing, preserving and protecting client privileged and confidential information, and special conflicts arising from a lawyer formerly with a government agency going into private practice and thereafter representing clients before the agency. Rule 1.1(c)(1) states, in regard to "competence" that the "lawyer shall not intentionally fail to seek the objectives of the client through reasonably available means permitted by law and these Rules."

Rule 1.2(a), addressing the "scope of representation," provides "...a lawyer shall abide by a client's decisions concerning the objectives of representation...[and]...shall consult with the client as to the means by which they are to be pursued."

Rule 1.2(c) says, "A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances, and the client gives informed consent...."

Rule 1.2(d) states, "The lawyer shall not support the client in illegal or fraudulent conduct," except that the lawyer may discuss the legal consequences of any proposed course of conduct with the client.

Rule 1.4(a)(1), Communication, provides "A lawyer shall promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(j)...is required by these rules...,(2) reasonably consult with the client about the means by which the client's objectives are to be accomplished, (3) keep the client reasonably informed about the status of the matter" and (b) "a lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed
decisions regarding the representation."

Rule 1.5: In respect to **Fees and Division of Fees**, (b) "A lawyer shall communicate to a client the scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible. This information shall be communicated to the client before or within a reasonable time after commencement of the representation and shall be in writing where required by statute or court rule."

Rule 1.5 (c) states: "...Promptly after a lawyer has been employed in a contingent fee matter, the lawyer shall provide the client with a writing stating the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer...litigation and other expenses to be deducted from the recovery; and whether such expenses are to be deducted before or, if not prohibited by statute or court rule, after the contingent fee is calculated. The writing must clearly notify the client of any expenses for which the client will be liable regardless of whether the client is the prevailing party."

In domestic relations matters, the lawyer must inform a prospective client with the statement of client's rights and responsibilities. Rule 1.5 (e).

There can be no division of fees between independent lawyers unless there is full disclosure including the respective percentages "and the client's agreement is confirmed in writing." Rule 1.5 (g).

Rule 1.6: **Confidentiality of Information** provides that the lawyer cannot disclose confidential information unless the client gives informed consent, as defined in Rule 1.0(j).

Rule 1.7: **Conflict of Interest with Current Clients**, provides that the lawyer cannot assume or continue representation if the conditions prescribed by the rule, including the requirement that "each affected client gives informed consent confirmed in writing" is not strictly observed. Further, "(f) A lawyer shall not accept compensation for representation of a client, or anything of value related to the lawyer's representation of the client, from one other than the client unless...the client gives informed consent." Additionally, "(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the client, absent court approval, unless the client gives informed consent in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims involved and of the participation of each person in the settlement."

Further, Subdivision (h) provides that the lawyer cannot represent a client who is involved in litigation with a lawyer who is related to the lawyer representing the firm's client "unless the client consents to the representation after full disclosure and the lawyer concludes that the lawyer can adequately represent the interests of the client."

Rule 1.11(a)(2), **Special Conflicts of Interest for Former and Current Government Officers and Employees**, provides that a lawyer who has formerly served as a public officer or employee of the government "shall not represent a client in connection with a
matter in which the lawyer participated personally and substantially as a public officer or employee unless the appropriate government agency gives its informed consent, confirmed in writing to the representation."

Rule 1.12, Specific Conflicts of Interest for Former Judges, Arbitrators, Mediators or Other Third-Party Neutrals, provides: (b) "(A) lawyer shall not represent anyone in connection with a matter in which the lawyer participated personally and substantially as an arbitrator, mediator or other third party neutral...a law clerk to a Judge or other adjudicative officer...unless all parties to the proceeding give informed consent, confirmed in writing."

Rule 1.13, Organization As Client, provides that, in respect to the organization that a lawyer is representing and when dealing with its employees and agents whose interests may differ, "the lawyer shall explain that the lawyer is the lawyer for the organization and not for any constituents." There can be concurrent representation of officers, directors, agents, etc., provided there is informed consent in writing.

Rule 1.17, Sale of Law Practice, states in subdivision (b)(5) and (6) that the seller may not provide the buyer with client confidential information or privileged information, "absent the consent of the client after full disclosure." The lawyer's client must be informed of the identity of the lawyer who will be acquiring and assuming responsibility for the law practice, and the rule requires that "conflict waivers are obtained in writing" by the lawyers who are parties to the transaction.

Rule 1.18, Duties to Prospective Clients, provides that (d) "{w}hen the lawyer has received disqualifying information...representation is permissible if...both the affected client and the prospective client have given informed consent, confirmed in writing."

Rule 5.8, Contractual Relationship Between Lawyers and Non Legal Professionals, states that the fact of such a contractual relationship must be disclosed to the recipient of the legal services, and the client, in addition to being given a "Statement of Client's Rights to Cooperative Business Arrangements" pursuant to Section 1205.4 of the Joint Appellate Division Rules," has given informed written consent.

Recent Case

A recent case, Fielding v. Kupferman,\(^2\) addresses the informed consent issue and its integral relationship to bad advice. Plaintiff-husband sued his matrimonial lawyer who represented him in a settlement with his former spouse. In exchange for receiving a cooperative apartment, plaintiff-husband agreed to pay his former spouse $1.6 million including relinquishing all claims to brokerage accounts. Initially, $1.2 million was to be paid and the balance in monthly installments. The $1.2 million was to be paid within 30 days of execution.

Plaintiff-husband anticipated obtaining a home-equity line of credit in order to complete this transaction which in reality could not occur. Plaintiff withdrew one-half of his

retirement account but was allegedly not advised by defendant-lawyer that there were significant tax consequences attendant to the withdrawal.

Counsel acknowledged the settlement was unrealistic and should have been better explained. However, it was conceded by plaintiff-husband that the lawyer expressly represented the "funds were immediately available." The plaintiff alleged legal malpractice and the court deemed sufficient the allegations. The court held that a reasonably competent lawyer reading the stipulation and knowing the source of funds was the retirement account had to know there were significant tax consequences that should have been addressed. The allegation also deemed sufficient was that the lawyer inadequately explained the operative document. The court held:

...[P]laintiff alleges that but for defendant's malpractice in advising him to sign the stipulation of settlement without advising him properly of tax consequences arising out of his withdrawal money from retirement accounts, he would have avoided actual ascertainable damage, i.e., the tax liability resulting from the withdrawal of the money. He further alleges that defendants were not knowledgeable with regard to the tax consequences and failed to advise him to obtain tax advice from another source.

Defendant's documentary evidence not only fails to refute plaintiff's allegations... conclusively, it supports plaintiff's claim of malpractice in a key respect. The stipulation identifies...accounts in plaintiff's name representing his financial assets and states that... [it] is in a "Profit Sharing Keogh Account," a retirement account that has specific rules regarding the withdrawal of funds and requires that significant taxes be paid upon pre-retirement withdrawal. Thus, the stipulation makes clear that the sum of money that plaintiff needed to comply with its requirements was not "immediately available," yet defendants advised plaintiff to sign it. Given that the ground for plaintiff's claim of malpractice is apparent from the face of the stipulation, the allegations contained in the complaint are not conclusory and plaintiff properly has pleaded a cause of action for legal malpractice.

Referring to precedent established by the New York Court of Appeals, the court passed over the slippery slope that can come about when we make disclosure rote and mechanical and do not consider what the lawyer must in reality communicate to the client and what the client does not need to be informed about because it is self-evident. The Appellate Division, First Department, observed:

The Court of Appeals recently stated that "the conclusiveness of [an] underlying agreement does not absolutely preclude an action for professional malpractice against an attorney for negligently giving to a client an incorrect explanation of the contents of a legal document." Bishop v. Maurer, 9 N.Y.3d. 910, 875 N.E.2d 883, 844 N.Y.S.2d 165 (2007). Although the Court found that the complaint in Bishop was devoid of any non-conclusory allegations that incorrect legal advice was given to the plaintiff, the facts of that case are distinguishable.

The First Department distinguished Bishop because the husband and wife in that case
executed trust documents that "contained an acknowledgement that both parties read and understood the documents and waived any conflict of interest due to their joint reliance on the same attorneys in executing the documents" and "[o]n their face, the documents were proper and did not establish that the defendants provided improper advice or engaged in any act of malpractice."

The court in *Fielding* overstated the breadth of the obligation to obtain informed consent because informed consent should both be within the scope of the representation, i.e., implicates the expertise for which the client hired the lawyer; and an issue beyond the capacity of the client to understand without an explanation from his or her lawyer. *Fielding* certainly raises the issue of how a reasonably sophisticated client could not know that there would be tax consequences to a withdrawal from a retirement account. It is clear from the New Code, however, that implied consent is no longer an option.

The lesson from the case and the New Code is that informed consent should not only be rigorous but confirmed in writing; and not as a mere formality. Boilerplate consent forms should not be employed because informed consent has to be thoughtful and not mechanical.

Also implicated in the concept of informed consent is not merely selection of a strategy or a course of conduct but competent legal advice as the essential premise of the client's informed choice. Getting a client to sign off is not sufficient; the lawyer has to be reasonably sure the client's signature or acknowledgement represents an informed choice. The courts, however, have to be balanced in their judgments and not allow clients to avoid responsibility for matters that come within the client's ken.

The Pervasive Theme

It is self-evident that "Informed Consent" and "Confirmed in Writing" is the pervasive theme in the New Rules of Professional Conduct for Attorneys in New York. The fact that these concepts are so prevalent in a number of the rules and informed consent can easily be evidenced and memorialized by either the lawyer's or the client's writing makes the rules a very effective means for every lawyer to prevent liability for legal malpractice and to avoid professional misconduct charges, whether with or without merit. A word of caution, however, lawyers should not rely on implied consent and at least on the material terms and strategies of the representation memorialize the client's informed consent to the course the engagement is going to pursue, both generally and specifically. Moreover that which is not self-evident should always be researched and discussed with the client in an informative manner.

There are a variety of contexts in which lawyers can find themselves presented with ethical issues that are in most instances resolvable by securing the client's informed consent and having that consent confirmed in writing so that it can be clearly established what the lawyer advised the client and the degree and extent of the client's reliance upon the lawyer. More certainty in this regard will inevitably minimize both the risk of liability and litigation as well.
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Endnotes:

1. The order in the subparagraphs of Rule 1.0 are reversed but for this article the sequence above is correct because it is more meaningful in context.

OFFICER OF THE COURT, THE BROADEST REACH OF THE LAW

In January 1991 the Professional Liability Column commenced as a regular bi-monthly article for the New York Law Journal. "A mere Sea Captain's desire to trace a new trade route gave way to a moral adventure for humanity" said Woodrow Wilson of Columbus.¹ The original purpose of the Column as suggested by the publishers and editorial staff was to study the principles of legal malpractice liability, draw from the experiences presented in one's own practice and that of one's colleagues, and then combine scholarship and practical wisdom to achieve appropriate methods to avoid liability. Achieving this objective was not merely for economic reasons, but to prevent the most hurtful sting to one's professional reputation caused by a malpractice claim. Further the approach was to resolve client disputes in a timely and cost-effective manner, always to an honorable end.

On the journey we have traversed to the point where risks can now be avoided and disputes resolved effectively. Now we take the higher ground, and hopefully with a clearer understanding of what it means to be an Officer of the Court, we as lawyers can achieve the best practices and the highest quality of service, both for the client and the legal system.

What is an Officer of the Court? Federal Rules of Civil Procedure ("FRCP") ¹ states the FRCP should be construed to achieve the "just, speedy and inexpensive determination of every action" and the Advisor's Notes significantly declare that lawyers as "Officers of the Court" share in the administration of justice to achieve FRCP 1's fundamental purpose.² The term "Officer of the Court", employed in judicial opinions, while not precise is broad in that it encompasses both compliance with the
competency and ethical standards of the profession so as to avoid malpractice liability, and also a positive motivator so that one’s professional conduct can serve the legal system’s objectives. It is in the latter dimension, if correctly understood and articulated that we can best define the term and its applicability to our everyday law practice.

**Antithetical Conduct**

Most of the case law that utilizes the term “Officer of the Court” defines it by illustrating conduct that is not consistent with being an Officer of the Court. In *Klein v Seenaubh et al* 3 plaintiffs brought a tort action against defendants when the minor plaintiff was thrown from her bike after her tire got stuck in a defective sidewalk located in front of defendants’ residence. Plaintiffs filed a notice of trial and a motion to strike was made since defendants did not have a chance to examine the bike. In response Plaintiff’s attorney affirmed that they could examine the bike at anytime and they would find absolutely nothing as a result of such examination. Nonetheless the bike was not produced. Pursuant to CPLR §3126 defendants then moved to dismiss and argued there was willful non-production. At this juncture and in opposition, plaintiffs argued that the bike had been thrown out.

The Court expressed in respect to the conflicting positions and representations that lawyers have a special relationship to the Court and are responsible and accountable for the accuracy of their representations. Judge Martin Ritholtz held:

“It is the ethical responsibility of every lawyer to maintain the integrity and improve the competence of the Bar to meet the highest standards…. A lawyer is an Officer of the Court and, as such, has a high duty to maintain the dignity of the legal system … Canon 1 of the Code prohibits an attorney from engaging in misrepresentation (Code of Professional Responsibility DR1-102 [A][4][22N.Y.C.R.R. 1200.3(a)(4)]). An attorney is held strictly accountable for his statements or conduct, which reasonably could have the effect of deceiving or misleading the Court in the action to be taken in a matter pending before it. The Court is entitled to rely upon the accuracy of any statement of a
relevant fact unequivocally made by an attorney in the course of judicial proceedings...[T]he Court is compelled to admonish members of the Bar that the mere avoidance of monetary sanctions is not the standard to be fostered. It is our collective duty to always remember that "(a) lawyer should maintain high standards of proper conduct and should encourage other lawyers to do likewise. (Code of Professional Responsibility ECI-')" (Emphasis added).4

Another case where the term “Officer of the Court” comes to the fore and the conduct described is significantly inconsistent with a lawyer serving in that role is *Reveson v Cinque & Cinque*.5 This was a case in which sanctions were in order because the lawyer subject to sanction wrote a letter threatening to tarnish the lawyer who formerly represented his client and was involved in a legal fee dispute with the client; making a sham offer to settle; accusing the lawyer of fraudulent billing practices; threatening to interfere with the firm’s other clients; serving overly broad subpoenas; threatening to accuse and report the lawyer for criminal conduct; unfair cross-examination; and making in Court statements unjustifiably attacking the lawyer’s reputation with such statements that he was “a disgrace to the legal profession”. How devastating such conduct can be to its target, was expressed when the lawyer who was subject to attack stated the following at the sanction hearing:

“Then my life became a living hell, because ...[the plaintiff’s lawyer] seized upon the concept that he was now going to accuse me of fraud as a lawyer, which is a very serious allegation, what did he do? He ...built upon the fraud claim consistently, claiming ... [because] I’m a fraud with ...[the former client], then I must be a fraud with all my clients.

The letters...[he] was writing, could you understand possibly how I might have been so beside myself at some point where I am threatened with criminality, loss of my entire practice, 30 years down the drain, that maybe I could have gotten violent with the man? Can anyone understand that? I’m not saying it would have been appropriate, obviously. But calling me a criminal? Taking my entire 30 years of existence.”6

In addressing the “rambo tactics” engaged in, the court also addressed why civility, one of the prime means always to uphold the dignity of the judicial process, is
essential for the Officer of the Court to comprehend and implement. U.S District Judge Chin quoting Justice Sandra Day O’Connor and then other authoritative sources, wrote:

"Incivility disserves the client because it wastes time and energy — time that is billed to the client at hundreds of dollars an hour, and energy; that is better spent working on the case than working over the opponent. According to an English proverb, "the robes of lawyers are lined with the obstinacy of clients." In our experience, the obstinacy of one lawyer lines the pockets of another; and the escalating fees are matched by escalating tension. I suspect that, if opposing lawyers were to calculate for their clients how much they could save by foregoing what has been called 'Rambo-style' litigation (in money and frustration), ... many clients, although not all, would pass in the pyrotechnics and happily pocket the difference." 

Civility is also important from a broader perspective:

"As lawyers and judges, we live out who we are by our actions. Professional is not something to don at the office or take off with our suits and our robes; our behavior continuously demonstrates whom we are. We can improve our own lives and spirits, those of our clients, opposing counsel and parties and the community as a whole, if we simply remember that our part in the system gives us tremendous power, to make life better for every citizen... If every lawyer and judge... would analyze every action she or he takes in light of the a goal of ensuring that the system works fairly and efficiently for everyone, questions about professionalism would simply... disappear – and tremendous good would result for our community." (Emphasis added)

In Murphy v Board of Education a plaintiff’s lawyer issued a number of third party subpoenas including one for defendant’s medical records, without notifying defense counsel, obtained the documentary information and then concealed at the hearing on a motion to quash the number of subpoenas and the full extent of the information sought and obtained. Such antithetical conduct violated privacy rights and the due process that every litigant is entitled to when such information is sought and notice is mandated. The Court noted:

"Taken to its logical extreme, any individual named as a defendant could become subject to the unfettered disclosure of his or her personal information — while the judiciary is relegated to the role of forcing closed Pandora’s box... [The attorney] through her actions, deprived [the] defendant... of his greatest safeguard under Rule [45] i.e. the ability to object to the release of the information prior to its disclosure..."
In a recent and insightful decision, *Blausel Stiftung v Sumitomo Corp.* United States District Judge Barbara Jones, stressed in the context of a lawyer who induced other lawyers and parties to show up at depositions abroad which neither he nor his client attended, the importance of truthful representations not just to the Court but to other lawyers and parties as well. A lawyer is an Officer of the Court as much outside of the Court as inside the Courtroom.

From the foregoing four cases we see the obvious i.e. the conduct in question was not becoming to an Officer of the Court. Falsity in representations to one’s adversary and the Court, ad hominem attacks on witnesses and litigants, and improper invasion of privacy, can never be squared with even the minimal standards of professional conduct. The question still remains, what is the meaning of Officer of the Court? More importantly “Am I an Officer of the Court?”

**The United States Supreme Court’s Concept**

The United States Supreme Court while not directly defining the term has discussed the concept in such a manner that we can derive a better understanding of what truly is an “Officer of the Court”. The United States Supreme Court in addressing the issue of whether states could impose an alienage restriction on membership in the bar held, while a lawyer was an Officer of the Court, he or she was not a state official. Justice Powell writing for the Court, held:

“Lawyers do indeed occupy professional positions of responsibility and influence that impose on them duties correlative with their vital right of access to the courts. Moreover by virtue of their professional aptitudes and natural interests, lawyers have been leaders in government throughout the history of our country. Yet they are not officials of government by virtue of being lawyers. Nor does the status of holding a license to practice law place one so close to the core of the political process as to make him a formulator of government policy.”

12
While not a state official the lawyer's responsibilities are still of a public nature and do not begin and end with what transpires in the Courtroom. Clearly to Justice Kennedy the lawyer's responsibilities and the true sense of what they are, extends beyond the Courthouse. The case involved a lawyer who was facing disciplinary proceedings for causing pretrial publicity in a criminal case. Justice Kennedy wrote:

"An attorney's duties do not begin inside the Courtroom door. He or she cannot ignore the practical implications of a legal proceeding for the client. Just as an attorney may recommend a plea bargain or civil settlement to avoid the adverse consequences of indictment especially in the face of a prosecution deemed unjust or commenced with improper motives, a defense attorney may pursue lawful strategies to obtain dismissal of an indictment or reduction of charges, including an attempt to demonstrate in the Court of public opinion that the client does not deserve to be tried."\textsuperscript{13}

In \textit{Nix, Warden v Whiteside}\textsuperscript{14} Chief Justice Burger's decision for the Court arose in the context of a lawyer who counseled his client against committing perjury and then reported the crime to the Court. Discussing the conflicting duties to the client and the Court system, Chief Justice Burger wrote:

"...[Counsel has a] duty of loyalty and ...[has an] overarching duty to advocate the defendant's cause. \textit{Plainly, the duty is limited to legitimate, lawful conduct compatible with the very nature of a trial as a search for truth}. Although counsel must take all reasonable means to attain the objectives of the client, counsel is precluded from taking steps or in any way assisting the client in presenting false evidence or otherwise violating the law. This principle has consistently been recognized in unequivocal terms by the expositors of the norms of professional conduct since the first Canons of Professional Ethics were adopted by the American Bar Association in 1908..." (Emphasis added)\textsuperscript{13}.

Chief Justice Burger noted that the authoritative literature also validates:

"... an attorney's revelation of his client's perjury to the court is a professionally responsible and acceptable response to the conduct of the client who has actually given perjured testimony...

..."

The essence of the brief \textit{amicus} of the American Bar Association reviewing practices long accepted by ethical lawyers is that under no circumstance may a lawyer
either advocate or passively tolerate a client's giving false testimony. This of course is consistent with the governance of trial conduct in what we have long called 'a search for truth'. The suggestions sometimes made that 'a lawyer must believe his client, not judge him', in no sense means a lawyer can honorably be a party to or in anyway give aid to presenting known perjury.' 16

The foregoing demonstrates that while the lawyer must be a zealous advocate for the client, he must also be an even more persuasive advocate to the client and thereby defend the integrity of the legal system's process before and also when it is compromised.

The United States Supreme Court in In re Synder 17 reviewed a disciplinary proceeding suspending a lawyer before the Federal Courts because of a refusal to submit CJA billing statements and the transmittal of and a letter considered as disrespectful to the lower Court. The Court reversed the suspension, holding that a lawyer's criticism of inequities did not warrant suspension or criticism. The Court did address the issue of what is an Officer of the Court and what is expected of the lawyer both in respect to the client and the public. The Court wrote:

"The phrase "conduct unbecoming a member of the bar" must be read in light of the "complex code of behavior" to which attorneys are subject. In re Bithoney, 486 F.2d 319, 324 (CA1 1973). Essentially, this reflects the burdens inherent in the attorney's duel obligations to clients and to the system of justice'.

Justice Cardozo once observed:

'Membership in the bar is a privilege burdened with conditions.' [An attorney is] received into that ancient fellowship for something more than private gain. He [becomes] an Officer of the Court, and, like the court itself, an instrument or agency to advance the ends of justice." People ex re Karlin v. Culkin, 248 N.Y. 465, 470—71, 162 N. E. 487, 489 (928) (citation omitted)'.

As an Officer of the Court, a member of the bar enjoys singular powers that others do not possess; by virtue of admission, members of the bar share a kind of monopoly granted only to lawyers. Admission creates a license not only to advise and counsel clients but also to appear in court and try cases as an Officer of the Court. A lawyer can cause persons to drop their private affairs and be called as witnesses in court. And for
depositions and other pretrial processes that, while subject to the ultimate control of the court, may be conducted outside courtrooms. The license granted by the court requires members of the bar to conduct themselves in a manner compatible with the role of courts in the administration of justice."18

As is evident from the case law, including the Supreme Court jurisprudence, the term “Officer of the Court” is not a term susceptible of precise definition. It nonetheless represents one of the core concepts and ideals of the law. The answer to the questions of “What is an Officer of the Court?” and “Am I an Officer of the Court?” in the last analysis must be answered by each of us, who are engaged in the practice of law.

Conclusion

In thinking through my response, continuing legal education comes to the fore so that we can always be current and render effective service. A lawyer who consistently keeps up with respect to competency standards for practice is less likely to be sued; more likely to avoid legal malpractice liability when suits do occur as is inevitable; and certain to make a positive contribution to the system’s proper functioning.

As transactional, regulatory, or even litigation lawyers operating in an adversarial context, lawyers must be effective advocates to the clients so that the clients will achieve their objectives only within the bounds of the law. Lawyers must also respect other lawyers by dealing with them in a straightforward manner. We must respect other lawyers too as Officers of the Court, judging them not by whom they represent but how they represent their clients; remembering both courageous advocacy for unpopular causes and wise and good counsel to problem clients keeping them within the bounds of the law is the best hallmark of our profession. Sharing in the administration of justice with
our courts, the “punctilio of honor” must also be observed in advocacy to the court that never yields candor.

We must always remember the profession is doing public as well as private service, especially with respect to indigents who are entitled as much as others to the benefits of “equal justice under the law”. The lawyer who gives ethical consideration to his professional conduct, especially in resolving client conflicts and conflicts when duties to the Courts are implicated is an Officer of the Court. When a client expresses intent to commit a crime such as perjury, the lawyer must counsel against it and take appropriate steps to prevent its occurrence.

Further, in today’s world after and because of the events of September 11, 2001, the Officer of the Court will help establish claims processes not only which will be time and cost effective, but which will above everything be perceptibly fair and just. Cooperative dispute resolution, especially facilitative mediation, accords unique opportunities. In today’s world also, especially in the financial services marketplace, a multi-disciplinary approach well enhances professional services and lawyers, as Officers of the Court should play a significant leadership role in developing appropriate frameworks. The Enron disaster should re-enforce our efforts in this regard.

For me the best answer to the question of what is an Officer of the Court, is a lawyer who in whatever context he or she finds himself or herself brings the law and applies it to its best ends. Dedication to and fulfillment of this ideal is the broadest reach of the law. Justice Benjamin Cardozo best defined “Officer of the Court” and expressed our profession’s aspirations:

“How it lies with you, to uplift what is low, to erase what is false, to redeem what has been lost; till all the world shall see, and seeing understand, that union of the
scholar's thought, the mystics yearning, the knight's ardor, and the hero's passion, which is still in the truest moments of self-expression the spirit of the bar.\textsuperscript{19}

The journey now begins again on the higher ground.

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Joint Representation, Conflicts, and Ethical Considerations

Norman B. Arnoff and Sue C. Jacobs

Our sense of professional responsibility and sensitivity to the Ethical Considerations (EC) and Disciplinary Rules (DR) in the Lawyers Code of Professional Responsibility are critical to our law practices if we wish to avoid legal malpractice claims and disciplinary sanctions. This article will address the pro-typical conflicts arising from joint representation that reoccur on both the plaintiffs’ and defendants’ side in any civil action.

Ethical Considerations

- And Disciplinary Rules. Civil litigation lawyers, whether representing plaintiffs or defendants, if they are to represent multiple clients, always need to have a heightened consciousness of actual and potential conflicts and the EC and DR that provide the intelligent guidance essential to avoid serious professional problems. The pertinent ECs are EC5-1, EC5-3, EC5-14 and EC5-16. The pertinent DRs are DR5-101 and DR5-105. The pertinent text quoted below should be read, re-read and internalized so that addressing conflict issues becomes second nature and our response will not only be intuitively right but right in fact.

The pertinent ECs and DRs are as follows:

EC5-1: The professional judgment of a lawyer should be exercised, within the bounds of the law, solely for the benefit of the client and free of compromising influences and loyalties. Neither the lawyer’s personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute the lawyer’s loyalty to the client.

EC5-3: The self-interest of a lawyer resulting from ownership of property in which the client also has an interest which may affect property of the client may interfere with the exercise of free judgment on behalf of the client. If such interference would occur with respect to a prospective client, a lawyer should decline proffered employment.

EC5-14: Maintaining the independence of professional judgment required of a lawyer precludes acceptance or continuation of employment that will adversely affect the lawyer’s judgment on behalf of or dilute the lawyer’s loyalty to a client. This problem arises whenever a lawyer is asked to represent two or more clients who may have differing interests, whether such interests be conflicting, inconsistent, diverse, or otherwise discordant.

EC5-15: If a lawyer is requested to undertake or to continue representation of multiple clients having potentially differing interests, the lawyer must weigh carefully the possibility that the lawyer’s judgment may be impaired or loyalty divided if the lawyer accepts or continues the employment. The lawyer should resolve all doubts against the propriety of the representation.... If a lawyer accepted such employment and the interests did actually come to differ, the lawyer would have to withdraw from employment with likelihood of resulting hardship on the clients; and for this reason it is preferable that the lawyer refuse the employment initially.... Simultaneous representation in unrelated matters of clients whose interests are only generally diverse, such as competing economic enterprises, does not by itself require consent of the respective clients. Likewise a lawyer may generally represent parties having antagonistic positions on a legal question that has arisen in different cases, unless representation of either client would be adversely affected. Thus, it is ordinarily not improper to assert such positions in cases pending in different trial courts.
EC5-16: Thus, before a lawyer may represent multiple clients, the lawyer should explain fully to each client the implications of the common representation and otherwise provide to each client information reasonably sufficient, giving due regard to the sophistication of the client, to permit the client to appreciate the significance of the potential conflict, and should accept or continue employment only if each client consents, preferably in writing. If there are present other circumstances that might cause any of the multiple clients to question the undivided loyalty of the lawyer, the lawyer should also advise all of the clients of those circumstances.

In all cases in which the fact, validity or propriety of client consent is called into question, the lawyer must bear the burden of establishing that consent was properly obtained and relied upon by the lawyer.

DR5-101: A lawyer shall not accept or continue employment if the exercise of professional judgment on behalf of the client will be or reasonably may be affected by the lawyer's own financial, business, property or personal interests, unless a disinterested lawyer would believe that the representation of the client will not be adversely affected thereby and the client consents to the representation after full disclosure of the implications of the lawyer's interest.

DR5-105:

A: A lawyer shall decline proffered employment if the exercise of independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, or if it would be likely to involve the lawyer in representing differing interests, except to the extent permitted under DR5-105 1200.24.

C: In the situations covered by DR5-105 [1200-24] (A) and (B), a lawyer may represent multiple clients if a disinterested lawyer would believe that the lawyer can competently represent the interest of each and if each consents to the representation after full disclosure of the implications of the simultaneous representation and the advantages and risks involved.

Joint Representation

* And Attorney-Client Privileged Communications and Confidences. Apart from conflicts of interests that are motivated by property and other economic reasons, serious attention in the arbitration and civil litigation context has to be focused on those conflicts that relate to the inconsistencies of the clients’ respective positions and the implications as well for the sharing and disclosure of privileged communications and confidential information. Criminal cases more frequently inform us of conflict issues, but these lessons should be adopted as well in a civil context. Basic to most conflicts that are not driven by economic self-interest is the material inconsistency between the position of the different clients, i.e., the testimony of one of the clients exculpates him but inculpates the other lawyer’s client. Conflicts of this nature occur more often than not in a criminal case, however, the dynamics of what happens is just as evident in other contexts. United States v. Cooper, et al.1 was a prosecution of a father, mother and son for wire fraud and conspiracy arising from false statements about the son’s work. The family engaged one counsel to represent all. Upon the government’s request, the court addressed conflict issues in the context of joint representation. The court addressed the inherent conflicts arising from a group of parties charged on the same set of facts and the compounding of the difficulties when one lawyer represents multiple clients and more significantly how such conflicts are dealt with so individual choice of counsel is respected but does not compromise the integrity of legal processes whether in court or arbitration. The court held:

Whenever two or more defendants are jointly charged and are represented by the same counsel or by counsel who are associated with the same law firm, a question arises whether the interests of the defendants conflict so that joint representation would be ineffective.

This Court held a hearing for consideration of the propriety of joint representation of the defendants. At the hearing, each of the defendants individually responded to an examination by the Court and by...[counsel] as to their consent to and understanding of the implications of the joint representation. Each defendant consented to...[the lawyer’s] joint representation.
It is settled that "requiring or permitting a single attorney to represent codefendants, often referred to as joint representation is not per se violative of constitutional guarantees of effective assistance of counsel." Holloway v. Arkansas, 435 U.S. 475, 482 98 S.Ct. 1173, 1178, 55 L.Ed.2d 426 (1978). We have never held that the possibility of prejudice that "inheres in almost every instances of multiple representation" justifies the adoption of an unflexible rule that would presume prejudice in all such cases. See Cuyler v. Sullivan, 446 U.S. 335, 348, 100 S.Ct. 1708, 1718, 64 L.Ed.2d 333 (1980). Instead, we presume prejudice "only if the defendant demonstrates that counsel 'actively represented conflicting interests' and that 'an actual conflict of interest adversely affected his lawyer's performance.'"

...[A] trial court must anticipate potential conflicts and take appropriate measures to protect the right to effective counsel when a conflict "is likely to arise."

...[T]he relative culpability of each codefendant may become a pivotal aspect of his or her defense. A single attorney cannot raise arguments as to the lesser culpability of a defendant without compromising the defense of the others. One of the defendants may have made or may make statements to counsel which support his or her defense while weakening the defense of another codefendant. In such an event, joint counsel for codefendants may be placed in the unethical position of having to "cross-examine" one of his clients to support the defense of another client. In addition, if defendants have varying levels of culpability, a single attorney may not provide an effective statement at closing or sentencing.

While it is true that a "defendant may waive his right to the assistance of an attorney unhindered by a conflict of interest,"...a trial court must find that the waiver is made "knowingly, intelligently, and with the awareness of the likely consequences of the waiver." United States v. Dolan, 570 F.2d 1177, 1181 (3d Cir. 1978). In determining whether a waiver is valid, a trial court must be cognizant that "a defendant may be competent to stand trial, but not competent enough to understand the complex, subtle, and sometimes...unforeseeable dangers inherent in multiple representation.

...[W]e are sensitive...to the fact that financial considerations may have affected the codefendants' decision to retain a single attorney. Joint representation may result in lesser attorney's fees for the [defendants]...and this consideration may have undermined the voluntariness of each defendant's waiver of the right to separate counsel.

...[A]n attorney must consider "the likelihood that conflict will eventuate...and, if it does whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client."

As noted, conflicts may or may not require an attorney’s withdrawal. In most cases informed consent and waiver after inquiry by the court in a criminal case or by counsel in a civil case can avert the problem. The New York Court of Appeals in New York v. Allah2 in the context where defense counsel was not present at a critical stage of the proceeding and one of the other counsel was asked to undertake the additional representation, held: Where codefendants are represented by the same attorney, the trial court must inquire, on the record, whether each defendant has an awareness of the potential risks involved in that course and has knowingly chosen it.... Only after sufficient admonition by the trial court of the potential pitfalls of joint representation can it be said that a defendant’s right to the effective assistance of counsel is adequately safeguarded....If such admonition appears on the record, appellate courts can determine whether a defendant’s decision to pursue joint representation is an informed one.
The record indicates that the court, by proper inquiry, took the necessary precautions to ensure that the defendant perceived the potential risks inherent in joint representation by counsel for the codefendants. Thus, we cannot conclude that defendant's decision to pursue joint representation in this case was an informed one. Respondent's argument that defendant consented to the joint representation in open court is unavailing.

'United States v. Poston'

Criminal and civil cases as far as the issue of conflicts arising from joint representation are significantly different with respect to the degree of care that must be extended in a criminal case as opposed to a civil matter, nonetheless, there has to be care and concern shown in every context. The standards, however, utilized in a criminal context can be adapted in all civil contexts including arbitrations. In United States v. Poston the U.S. Court of Appeals for the Eighth Circuit articulated the standards for informed consent and effective waiver as follows:

[The] district court should address each defendant personally and forthrightly advise him of the potential dangers of representation by counsel with a conflict of interest. The defendant must be at liberty to question the district court as to the nature and consequences of his legal representation. Most significantly, the court should seek to elicit a narrative response from each defendant that he has been advised of his right to effective representation, that he understands...the details of his attorney's possible conflict of interest and the potential perils of such a conflict, that he has discussed the matter with his attorney or if he wishes with outside counsel and that he voluntarily waives his Sixth Amendment protections.... It is, of course, vital that the waiver be established by "clear, unequivocal and unambiguous language." ...Mere assent in response to a series of questions from the bench may in some circumstances constitute an adequate waiver, but the court should nonetheless endeavor to have each defendant personally articulate in detail his intent to forgo this significant constitutional protection. Recordation of the waiver colloquy between defendant and judge will also serve the government's interest by assisting in shielding any potential conviction from collateral attack, either on Sixth Amendment grounds or on a Fifth or Fourteenth amendment "fundamental fairness" basis.

'Camera v. Bombard'

Joint representation can be challenged either by the former client or another party in the litigation whether criminal, civil or arbitration. For the challenge to be effective, however, there must be a showing by the party challenging the representation that it be prejudicial to one of the clients or litigants. In Camera v. Bombard the Court held:

"When a potential conflict arises, either where a court has assigned the same counsel to represent several defendants or where the same counsel has been retained by codefendants...the proper course of action for the trial judge is to conduct a hearing to determine whether a conflict exists to the degree that a defendant may be prevented from receiving advice and assistance sufficient to afford him...[the] quality of representation guaranteed. The defendant should be fully advised by the trial court of the facts underlying the potential conflict and be given the opportunity to express his view.

"The mere representation of two or more defendants by a single attorney does not automatically give rise to a constitutional deprivation of counsel. It is settled in...[the Second Circuit]
that some specific instance of prejudice resulting from joint representation must be shown to exist."

The court in Sullivan v. Dalsheim5 noted "the prejudicial conduct of the attorney must be the consequence of a conflict between the interests of the codefendants, and it must be inconsistent with sound trial strategy." In other words, the conflict must have a causal effect but no false confidence should be taken since "it is possible for an omission by counsel arising out of joint representation to constitute prejudice." In the context of a conflict the lawyer's error is more likely to be misconstrued as bad faith and he is less likely to be given the benefit of the doubt that his error was in the zone of reasonable judgment. Where, however, there is no viable defense (or claim for that matter) and no harm results the challenge is not likely to affect the matter's outcome.6

Joint representation and the potential conflicts that may arise, however, should not be taken lightly and can be the basis of a motion to disqualify counsel. The challenge, however, is not necessarily restricted to former or current clients and can be made by other parties to the litigation. When this occurs, a knowing and intelligent waiver by the clients jointly represented can be required to avert disqualification of counsel. In Burg v. Brunswick Hospital Center7 the court held:

"While courts in the past have accepted written statements from the parties indicating knowing and intelligent consent to joint representation.... The Second Circuit's recent decision in Oneida, supra indicates that in certain circumstances "other parties to the litigation are entitled to the assurance of an on the record consent sufficient to preclude any subsequent challenge to a judgment...[because of joint representation].... Since personal counsel for...[one of the two doctor defendants] has already acknowledged that individual liability in this case may exceed the doctor's policy limits, the Court finds it appropriate to ascertain in open court that both doctors fully appreciate the potential risks of joint representation and that each defendant wishes to proceed in the face of a waiver of their right to object to joint representation.

Joint representation not only presents issues that may lead to an attorney's disqualification but an inadvertent waiver of one or more of the clients' attorney-client privileges. Issues that arise also concern the extent of the waiver, whether it is limited to those communications actually shared or to anything dealing with a particular subject matter concerning the group of people jointly represented or constituting a community of common interest. In re: Bruce W. and In re: Terry C.8 addressed the waiver issue in the criminal context and emphasized substance over form with respect to waiver. The court held, following the precedent set by the Court of Appeals...

"Attorneys are under an ethical obligation to disclose to their clients, at the earliest possible time, any conflicting interests that might cloud their representation. Disclosure alone is not enough. The lawyer may not act for his client unless the client has given his informed consent to further representation."

We hold therefore as a matter of law that when the Legal Aid Society represents alleged coperpetrators of the same criminal transaction, it does so (a) with full knowledge that a prima facie conflict exists; that it must affirmatively rebut the assumption of conflict;...and (c) that failing rebuttal thereof, it is incumbent upon it to show that both alleged coperpetrators were made fully aware of the conflict and exercised informed waivers thereof.

For this reason as observed in Neighborhood Development Collaborative v. Murphy9, "[j]oint representation of clients with potentially adverse interest should be undertaken only when subject to very narrow limits" and "full disclosure of all possible dangers inherent in dual representations" should be made to the clients.
The court in Teleglobe Communications Corp. et al. vs. BCE Inc. et al. explained the differences between joint representation of multiple clients, simultaneous representation of co-clients, and a number of lawyers who represent different clients with a community of common interest. The appeal raised "core questions about the proper operation of a corporate family's centralized in house legal department." The court explained the subtleties as follows:

While it is permissible for lawyers and clients to limit the scope of representation in a single-client representation,…it is particularly common in co-client situations because of the limited congruence of the clients' interests.…[A] co-client relationship is limited by 'the extent of the legal matter of common interest'…. While written agreements limiting the scope of a joint representation might be preferable, nothing requires this so long as the parties understand the limitations.

When co-clients and their common attorneys communicate with one another, those communications are “in confidence” for privilege purposes. Hence the privilege protects those communications from compelled disclosure…to persons outside the joint representation. Moreover, waiving the joint-client privilege requires the consent of all joint clients…. A wrinkle here is that a client may unilaterally waive the privilege as to its own communications with a joint attorney, so long as those communications concern only the waiving client; it may not, however, unilaterally waive the privilege as to any of the other joint clients’ communications or as to any of its communications that relate to other joint clients.

One codefendant could not waive the privilege that attached to the shared information without the consent of all others. Later, courts replaced the joint-defense privilege, which only applied to criminal codefendants, with a broader one that protects all communications shared within a proper “community of interest,” whether the context be criminal or civil. Thus, the community-of-interest privilege allows attorneys representing different clients with similar legal interest to share information without having to disclose it to others. It applies in civil and criminal litigation, and even in purely transactional contexts.

This joint representation occurs where one lawyer represents multiple clients in a matter and while the relationship exists attorney-client privilege applies to communications by and between counsel and is essentially only waived when one client sues or has an adverse claim against the other, where a number of lawyers represent clients with a community of interest the law now has extended the attorney-client privilege to communications related to the common matter the lawyers are representing the clients. This is the joint defense privilege. The third scenario is where one lawyer is representing a number of clients at the same time without necessary relationship of the matters that are the subject of the representation. In those circumstances, the privilege remains in tact unless waived by the individual. Any waiver, whether intentional or inadvertent, applies to only the individual.

The court gave special recognition to the frequently moving target that the above situations can present by observing as follows:

In undertaking a joint representation, the prospective joint attorney must always consider whether she can fulfill her duties to each co-client…. When the co-clients desire to shield information from one another, this inquiry becomes more difficult in light of the prospective joint attorney’s duty of candor to each. …

When a joint attorney sees the co-clients’ interest diverging to an unacceptable degree, the proper course is to end the joint representation…courts are presented with a difficult problem when a joint attorney fails to do that and instead continues representing both clients…. In this situation, the black-letter law is that when an attorney (improperly) represents two clients whose interests are
adverse, the communications are privileged against each other notwithstanding the lawyer’s misconduct.

Three Scenarios

The above three scenarios, i.e., joint representation of multiple clients in a matter, representation of one client in league with other lawyers in a matter, and representation of a number of individual clients at the same time in a matter not necessarily related, present problems on a regular basis for in-house corporate counsel and other attorneys who jointly represent clients in a single matter or co-clients having a community of interest. In-house counsel are particularly susceptible to these conflicts.

A recent case published in the New York Law Journal, May 23, 2008, People v. Hussein, Supreme Court, Kings County, while a criminal case, highlights the risks and responsibilities with respect to joint representation that should be discerned and applied as standards for professional conduct in any civil action or arbitration context. Father and son were charged with burglary, assault and robbery and represented by the same counsel. There was another defendant represented by separate counsel. The case against the son was particularly weak and as a result the significant differences in the “type and quantum” of evidence against each...“suggested different theories and tactics of defense for each” such that “the defendants did not have to demonstrate that the conflict created actual prejudice to their defense or that an alternative defense would likely have produced a more favorable outcome.” The lawyer was inhibited by the father's position in the case to bring out the weaknesses in the identification and other evidence against the son.

Not only did the opinion criticize counsel for not engaging in an in-depth inquiry or making appropriate disclosures to obtain informed consent to the joint representation, but the prior court was deemed to be remiss.

Counsel as an officer of the court must be fully responsible for the necessary inquiry and disclosure as well as adequately memorializing the client’s informed consent in the event there is a subsequent professional liability issue in the wake of an unfavorable judgment. This eventuality is not remote and attorneys should not take comfort that a showing of proximate cause in a legal malpractice action is exceedingly difficult because of the “case within a case” requirement. The test of causation for breach of fiduciary that implicates more significantly the lawyer’s ethical responsibilities is whether the lawyer’s actions or omissions are a substantial factor in the sequence of causation.11

Waiver of privilege issues relating to joint representation, representing a client pursuant to a joint defense privilege, and representing clients with a community of interest require special sensitivity.

Precautionary Measures

In the undertaking of any representation lawyers should ameliorate if not eliminate conflict issues by obtaining the client’s consent to the representation and the basic strategic approaches, as well as, on an ongoing basis, addressing potential conflicts with the client and obtaining the client’s informed consent as to the actual and possible conflicts as they arise.12

Prudence should also dictate that unless there are compelling economic necessities when representing multiple clients in cases having the same or similar subject matter the individual client or
prospective one should be advised to obtain separate counsel and in any event the client should be assisted in making an informed choice if separate counsel is decided to be not preferable.

When working with other counsel on a matter the joint defense privilege should be observed, communications limited to the matter at hand, and the client advised of the risk of adversity developing between clients and the resulting waiver of attorney-client privilege.

When the lawyer represents more than one client and there is a hint of commonality there should be heightened concern so as not to compromise each client’s confidential and privileged information. These prophylactic rules of practice apply in the context of all legal representations.

2. 80 NY2d 396; 605 NE2d 327; 590 NYS2d 84-; 1992 NY Lexis 3906 (Court of Appeals 1992).
5. 1979 US Dist. Lexis 11085 (SDNY 1979)
8. 114 Misc2d 91; 450 NYS2d 734; 1982 NY Misc. Lexis 3440 (Family Court, Queens County 1982)
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IT IS THE PUNCTILIO of care, competence and honor. Benjamin Cardozo, Chief Judge of the New York Court of Appeals, beautifully expressed the meaning of fiduciary duty. n1 He articulated both a professional standard of conduct and what members of the bar should always aspire to have their conduct be and to have others perceive it to be when legal services and issues have significance.


The statutes, cases and codes of professional responsibility do not always give precise definition to what must and must not be done; but, because of the importance of the profession, to the rule of law and the welfare of society, attorneys are held strictly to fiduciary standards and must always be motivated to identify and perform their requirements. Whether a review of jurisprudence is historical or involves more recent cases, a lawyer has several basic fiduciary duties. They are preserving the confidentiality of client information, continuing to accord the client access to that information, honesty and fair dealing in the handling of other people's money, entering into only fair and honorable contracts with those served and avoiding both the appearance and the reality of conflicts of interest that diminish the competence and ethics of professional responsibilities and civic obligations.

Duty to Defend Client Privacy

A lawyer has a fiduciary obligation not only to treat as confidential information imparted in the course of attorney-client communication but also other information about the client learned from third parties. The obligation extends beyond the attorney-client privilege and gives effect to what Justice Louis Brandeis deemed to be a fundamental right, the right of privacy. The lawyer's necessary and extensive access to client information mandates this obligation if people are to seek legal counsel and have privacy in their affairs.

The fiduciary duty to preserve client confidences is a continuing duty extending beyond the termination of the attorney-client relationship. It also entails according the client access to information that the attorney may have and the client does not have regarding the client's affairs. The duty is one of openness and disclosure to the client and an obligation to defend client privacy against an intruding world.

n2 In Tekni-Plex Inc. v. Meyner and Landis, the New York Court of Appeals addressed attorney disqualification issues in the context of a corporate merger and arbitration after the merger. The post-merger arbitration was between
the predecessor entity and its sole shareholder and the successor entity. The dispute related to indemnification rights regarding environmental compliance issues and the disclosures and representations in the contracts.

An issue was raised whether counsel for the pre-existing entity and former shareholder could represent the latter in the arbitration. The Court held that the attorney must be disqualified. The attorney-client privileged communications were an incident of the sale, and the privilege belonged to the new entity. There was a substantial relationship in the representations.

In respect to the merger transaction, the communications were not privileged against the former shareholder. To give the new entity control over these specific attorney-client communications "would thwart, rather than promote, the purposes underlying the privilege." On the duty to protect client confidences, the Court held:

Attorneys owe fiduciary duties of both confidentiality and loyalty to their clients... The Code of Professional Responsibility thus imposes a continuing obligation on attorneys to protect their client confidences and secrets. Even after representation has concluded, a lawyer may not reveal information confided by a former client, or use such information to the disadvantage of the former client or the advantage of a third party" An attorney, moreover, "must avoid not only the fact, but even the appearance of representing conflicting interests. n3

Assuming the absence of a valid retaining lien, the content of a client file is regarded as the client's information, and access to that information also cannot, as a matter of fiduciary obligation, be denied. In The Matter of Sage Realty Corp. v. Proskauer Rose Goetz & Mendelsohn, the New York Court of Appeals was presented with the issue of the proprietary rights in and attendant access to a law firm's internal legal memoranda, mark-ups, notes and drafts of contracts and other transactional documents. The Court of Appeals astutely held:

We can discern no principled basis upon which exclusive property rights to an attorney's work-product in a client's file spring into being in favor of the attorney at the conclusion of a represented matter. Indeed, this case illustrates that often, no unequivocal line can be drawn between pending and completed legal matters; hence, the continued likelihood of useful reference to work product materials in the client's file. n6

There is, however, a qualification with respect to the foregoing duty of disclosure and openness. Duties to third parties and those imposed by law cannot be violated. Further, the obligation to accord open access is not absolute if the document sought serves no useful purpose and was only intended for internal law office facilitation of services and their review.

n2 Tekni-Plex Inv. V. Meyner and Landis et al., 89 NY2d 123 (1996).

n3 Id. at 651.

n4 Id. at 651.


n6 Id. at 666 NYS2d 988.

n7 Id. at 666 NYS2d 988.
Strict Duty of Care

In handling other people's money, the attorney is like every other citizen, prohibited from deception and misappropriation. The lawyer also must follow a strict standard with respect to the funds and property entrusted to the lawyer's care so that they are only used and given over to those that have the true entitlement.

The strict letter of the client's instruction must be followed. In *Leon v. Martinez*, the New York Court of Appeals addressed issues where a lawyer, on the client's instructions, drafted an agreement giving a percentage of a personal injury recovery to a named third party. Upon recovery, however, the third party was not given any portion of the recovery and brought suit. The Court of Appeals held that the lawyer's fiduciary obligation was to follow the client's instructions:

We reject the law firm defendant's argument that compliance with the alleged assignment would have required them to violate their ethical duties to their client... under Code of Professional Responsibility DR9-102. Even if the sole attorney-client relationship that existed... was between... [defendant law firm] and... [the personal injury plaintiff] we conclude that... argument fails for two reasons. First, the cited Disciplinary Rule mandates only that an attorney pay to the client those funds in the possession of the attorney "which the client" is entitled to receive (Code of Professional Responsibility DR9-102 [c][4]) (emphasis added) which is not the case to the extent that the client has conveyed a right to those funds by an enforceable assignment. Second, DR9-102 explicitly creates ethical duties running to third parties as to funds in the possession of the attorney to which those third parties are entitled. Assuming an enforceable assignment -- [the lawyer] was then ethically obligated not only to notify the plaintiff upon his receipt of the funds (DR9-102 [c][1]) but also to pay the funds to plaintiffs as the persons then entitled to receive them (DR9-102 [c][4].) n9


n9 Id. at 614 NYS2d 975.

The First Department in an attorney disciplinary proceeding affirmed findings of "violations" [consisting] of specific and obvious failures "to require compliance with the documents." The improper release of the escrowed funds occurred in the context of a fraudulent lending scheme and, therefore, "after his suspicions had been aroused," the lawyer should not have entered into a similar arrangement.


Strict compliance, coupled with due diligence, can only give true comfort that we are performing our fiduciary duties in regard to other people's money. It should be underscored that there is a duty to provide an accounting, irrespective of whether there was irregularity or wrongdoing in the handling of the funds. n11

n11 *Adam v. Cutner & Rathkopf*, 238 AD2d 234 (1st Dept. 1997).

Honorable Contracts

In entering into and performing contracts with clients, the lawyer's fiduciary obligation is to deal fairly and honorably. When the contract is challenged, the lawyer has the burden to prove it is free from fraud. Moreover, in cases where there are ethical or fiduciary breaches, lawyers lose their entitlement to their fees.

In *Greene v. Greene*, plaintiff, a college student, received treatment for mental illness in 1964. In 1965, she executed a trust agreement, surrendering all management and control over her inheritance for her lifetime. Upon her release from the hospital in 1967, plaintiff retained defendant-lawyer and his firm to rescind this agreement. The Court rescinded the agreement, holding there was overreaching by the trustee.

In 1968, defendant-lawyer executed a new trust agreement with the power to invest up to $100,000 without plaintiff-client's consent and incorporated a provision that the lawyer was entitled to 10 percent of the profit from the sale of trust assets. The agreement also provided authorization to make investments "not of the type customarily made by trustees" and that liability for handling the funds was "limited solely to...willful misconduct or gross neglect."

The trust also provided for automatic renewal, unless there was notice of termination. In addition to addressing the allegations relating to the unconscionable terms of the trust, issues of mismanagement and investment in companies in which the lawyer had an interest were also involved in the case. The Court of Appeals on the issue of attorneys' contracting with their own clients articulated the following fiduciary duty principles:

An attorney is not prohibited from entering into a contract with a client. He must do so, of course, with respect to his retainer for legal services and, although it is not advisable, an attorney may also contract with a client with respect to matters not involving legal services. Thus a contract between an attorney and his client is not avoidable at the will of the client.

However, the relationship between an attorney and his client is a fiduciary one and the attorney cannot take advantage of his superior knowledge and position. The basic rule, as stated -- is that "an attorney who seeks to avail himself of a contract made with his client, is bound to establish affirmatively that it was made by the client with full knowledge of all the material circumstances known to the attorney, and was in every respect free from fraud on his part, or misconception on the part of the client, and that a reasonable use was made by the attorney of the confidence reposed in him." Under this rule it is not necessary for the client to show that the agreement was obtained by fraud or undue influence on the part of the attorney, although, of course, that would make the agreement unenforceable if it were proven. Even in the absence of such misconduct the agreement may be invalid if it appears that the attorney "got the better of the bargain," unless he can show that the client was fully aware of the consequences and that there was no exploitation of the client's confidence in the attorney. n13

n13 Id. at 451 NYS2d 49.

The Court held that plaintiff sufficiently stated a breach of fiduciary duty cause of action in drafting a trust with greater than normal fiduciary powers and relief from liability save in circumstances involving fraud or gross neglect.

Specifically prohibited are contracts without full disclosure and independent counsel's review that relieve an attorney of liability for legal malpractice, especially in the course of the representation. In Swift v. Choe, n14 allegations were made that the client's severe vision problems prevented him from deciphering the contents of the release at the time it was signed and that the full contents of the release were not explained, especially since the representation had been ongoing.

n14 Swift v. Choe, 242 AD2d 188 (1st Dept. 1998).

The First Department held that such circumstances militated against the attorney's meeting the requisite burden and, in fact, construed the language of the release not to include a release of the client's legal malpractice cause of action. The Court said:

Nor does...[the client's] execution of the release...warrant dismissal under CPLR 3212...Soliciting a client's execution of a release during the course of representation violates Code of Professional Responsibility DR6-102(A) (22 NYCRR 1200.31[a]). "A lawyer shall not seek, by contract or other means, to limit prospectively the lawyer's individual liability to a client for malpractice, or, without first advising that person that independent representation is appropriate in connection therewith, to settle a claim for such liability with...an unrepresented or former client (see also, EC6-6). While a violation of a disciplinary rule "does not, in itself, generate a cause of action...a release obtained in violation of a disciplinary rule should not serve to shield a lawyer from liability before the facts and circumstances surrounding the execution of the document are fully examined," n15...Mergler v. Crystal Props Assocs. (179 AD2d 177, 181) while upholding the validity of a release entered into following the termination of a lawyer-client relationship, specifically distinguished between such releases and those executed "during the course of the attorney-client relationship" n16
n15 Facilitative and Confidential Mediation with a Neutral reviewing the circumstances may be appropriate in this context.

n16 Id. at 674 NYS2d 192-193.

In determining the validity of a charging lien and, in consequence, the fairness of fees charged and/or received pursuant to a retainer contract, the First Department held that consideration should be given to a number of relevant factors, "among them, the nature of the litigation, the amount of money involved, the results achieved, amounts customarily charged for similar services in the same locality, the certainty of compensation and... professional deportment" and noted breach of ethical and fiduciary duties could entail loss of compensation. n17


Conflicts of Interest

In appearance and reality, conflicts of interest invariably undermine the quality of legal representation and the lawyer's performance of fiduciary responsibilities. Disclosure and informed consent can cure some conflicts. Others are irreconcilable and require declining or withdrawing from the representation. The lawyer must give a keen regard to this fiduciary duty. Chief Judge Cooke of the New York Court of Appeals emphasized this important obligation in Greene v. Greene n18:

It is a long-standing precept of the legal profession than an attorney is duty bound to pursue this client's interests diligently and vigorously within the limits of the law. For this reason, a lawyer may not undertake representation where his independent professional judgment is likely to be impaired by extraneous considerations. Thus attorneys historically have been strictly forbidden from placing themselves in a position where they must advance or even appear to advance, conflicting interests... This prohibition was designed to safeguard against not only violation of the duty of loyalty owed the client but also against abuse of the adversary system and resulting harm to the public at large.


Perhaps the clearest instance of impermissible conflict occurs when a lawyer represents two adverse parties in a legal proceeding. In such a case, the lawyer owes a duty to each client to advocate the client's interest zealously. Yet to properly represent either one of the parties he must forsake his obligation to the other. Because dual representation is fraught with the potential for irreconcilable conflict, it will rarely be sanctioned even after full disclosure has been made and the consent of the clients obtained... Particularly is this so when the public interest is implicated... or where the conflict extends to the very subject matter of the litigation. n19

n19 Id. at 418 NYS2d 381-82.

Another irreconcilable conflict noted by the Court was where the lawyer had a financial interest in the litigation akin to the parties. n20

n20 Id. at 418 NYS2d 382.

Duties to Partners

In the culture and framework in which we lawyers practice we must recognize obligations owed to our partners and to those intended to be benefited by the services of other fiduciaries. In Graubard Mollen Dannett & Horowitz v. Moskowitz, n21 the Court of Appeals addressed issues dealing with the withdrawal of a partner, his solicitation of clients prior to withdrawal, and the inconsistency of these activities with a withdrawal and retirement agreement. Chief Judge Kaye, in writing for the Court, defined the lawyer's duty to his partners, appropriately balancing this obligation against the freedom of the client to select counsel. Chief Judge Kaye held:
It is unquestionably difficult to draw hard lines defining lawyers' fiduciary duty to partners and their fiduciary duty to clients. That there may be overlap, tension, even conflict between the two spheres is underscored by the spate of literature concerning the current revolving door law firm culture.

... Pre-resignation surreptitious "solicitation" of firm clients for a partner's personal gain... is actionable. Such conduct exceeds what is necessary to protect the important value of client freedom of choice in legal representation, and thoroughly undermines another important value -- the loyalty owed partners (including law partners) which distinguishes partnerships from bazaars.

* * *

At one end of the spectrum, where an attorney is dissatisfied with the existing association, taking steps to locate alternative space and affiliations would not violate a partner's fiduciary duties... As a matter of ethics, departing partners have been permitted to inform clients with whom they have a prior professional relationship about this impending withdrawal and new practice, and to remind the client of its freedom to retain counsel of its choice. Ideally, such approaches would take place only after notice to the firm of the partner's plans to leave...

At the other end of the spectrum, secretly attempting to lure firm clients (even those the partner has brought into the firm and personally represented) to the new association, lying to clients about their rights with respect to the choice of counsel, lying to partners about plans to leave, and abandoning the firm on short notice (taking clients and files) would not be consistent with a partner's fiduciary duties. n22


n22 Id. at 629 NYS2d 1013-1014.

In the case of In re Clarke's Estate, n23 the attorney for the fiduciary was held by the Court of Appeals also to have a fiduciary duty of undivided loyalty so that the fiduciary would not be prevented from performing his obligation to the beneficiary. As a result of not performing this obligation "the attorney's conduct came within the fixed rule of law denying compensation in cases of divided loyalty of fiduciaries or their attorneys." n24

n23 In re Clarke's Estate, 12 NY2d 183 (1962).

n24 Id. at 237 NYS2d 697.

Conclusion

Legal malpractice is a violation of the minimally appropriate professional standard that proximately causes harm. Breach of the lawyer's fiduciary duty on the other hand is a deviation from a significantly higher standard of conduct for which the law imposes strict accountability. We, as Judge Cardozo expressed, should always "consciously" strive to maintain and not lower that high standard.
Professional liability insurance is essential for the legal as well as other professions in our current world. Professional malpractice in the truest sense is a rare phenomenon, however, lawsuits between lawyers and former clients are not so rare especially when there are fee disputes or between accountants and clients when there is a misleading financial statement and a late filing on a tax return or between customer and broker after the account sustained significant losses in a down market.

The costs of litigation and arbitration are significant and, accordingly, prudence dictates that professional liability insurance be purchased. However, it is especially important to examine what the insurance does cover and whether the claims management of the insurers fairly and honorably meets the needs of the insureds.

Abusive Practices

As a result of the abusive claims practices that this practicing lawyer has experienced in the last year in regard to a number of client insureds, I think it will be helpful to review the essentials of the 'litigation insurance' component of professional liability insurance to more effectively protect not only the client but also your own firm and yourself when coverage disputes arise with the insurer and to assure that the carrier will not overstep and engage in abusive claims practices.

Abusive practices start with initial evaluation of the claim and extend through the claims handling process even when the insurer provides a defense. To walk away from defense obligations insurers employ 'the complaint taken as a whole' subterfuge, i.e., while the insured had the professional relationship covered by the policy, the insured was really serving another role and, according to the insurer, any professional services were incidental. Further exclusions in the policy not only expressly deny indemnity by virtue of the specific products or services but any 'allegation' or any activity 'related to' the product or service is excluded...
so the insurer disclaims defense coverage even when the insured denies being involved in such activity. This is specious since insurers are to defend even when the claims are false, fraudulent and groundless.

Defense coverage where there is a reservation of rights and the insurer is obligated to respect the insured's choice of counsel and pay its reasonable fees is diluted when the insurer attempts to limit the insured counsel's hourly rate to the minimal rate set for panel counsel who defend when the insurer assumes the liability risks. Further, paying expert consultants and witnesses is often partially or wholly avoided with the contention that notwithstanding counsel's tactical choice to engage the expert as a consultant and/or testifying witness, the expert is not needed and is not allowed for by the insurer's 'budget.'

In one recent securities arbitration, this author experienced a claims person declaring the carrier would only pay for the expert's time on the witness stand and not for preparation or attending the hearing so that he could render an opinion on the record as a whole.

The foregoing, as will be demonstrated in this article, is bad faith and should be remedied by the industry and professional associations as well as the regulators because it defeats the purpose of 'litigation insurance' paid for by substantial premiums.

Settled Principles

In professional liability insurance, the insurance covers both the risks of litigation and liability. [FN1] It is a combination of litigation insurance and liability insurance that additionally provides indemnification for the insured in the event of an adverse award or judgment and/or settlement. [FN2] Most policies indicate also that the insurer has both the right and duty to defend. When the insurer accepts the insured's risks of liability it has no conflict and is entitled to control the defense, i.e., has the right to defend. However, when the insurer disclaims the risk of liability the insurer still must provide the defense for which it received premiums although the insured controls the defense by selecting his own counsel at the insurer's reasonable expense. [FN3]

If a reading of the policy in conjunction with the pleadings merely suggests the possibility of a covered claim or even if it does not, but the facts outside of the pleadings suggest a covered claim, the insurer must defend. [FN4] It is the insurer's burden to establish, as a matter of law, that the allegations of the complaint unambiguously 'cast the pleading solely and entirely within the policy exception.' [FN5] This is the settled law that is so deeply rooted that the insurer's disregard more often than not has to be conscious and willful and a mandate for the court to swiftly remedy. [FN6]

Further, if one claim in a multiple claim complaint potentially falls within the indemnity coverage provided for in the policy, the insurer must defend the entire
action. [FN7] The cases also stand for the proposition that even if the pleadings do not trigger the duty to defend there is such a duty when extrinsic facts outside of the complaint trigger the obligation. [FN8] Moreover the cases also stand for the proposition that the insurer may not rely on outside facts to negate the obligation. [FN9]

All jurisdictions including New York adhere to the above-stated propositions. In 1974, the Court of Appeals addressed a case where plaintiff sought to recover from its insurer the legal fees and disbursements incurred in defending an action brought by an employee in which damages were sought for personal injuries by reason of plaintiffs' alleged negligence. The insurer disclaimed liability and refused to defend the negligence action. The plaintiff was required to retain counsel to represent it in the underlying litigation that resulted in a dismissal of the action. The Court in International Paper Company v. Continental Casualty Co., in determining the insurer breached its duty of defense held:

It is manifestly clear that the negligence complaint did not allege facts sufficient to find on its face, that it was subject to...[the] policy exclusions, and...if the insurer is to be relieved of a duty to defend it is obligated to demonstrate that the allegations of the complaint cast that pleading solely and entirely within the policy exclusions, and, further, that the allegations, in total are subject to no other interpretation. As a consequence, even if the complaint fails to articulate adequately an action grounded solely in negligence, the insurer is required to defend. An insured's right to be accorded legal representation is a contractual right and consideration upon which his premium is in part predicated, and this right exists even if debatable theories are alleged in the pleading against the insured. (Emphasis added)

The Court further held, as would be true in every case a policy is purchased for litigation insurance:

In plain and concise language, and without equivocation, the defendant obligated itself to defend any action brought against the ...insured whenever alleged a cause of action in negligence covered by the policy regardless of the ultimate factual determination of the occurrence...

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An insurer's obligation to furnish its insured with a defense is heavy indeed, and of course, broader than its duty to pay. The rule to be followed is clearly set out in Goldberg v. Lumber Mut. Cas. Ins. Co. of New York (297 N.Y. 148, 154), wherein this Court wrote: 'Indeed even in cases where the policies do not render the allegations by the injured party controlling,' it has been said, the distinction between liability and coverage must be kept in mind. So far as concerns the obligation of the insurer to defend the question is not whether the injured party can maintain a cause of action against the insured, but whether he can state facts
which bring the injury within coverage. If he states such facts the policy requires the insurer to defend irrespective of the insured's ultimately liability...

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The insurer is cloaked with the burden of proving that the incident and claim thereunder came within the exclusions of the policy... (Emphasis added)

Clearly the duty to defend is broader than the duty to indemnify. [FN10]

In Public Service Insurance Co. v. Goldfarb, the Court held that the determination of an insurer's duty of indemnification comes after a finding of the facts and a special jury verdict is returned by the jury. Before that point the insurer 'must...defend...in the pending lawsuit because a claim within the stated coverage has been made' and 'moreover, inasmuch as the insurer's interest in defending the lawsuit is in conflict with the defendants' interest -- the insurer being liable only upon some of the grounds for recovery asserted and not upon others...[the insured] is entitled to defense by an attorney of...[the insured's] own choosing, whose reasonable fee is to be paid by the insurer.' [FN11]

Litigation Insurance

In regard to litigation insurance the Court of Appeals said:

An insurer must defend whenever the four corners of the complaint suggest -- or the insurer has actual knowledge of facts establishing a reasonable possibility of coverage...the duty is broader than the insurer's obligation to indemnify: 'though policy coverage is often denominated as 'liability insurance,' where the insurer has made promises to defend 'it is clear that the [coverage] is, in fact, 'litigation insurance' as well.' (Emphasis added)

Moreover, it is the insurer's burden to 'establish as a matter of law that there is no possible factual or legal basis on which it might eventually be obligated to indemnify its insured under any policy provision' (emphasis added). If the complaint in the underlying action merely suggests a malpractice or breach of fiduciary claim by a professional, the action is squarely within the ambit of coverage and presents a burden that cannot be met by the defendant insurer. [FN12]

In fact, any review of the cases demonstrates it is a virtual impossibility to preclude coverage if the insured is acting in the context to which the insurance applies. In Steadfast Insurance Company v. Stroock & Stroock & Lavan LLP, [FN13] a lawyer liability case, the Court held:

An insurer may escape its duty to defend only if the insurer demonstrates that the allegations of the complaint cast the pleadings wholly within...[the] exclusion, that the exclusion is subject to no other reasonable interpretation and that there is no possible factual or legal basis upon which the insurer may eventually
be held obligated to indemnify the insured under any policy provision. If any of the claims against the insured arguably arise from covered events, the insurer is required to defend the entire action. (Emphasis added).

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If the universe of claims against the insured requires proof of conduct that is excluded from coverage then the insurer has no duty to indemnify or defend its insured...

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The insurer bears the burden of proving that the exclusions apply in a particular case...'this burden is heavy, especially when the insurer is seeking to avoid the duty to defend.'.... Exclusionary clauses are strictly construed to give the interpretation most beneficial to the insured...a construction favorable to the insurer will be sustained only if it is the only construction which may fairly be placed on the [words used]. (Emphasis added)

Insurer Avoiding Obligation

An insurer can only avoid its obligation to defend if it can show as a matter of law no such duty. [FN14] This can almost never be shown so it is incomprehensible there are as many coverage disputes relating to the duty to defend as occur today. Further, there is no prejudice to the insurer defending as observed in Steadfast Insurance Company v. Stroock & Stroock & Lavan since the insurer can issue a reservation of rights that precludes the insurer from waiving its coverage defense.

Almost 30 years from the date the New York Court of Appeals articulated the breadth of the duty of defense and the standards for its interpretation and application the U.S. District for the Southern District of New York in Admiral Insurance Company v. Weitz & Luxenberg, et al. [FN15] articulated and applied the same rooted principles to make a determination in regard to the insurer's duty of defense. The case was also a lawyer liability action.

The Court held:

Courts in New York have held that an insurer's duty to defend and to pay defense costs under liability insurance policies must be construed broadly in favor of the policyholder. Further, it is broader than the duty to indemnify.

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an insurer's duty to defend arises whenever the allegations in a complaint state a cause of action that gives rise to a reasonable possibility of recovery under the policy.... If the allegations of the complaint are even potentially within the language of the insurance policy, there is a duty to defend.... If any of the claims against [an] insured arguably arise from covered events, the insurer is re-
quired to defend the entire action.... Indeed, 'the duty to defend arises whenever the allegations in the complaint against the insured fall within the scope of the risks undertaken by the insurer...[and it is immaterial] that the complaint against the insured asserts additional claims which fall outside the policy's general coverage or within its exclusionary provisions'...the merits of the complaint are irrelevant. (Emphasis added)

If any segment of the complaint implicates a covered risk, then there is defense coverage. In Admiral Insurance Co. v. Weitz and Luxenberg PC, et al., the Court further observed that if the insurer has a duty to defend 'it has a duty to defend against the entire complaint.' Further, the Court in the case held '[a] policyholder may recover attorney's fees incurred in successfully defending itself against an insurer's attempt to free itself from its obligations under an insurance policy.' There should be no distinction between the insurer bringing an action to deny coverage and its stonewalling its obligations to provide a defense forcing its insured to bring an action for declaratory judgment. In the context the insured is in as much of a defensive posture after a disclaimer as the insured being required to defend against the insurer bringing a declaratory judgment action to deny coverage. In fact, an insured having to defend against liability and personally incur substantial litigation expenses after paying ever-increasing premiums on a yearly basis is clearly in a defensive posture.

In Napoli Kaiser & Bern LLP v. Westport Insurance Corp., [FN16] the Court addressed an equivocal breach of fiduciary claim asserted against a law firm as follows:

A breach of fiduciary duty claim can be based on negligence and the complaints carefully do not allege that the breach was intentional.... The Claimant Firms, in addition to the primary allegations of fraud, have alleged that...[the Claimant Firm] breached its fiduciary duty in obtaining low settlements for the referred clients. It is entirely possible that Claimant Firms will be unable to prove a scheme by...[Claimant Firm] to distort settlements, but that they will be able to show that.... [Claimant Firm] negligently represented the referred clients. Such a 'reasonable possibility' of coverage is sufficient to trigger the duty to defend ...(Emphasis added)

As a result of the foregoing, insurers should better monitor their claims personnel and coverage counsel to make sure the insurer honors its duty to defend. Bar associations, professional organizations and insurance regulators should also be attentive to this issue.

Bad Faith

In Smith v. American Family Mutual Ins. Co., [FN17] the court addressed the sufficiency of allegations against an insurer for breach of the implied covenant of good faith and fair dealing holding that such a cause of action can be sustained.
where the insurer objectively acts without justification. Further, neither the breach of the covenant of good faith and fair dealing, nor the claim of bad faith and fraudulent marketing and claims practices is limited to the duty of indemnification. In Hugo Boss Fashions Inc., et al v. Federal Insurance Co., [FN18] the U.S. Court of Appeals held: '...an insurance company could perfectly reasonably disclaim indemnify coverage, and yet be in bad faith in refusing to defend until the scope of coverage was determined.' To be entitled to attorney's fees and costs for securing coverage and a punitive damage award there must be 'a gross disregard for its policy obligations' by the insurer.

Citing New York case law the Court held:

...[t]here remains a strong presumption in New York against a finding of bad faith liability by an insurer.... 'It is...well-settled that an insured cannot recover his legal expenses in a controversy with a carrier over coverage, even though the carrier losses the controversy, and is held responsible for the risk.' The presumption against bad faith liability can be rebutted only by evidence establishing that the insurer's refusal to defend was based on 'more than an arguable difference of opinion' and exhibited 'a gross disregard for its policy obligations.' (Emphasis added)

In the case cited above the bad faith issue was decided by the Court after a jury trial. The policyholder did not adduce sufficient evidence 'as a matter of law, to overcome the presumption.' The court drawing a similar conclusion to a cited New York State case held "the record shows merely an arguable case in which the carrier was held wrong...[and] (t)hat is not enough to impose a liability beyond the terms of the contract." Where the policy language and pleadings clearly indicate the possibility of a covered claim there is not nor can there be any reasonable difference on the issue of the duty to defend, i.e., what is written cannot be ignored. As noted in Pavia v. State Farm Mutual Automobile Insurance Co., [FN19] when the facts show 'an extraordinary... disingenuous or dishonest failure to carry out the insurance contract,' bad faith is demonstrated. Bad faith is more apt to be shown by the comparison of the language in the policy and the pleadings and therefore a breach of the duty to defend can more easily fit in the bad faith category than other acts or omissions of insurers.

Nor is the cause of action for breach of the duty of good faith and for fair dealing duplicative of plaintiffs' cause of action for bad faith and fraudulent marketing and claims practices. The insurer's breach of its obligations under its insuring agreement with the individual plaintiffs when there is serious misconduct also constitutes 'acts or practices' that 'must...[and does] have a broad impact on consumers at large.' [FN20] It is not strictly a matter of private contract.

Claims for breach of the covenant of good faith and fair dealing distinctly permit insureds to recover defense costs in the underlying action and the bad faith and fraudulent marketing and claims practice claims encompass recovery for the at-
torney's fees and costs in securing defense coverage and do justify the courts upon the evidence to submit a special verdict form to the jury as to whether punitive damages should be awarded. The cause of action based on bad faith and fraud is also based on facts relating to the marketing and claims practices that predate the particular claims made policy in issue because the insurer continues to offer 'litigation insurance' and collects significant premiums with apparently no intent to honor its defense obligation under the policy when circumstances would trigger that obligation. Such conduct breaches duties independent of the specific insuring agreement and relates to ongoing and continuous acts and omissions of the insurer to collect premiums based upon publicly stated commitments it has no intent to honor.

The bad faith and fraudulent marketing and claims practices are not merely limited to a breach of a specific contract or a private wrong. Recovery for such deceptive marketing and claims practices are also permissible under General Business Law (GBL) §349. [FN21] Over the years when insureds purchase and renew their lawyer's professional liability policy and pay significant yearly premiums, and the insurers repeatedly represent and promise that the policy will be providing 'litigation insurance,' with no intent to perform; there should be no doubt that a case is made out for bad faith. Such a wrong is consumer-related and adversely affects the public interest.

The insurer should not be entitled to avoid liability for the insured's attorney's fees and costs in bringing the coverage action by itself and not bringing the action to settle coverage issues, because the insured, by virtue of having to defend an underlying action without the defense coverage provided by the policy, is truly in a defensive posture created by the insurer's unjustified disclaimer. Even if New England Mutual Life Insurance Co. v. Johnson [FN22] and Mighty Mid-gets Inc. v. Centinental Insurance Co., [FN23] are given restrictive scope, the insurer, by virtue of its bad faith denial of coverage, should be estopped from such a defense. [FN24] In any event §349 of the GBL allows for such recovery. [FN25]

A bad faith denial of defense coverage is also appropriate for punitive damages. In Walker v. Sheldon [FN26] the Court held:

Punitive or exemplary damages have been allowed in cases where the wrong complained of is morally culpable or is actuated by evil and reprehensible motives, not only to punish the defendant but to deter him, as well as others who might otherwise be so prompted from indulging in similar conduct in the future.

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Although they have been refused in [an] 'ordinary' fraud deceit case...we are persuaded that on the basis of analogy, reason and principle there may be exemplary damages in fraud and deceit actions where the fraud, aimed at the public generally is gross and involves high moral culpability.
It is unlawful in New York to engage in '[d]eceptive acts or practices on the conduct of any business trade or commerce.' [FN27] Any person injured by such violation of the deceptive acts or practices prohibition is entitled to bring an action in his own name to recover his damages not to exceed one thousand dollars. The court may award a prevailing plaintiff attorney's fees. Id. In order to plead a claim under Gen Bus. Law §349, it must be shown the unlawful conduct is consumer-oriented, that it is deceptive and has injured the plaintiff. [FN28] Conduct is considered deceptive if it is likely to mislead a reasonable consumer acting reasonably under the circumstances. [FN29] In order for conduct to be consumer-oriented, it does not need to be repetitive or recurring but...must have a broad impact on consumers at large....' [FN30] Denying wrongfully an essential feature of professional liability insurance that is the prime reason for insureds buying the insurance is a wrong that, when it occurs, has to be a consumer-oriented wrong fitting within the General Business Law's prohibitions, as well as an independent wrong actionable under the common law of torts.

Conclusion

To maximize one's professional liability insurance coverage and to effectively resist a wrongful denial of coverage one merely has to start with the proposition that when the policy language read in conjunction with one specific allegation in the pleading indicates there is the mere possibility of at least one covered claim, the insurer cannot squirm out of its obligations.

When a reservation-of-rights letter is issued indicating there is a conflict between the insurer and insured, the insurer thus has given up its right to control the defense although it still may have a clear duty to defend for which it will be held strictly responsible. In such instances the insurer should pay the reasonable fees of the insured's counsel and other litigation costs that it cannot 'skimp on,' as exceeding its guidelines, because it no longer controls or should control the defense.

Professional liability insurance is very important today. The underwriting process, if done right, can lead to sound risk management and avoidance. Professional insureds will be protected against catastrophic economic injuries but most significantly the ever-increasing economic burdens of litigation will be ameliorated for the individual and small firm professional.

Justice Louis Brandeis once observed, 'Sunlight is the best disinfectant.'

This is why the claims practices relating to 'litigation insurance' need to receive the 'sunlight' of our attention, so that bad and fraudulent practices can be eliminated and both the insurers and the professional insureds can and shall engage in best practices.

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FN6. See also the following cases that hold that as long as the allegations of the complaint give rise to the possibility of recovery on a covered claim there is a duty to defend: Continental Cas. Co. v. Rapid-American Corp., 80 N.Y.2d 640, 593 N.Y.S.2d 966 (1993); Lusalon, Inc. v. Hartford Acc. & Indem. Co., 400 Mass. 767, 511 N.E.2d 595 (1987).


FN12. See also the following cases holding that the duty to defend which is essentially 'litigation insurance' requires the insurer even to defend 'groundless, false or fraudulent claims.' See Monroe County Water Auth v. Travelers Ins. Co., 195 A.D.2d 1043, 600 N.Y.S.2d 862 (4th Dep't 1993); Trizec Properties Inc. v. Biltmore Constr. Co., 767 F.2d 810 (11th Cir. 1985).


FN17. 294 NW 2d 751 (N.D. 1980).


FN19. 82 NY2d 445, 626 NE2d 24 (Court of Appeals 1993).


FN26. 10 NY2d 401, 405, 223 NYS2d 488, 179 NE2d 497 (N.Y. Court of Appeals).


FN30. 87 N.Y.S.2d at 320, 639, N.Y.S.2d at 290.

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Reliance on the advice of counsel is a recognized and frequently asserted defense in criminal fraud prosecutions and regulatory proceedings as it effectively negates bad faith and intent when they are elements of the charges. The point from which this defense is viewed is that of the client or former client. Upon reflection, however, the elements or better yet, their absence establish a most effective defense to a legal malpractice cause of action. From the viewpoint of the lawyer sued by the former client, if the former client cannot establish the elements there is not a viable legal malpractice claim. Proximate causation, a necessary element of legal malpractice, cannot be established without satisfying the requirements of the defense of reliance on counsel. Therefore, this must be the starting point of analysis if reliance on counsel is to be placed in the framework of addressing legal malpractice.

CORE ELEMENTS

In the case, In re: G-I Holdings Inc., a Debtor was challenged by the IRS on the sale of property i.e., the sale failed to qualify as a non taxable contribution and, in fact, the transaction was a disguised sale of taxable property. The Court held:

“When a party cites legal representation as an affirmative defense to a claim, however, the party puts that advice ‘at issue’ and waives the attorney-client privilege...There is] a three part test for finding (at issue) waiver: ‘(1) assertion of the privilege was a result of some affirmative act, such as filing suit, by the asserting party; (2) through this affirmative act, the asserting party put the protected information at issue by making it relevant to the case, and (3) application of the privilege would have denied the opposing party information vital to his defense”
Courts have found that by placing the advice in issue, the client has opened up to examination facts relating to that advice. The advice of counsel is placed in issue where the client asserts a claim or defense by disclosing or describing the attorney client communication.

In referring to a Court that upheld waiver under such circumstances, the Court observed,

"The Court there rationalized that the party defending against a ‘reliance-on-counsel’ claim must be able to test what information was conveyed by the client, whether counsel was provided with all material facts in rendering advice and whether that advice was relied upon by client" (emphasis added).

In Schilling v. Farmers Bank & Capital Trust, a judgment notwithstanding the verdict was granted to the bank in a suit by the bondholders that claimed the bank as an indenture trustee for bonds issued to finance the conversion of a school into a nursing home improperly permitted the project manager to continue after a series of defaults on the bonds. The bank claimed reliance on counsel in accepting the assurances of the nursing home that the payments would be made. The Court held:

“It is well settled that the defense of reliance on the advice of counsel is an absolute defense that may be defeated only by showing bad faith on the part of the party claiming the defense or by showing that the advice of counsel was unreasonable and that the client knew or should have known that the client knew or should have known that it could not rely on the advice.”

The bank presented proof that it consulted counsel on the available remedies. The bank could not have replaced the project’s management because it did not have this power. It had the burden of going forward, but once it presented its proof the burden shifted to the bondholders. In accepting the reliance on counsel defense the Court held:
“...[W]e need not address the question of causation as even if the bondholders proved that the bank’s actions proximately caused their losses, the defense of advice counsel protects the bank from liability.”

In US v. Wegner\textsuperscript{iii} the defendant published a newsletter and had a syndicated radio program. The investors were not informed the recommended companies paid compensation to defendant for touting the stock. Defendants were convicted of criminal violations of Section 17(a) of the Securities Act of 1933 (“Securities Act”) and Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) for unlawfully publicizing a stock for consideration from an issuer, underwriter or dealer without disclosing the fact and amount of the payments and illegally selling short penny stock. In respect to the reliance on counsel defense, the Court held:

“Good faith reliance on counsel, however, is not a complete defense, but is merely one factor a jury may consider when determining whether a defendant acted willfully... To establish a good faith reliance on counsel defense, the defendant must show '(1) a request for advice of counsel on the legality of a proposed action (2) full disclosure of the relevant facts to counsel, (3) receipt of advice from counsel that the action to be taken will be legal and (4) reliance in good faith on counsel’s advice.’”

The Court of Appeals affirmed the conviction and admitted prior bad acts to negate the defense of reliance on counsel.

In SEC v. Scott\textsuperscript{iv} the SEC brought an action seeking to enjoin the C.E.O. of a reinsurance corporation and securities analyst who was a limited partner of a broker-dealer that was an underwriter in a stock offering. The SEC alleged the prospectus was misleading in that it represented the proceeds of the offering would be invested primarily in liquid fixed income securities; the reinsurance company would
manage its own portfolio; and the issuer would enter the reinsurance business. There was also material non-disclosure that the proceeds of the offering would not be in speculative securities. Instead, the investments were in Canadian real estate ventures and the reinsurance corporation’s president had been convicted previously of fraud which adversely affected the company’s license in the Cayman Islands.

Further, during the offering proceeds of $1.6 million were invested in equity and not fixed income securities. These securities had been underwritten by the broker-dealer that underwrote the reinsurance offering. Notwithstanding the representations about how the proceeds were to be invested, “(i)t soon became clear... that a sizeable portion of the proceeds was destined not for conservative investments but for purchasers of ‘new issues underwritten by [the broker-dealer].’”

Counsel advised that if the proceeds were invested in this manner they would withdraw their legal opinion. The Board ratified the investments and counsel concluded because the amount of the equity investments were reduced, the registration statement did not need to be amended and the prospectus stickered. Counsel’s concerns were apparently resolved in that a Form SR was filed indicating the use of the proceeds complied with applicable law and the stated disclosures. A certificate signed by the issuer’s officers were prepared so that there were no material adverse changes except those set forth in the prospectus and its amendments. The broker-dealer collapsed and the reinsurance company’s portfolio was exposed to be equity securities underwritten by the broker-dealer and the offering proceeds were misapplied.

The securities analyst could not raise a defense of reliance on counsel since as the Court held “his failure to prove that he asked for, received and acted on the advice of
counsel regarding the purchases... of the securities] precludes the defense of reliance
on counsel.” The Court further held:

“The Courts have recognized the defense of reliance on counsel has required proof that the defendant (1) made a complete disclosure to counsel, (2) requested counsel’s advice as to the legality of the contemplated action and (3) relied in good faith on that advice...Moreover, the fact that a defendant justifiably relied on advice of counsel in taking the unlawful action has not been viewed as an automatic defense to liability but rather has been regarded as only one factor considered in determining the propriety of injunctive relief.”

In the case, even though counsel may ultimately have gone along with the transaction no request was made for the informed opinion of counsel regarding how the proceeds were to be invested in equities as opposed to fixed income securities. The Court observed:

“The reliance-on-counsel defense, however, does not mean that one can totally abdicate responsibility by consulting counsel... The reliance-on-counsel defense requires more than such a complacent attitude. A defendant must establish that he actively sought and relied on advice of counsel, a showing that cannot be made on this record...” (Emphasis added).

Waiver of the Attorney Client Privilege

The assertion of the defense of reliance on advice of counsel as is the institution of a legal malpractice claim by the client is an implied waiver of the attorney-client privilege. In re: Broadcom Corp. Securities Litigation addresses and explains the waiver issue. The case involved false press information and market manipulation alleged in a securities class action. The issue was whether the defense had been asserted. The Court held:

“The defense of reliance on counsel is an implied waiver of the attorney client privilege...Once the privilege is waived all
communications relating to the same subject matter are discoverable. While waiver extends to all communications on the same subject matter, it should be no broader than needed to ensure the fairness of the proceedings...the purpose of the waiver is to allow the opposing party to respond to the reliance on counsel defense. Here, since the purported reliance on counsel extends only to the issue of the defendant’s knowledge of the legality and accuracy of...[the corporation’s] public statements, ‘the waiver should be deemed to extend only to those communications relating to the public statements at issue.’"

The defendants were corporate officers and had authority to waive the corporations’ privilege and attorney work-product was included in the waiver. Since defendants’ state of mind and knowledge were relevant, “fairness principles underlying waiver” was a key consideration and the privilege was deemed waived as to the subject matter of the litigation.

Such a result precludes selective waiver in respect to the subject matter over which the legal advice is in issue. In SEC v. Forma vi the Court observed:

“\[\]It is well established that a defendant cannot claim that the assurances of counsel protect him from liability and at the same time preclude discovery of attorney-client communications related to that advice. In such circumstances, the defendant is deemed to have impliedly waived the privilege.

Nevertheless, parties are entitled to plead in the alternative...Because the reliance on counsel defense will result in the disclosure of privileged communications, defendants should first be permitted to test the validity of other defenses.”

Before the “self-defense” exception to the attorney client privilege is invoked, the client has to definitively put in issue the attorney’s advice. In SEC v. Fields vii where SEC staff were seeking the lawyer’s testimony as an alleged aider and abettor, the Court
observed:

“...There must...exist] some objective factual basis for the allegation. Otherwise, the SEC could elicit testimony from lawyers incriminating their clients merely by charging the attorneys, without foundation, as aiders and abettors...[T]he attorney client privilege is too important to be breached by innocent but wrong headed...actions that cause a vulnerable attorney to disclose confidential communications...”

More often than not before the attorney-client privilege is waived and the advice becomes an issue, the client or former client has to testify. In the case of In re: Buspirone Antitrust Litigation the issue was whether work product of outside counsel should be disclosed where their opinion may have conflicted with inside counsel. The United States Magistrate Judge described the “at issue” waiver doctrine and its rationale as follows:

“...The attorney-client privilege is waived when the party places otherwise privileged communications ‘at issue’ in the litigation... Communications are ‘at issue’ when the party makes an assertion ‘that in fairness requires examination of protected communications.’”

Other Courts have expressed “the privilege may not simultaneously be used as a shield and a sword; where a defendant opens the door by waiving the attorney-client privilege...the defendant cannot open the door only to the information he would like to admit.”

Other Predicates and Limitations

When the defense of reliance on counsel is asserted it has to be anticipated the advice giver will have to testify and be disqualified. Furthermore, the defense of reliance on counsel has to be asserted on a timely basis Amquip Corp v. Admiral Insurance Co. was a declaratory judgment action against the insurer seeking to order the insurer it had a
duty to defend and declare bad faith on the insurer’s part if it did not defend. There was what appeared to be intentional failure to assert a reliance on counsel defense and timely amend the pleadings to add the defense. The Court held Rule 15 of the Federal Rules of Civil Procedure ("FRCP") permits amendment freely and "delay does not preclude amendment." Although there was no undue prejudice the delay was held to be inexcusable in this case. What is most critical is that the advice in issue must be legal advice; not business, psychological, investment or other types of advice. Where there is not an outstanding legal issue that will affect a future course of conduct the defense cannot be asserted. Rodriguez v. Ortegon\textsuperscript{13} was an action for conversion of corporate stock by minority stockholders. The Court held the legal defense of reliance on corporate counsel could not be asserted in respect to the refusal to transfer stock as authorized by the stockholders when no legal justification for refusal existed. The Court held:

"The defense of good faith is not available to a party to excuse his actions in a conversion suit..."The requisite intent is only one to assert a right in the property, and a wrongful intent is not required"...Therefore, good faith could not have been asserted by the appellant to legally excuse his unreasonable refusal to transfer the stock."

The Court further observed "...[a] party may not assert the legal defense of reliance on corporate counsel when no legal justification for the refusal exists." In Texas, the Court also noted there was a statutory requirement that the defense of reliance on counsel could only be asserted where there was a written opinion. This makes eminent good sense in a commercial or property transaction.

In certain contexts, both the defense and a legal malpractice claim to be asserted must have as a threshold a supportive expert opinion. In Hatfield v. Herz\textsuperscript{14} plaintiff was
sued in state court in his capacity of a board member of a co-op. A judgment was entered against defendant and an appeal was not timely perfected. Plaintiff did not submit an expert affidavit. Plaintiff offered only general and not specific allegations and summary judgment was granted. The Court held an attorney is not held liable because the former client has “dissatisfaction with strategic choices” and performance was not “optimal.” The malpractice alleged in part was the failure to call the co-op’s counsel in the underlying case who plaintiff claimed had been relied on in handling a sublease issue. The defense argued reliance on counsel was not viable because the questionable conduct occurred before the co-op counsel was retained and because plaintiff “continued to direct the sublease negotiations without consulting...[counsel]”. There was no suggestion that when the underlying case was being litigated the lawyer’s testimony was required for the defense. The issue was then “squarely before the Court” and should have been raised at that point in time. Further “evidentiary proof” was not presented that “a proper defense would have altered the result.”

**Advice of Corporate Counsel**

Another key consideration in today’s context is that where attorneys advise and represent corporations they indirectly advise and represent corporate directors, officers, and employees. The advice can have significant personal consequences.

In **Howard v. SEC**15, the SEC instituted an administrative proceeding against a broker/director for his approval and participation in two “partial or none offerings” which were violative of applicable law and regulatory requirements. The Court of Appeals reversed the imposition of sanctions because the broker/director was held to have acted in good faith and with due care because inside and outside counsel communicated their
approval of the transactions to the organization and its officers and directors.

The Court, in upholding the defense, negating the SEC’s claims of willfulness, recklessness, and intent, expounded:

“The ALJ made the...finding: Howard believed that...higher management...and outside counsel had approved actions that violated the anti-fraud provisions and Rule 10(b)-9...Matcovsky who headed...the corporate finance department and had been a lawyer with the SEC’s Division of Market Regulation called Howard...to solicit his vote. Matcovsky was also a member of...the] board...Only after Matcovsky reported that the board had voted in favor of the transaction and that Rogers & Wells had approved it did Howard add his approval. (The partner in charge of Rogers & Wells specialized in securities law and had more than 20 years of experience.)...As with the first offering, Howard played no role in drafting...documents, again relying on the expertise of outside counsel and...the] corporate finance department. The SEC dismissed this and other such evidence on the ground that ‘Howard had an ongoing obligation to familiarize himself with pertinent legal requirements in order to protect investors from illegality’. This entirely misses the significance of the evidence... In this case, rather than red flags, Howard encountered green ones, as outside and inside counsel approved...the] transactions...”

The Court also significantly held that the defense of reliance on counsel was not defeated because officers and directors subordinate to the higher ups did not directly communicate with counsel. The Court further explained:

“Suppose a company president communicates directly with competent outside counsel, makes full disclosure, is advised incorrectly - that the proposed transaction is entirely lawful; tells junior officers in the company of the legal advice; and instructs them to consummate the transaction. Under the SEC’s theory, the president could avoid charges of fraudulent conduct by using the attorney’s advice to prove his lack of scienter while those working under him could not. That is illogical and makes no sense whatsoever.”

Where corporate counsel specifically knows lower level corporate management and
employees will rely on his advice, there is a risk of malpractice exposure to this group.

**The Absence of Reliance on Counsel Defense**

The defense creates a viable framework for determining the viability of a legal malpractice cause of action. Legal malpractice occurs where there is an attorney-client relationship, the lawyer breaches the appropriate standard of care, and as a result “proximately causes” actual damages. If the malpractice is bad advice, the former client to assert a viable claim has to seek legal (and not business, psychological, or investment) advice, disclose all relevant facts to the lawyer and show reliance on that specific advice for the course of action taken. If the former client cannot establish these elements, lawyers and their firms have a very viable defense that can be easily articulated and applied to the facts.
End Notes

12. 231 F.R.O.197 (E.D. PA 2005)
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A GUIDE TO PROFESSIONAL LIABILITY INSURANCE FOR THE INVESTMENT PROFESSIONAL

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INTRODUCTION

Whether broker-dealer, investment adviser, registered representative, or investment adviser representative, securities industry professionals in the litigious arbitration environment in which we live today not only have to understand the basic concepts of professional liability insurance and the proto-typical provisions of the policy forms, but most importantly, how to navigate the choppy waters of coverage issues. Policies should be reviewed from the point of view of (1) their scope, (2) the exclusions, (3) the insurer’s obligations, (4) the insured’s obligations, (5) the definition of terms in the policy, (6) the retention and limits, and (7) coverage issues and disputes. Reading the policy forms closely; carefully negotiating the endorsements; filling out the policy application truthfully and completely; timely reporting a claim or circumstances giving rise to a claim; fully cooperating with the insurer should a claim arise; working with counsel to protect coverage when the insurer disclaims coverage or issues a reservation of rights letter; and, above all, being practical and acting with common sense are the fundamentals for approaching professional liability insurance.

This article will discuss some of the typical provisions in these policies and their potential impact on insureds. We then suggest ways in which securities industry professionals can improve coverage. In addition, we describe briefly the applicable law, as it relates to the duty to defend, reservations of rights letter, scope of coverage issues, and other areas of possible conflict between insurer and insured. Finally, we examine some practical issues that face securities industry professionals involved in arbitration and litigation disputes from the standpoint of working effectively with their insurers, while preserving their rights as insureds.

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SCOPE

Today, most policies are Claims Made Policies, i.e. they cover “any loss arising from claims first made against the insured during the policy period or the extended reporting period (if applicable) ...[what is known as a ‘tail’])” resulting from the "rendering of or failure to render professional services" in connection with the named insured entity acting as a registered broker-dealer and/or investment adviser and the individual insured acting as a broker-dealer registered representative or an investment adviser representative. The scope provision or a policy endorsement can refer to a "Retroactive Date"; i.e., even though a claim is made within the policy period if the underlying conduct giving rise to the claim occurs prior to a fixed and negotiated date, coverage does not exist. The date assigned can relate to the dollar amount of the premiums charged.

“Professional services” typically means “the purchase, sale, or servicing of securities... on behalf of a customer or client... pursuant to a written agreement between the Broker-Dealer [or Investment Adviser] and its customer [or client]” and means also for the customer [or client] “the purchase or sale of life, accident and health or disability insurance, whether purchased through the broker-dealer or directly from a life insurance carrier if the registered representative is licensed with or in contract with the insurance carrier.” Professional services also includes “the purchase, sale, or servicing of life, annuities or variable annuities, but only with respect to products that have been placed with an insurer that has an A rating.” Typically, the insured receives coverage for “providing brokerage services for individual retirement accounts, Keogh retirement plans and employee benefit plans...” and the firm and its Representative are covered as well for “... providing economic advice, financial advice or investment advisory services...[and] financial planning advice.” However, what is and is not within the scope of professional services is often unique to the insurer’s underwriting policies. Great care should be taken in reviewing the policy in the application process. There is coverage for these products and services if they have been “previously approved by the broker-dealer.”

In addition to coverage being limited to “professional services,” the claim must relate to “wrongful acts,” as defined. “Wrongful Acts” can mean any “[negligent] act, error or omission by the Broker-Dealer or by any director, officer, partner, employee or registered representative thereof [that causes economic harm], solely in their respective capacities as such.” As discussed, this wrongful act must occur after the specified "retroactive date," if such exists.

THE EXCLUSIONS

Typical product exclusions involve “advice in connection... [with] commodities, futures contracts, cont'd on page 3
forward contracts or any type of uncovered option or futures or option contract... any collectible... or any other tangible personal property...; any equity security which is not traded on a United States National Securities Exchange and is priced under $5.00 (i.e., “penny stock”) at the time that the wrongful act triggering such claim occurred... [and] annuities used in connection with any structured settlement.” Policies also exclude viatical settlements. Not only are the foregoing exclusions operative with respect to indemnity coverage but sometimes defense coverage is not provided, i.e., where there are claims “alleging, arising out of, based upon or attributable to transactions” involving the exclusions. (Emphasis Added)

Other exclusions typically involve clearing agency functions, acting in the capacity as an actuary, attorney, accountant, real estate agent, tax preparer, a representative before the IRS and third party claims administrator, as well as acting as a trustee, fiduciary, partner, officer, director, managing general partner of an entity “other than that of the broker-dealer.” What if the entity is dually registered as an investment adviser or affiliated with an investment adviser? Is the firm not covered as an investment adviser? This is precisely what the firm’s insurance broker and counsel should attend to so that the coverage also includes the organization or its affiliate for investment adviser services.

Other exclusions can involve “alleged” (and/or) arising out of, based upon or attributable to sexual discrimination and harassment; “bankruptcy, insolvency, the appointment of a conservator, receivership or liquidation of... any broker or dealer in securities or commodities clearing agency, any bank...any insurance or reinsurance entity”, although the exclusion will usually not apply to an investment in the stock of any such entity, diminution in the value of securities other than diminution “due solely to a wrongful act for professional services”; damages to tangible property other than damage resulting from the loss of client records; employee benefit plans or trusts owned or managed by any insured or in which the insured participates as a fiduciary or where the insured is an administrator or fiduciary under the Employment Retirement Income Security Act of 1974 (ERISA); “any mechanical or electronic failure, breakdown, malfunction or unauthorized access to... any computer system... or information transmission system in any digital electronic or mechanical system or unit; investment banking activity; management services for entities other than the broker-dealer; express warranties, guarantees or hold harmless agreements; misappropriation for funds or accounts; misusing or aiding and abetting the misuse of non-public information, and infringement of intellectual property; and misappropriation of trade secrets, passing off, plagiarism or unfair competition. (Emphasis Added)

Other typical exclusions that involve described conduct are the following: (1) criminal, fraudulent or dishonest conduct; (2) unjust enrichment; (3) conduct causing bodily injury, emotional distress, mental anguish, sickness, disease or death; (4) money laundering; (5) solicitation or receipt of excessive, additional, undisclosed or improper compensation relating to an offering or compensation greater than disclosed in the prospectus or registration statement; (6) improper solicitations or tie-in agreements and violations of (a) Regulations S-K (non-financial item disclosure), (b) the SEC’s Regulation M (which governs the activities of underwriters, issuers, selling securities holders, and others in connection with offering of securities), or (c) NASD Conduct Rules 2110 (Standards of Commercial Honor and Equitable Principles of Trade) and 2440 (Fair Prices and Commissions in the over-the-counter market).

Additional exclusions are for claims or circumstances “which might lead to a claim in respect of which any insured has given notice to an insurer under any other policy in force prior to the effective date of this policy” and claims “arising out of any acts, errors, or omissions which took place prior to the effective date of this policy, if any insured on the effective date knew or could have reasonably foreseen that such acts, errors or omissions might be expected to be the basis of a claim.” These exclusions protect the insurer from actual or constructive fraud in the inducement of the policy. Typically, the duty to defend is broader than the duty to indemnify and the presence of one covered allegation can result in the insurer’s obligation to provide a defense even if the conduct ultimately proven is non-covered. The mere allegation of criminal conduct should also receive defense coverage.

**INSURER/INSURED OBLIGATIONS**

Typically, the insurer has the right and duty to defend thus implying that the choice of defense counsel, absent a conflict between insurer and insured, is the sole decision of the insurer. When is the insured entitled to select counsel and not have his coverage prejudiced? The right arises when there is an actual or potential conflict between the insured and insurer, usually evidenced by a reservation of rights letter sent by the insurer to the insured. When this occurs, the insured can usually select counsel with the reasonable expenses thereof to be paid by the insurer. However, incurring reimbursable defense expenses (legal, expert or otherwise) and entering into a settlement can usually only be done with insurer’s consent.

Policies often have “hammer clauses.” These provide that, if the insured refuses to consent to a settlement offer within policy limits that is acceptable to the claimant, and a judgment is then entered exceeding the settlement offer, the insurer is not liable in excess of the dollar amount of
the prior available settlement offer. In other words, by refusing the available settlement offer, the insured has taken on all liability in excess of that amount of that offer.

The insured also generally has the duty to report in writing and in sufficient detail “complete details of the claim, the exact date the claim was first made, the location, the circumstances giving rise to such claim, the identity of all claimants and a full description of the nature and scope of the alleged damages” and “every demand, notice, summons or other process received by it or its representative.” Timely reporting of not merely an actual claim but “circumstances and reasons for anticipating a claim” is obligatory, and if the obligation is discharged “for the purpose of... [the policy]... the claim when it is eventually asserted will be treated as a claim made at the time such written notice was given to... [the] underwriters.” Timely reporting of such circumstances locks in coverage. The date of mailing will be the date of notice. In the absence of a timely report of a claim, coverage can be lost.

In the event of payment by the insurer, under the policy the carrier shall have right of subrogation to the insured’s rights of recovery that would include other brokers and broker-dealers.

DEFINITIONS

Important and typical definitions are as follows:

The “named insured” is the broker-dealer or investment adviser organization to which the policy is issued. In contrast, the term “insured” generally means “any past, present or future director, officer, partner or employee of the broker-dealer” and any past, present or future registered representative... for acts on behalf of the broker-dealer.

Claims expenses “shall mean those reasonable fees, costs and expenses incurred by outside legal counsel selected... [by or with the consent of the carrier].” Claims expenses typically do not include reimbursements of expenses for the insured’s in-house counsel.

The term “criminal conduct,” which is universally excluded from coverage, means “conduct that constitutes (or would constitute) a criminal offense in any part of the world.”

Loss means “damages and claims expenses which an insured is legally obligated to pay as a result of a claim” but not (1) “fines, sanctions, taxes or penalties imposed by law”; (2) “salaries, wages, fees, overhead or benefit expenses...”; (3) compliance costs for any settlement or non-monetary award; (4) restitution or return of fees, commissions, and other compensation; (5) civil, regulatory or criminal fines or penalties or punitive damages; and (6) costs automatically assessed by operation of law.

RETENTION

Often, claims expenses may be applied against the limits, which means that the insurer’s payment of legal defense costs adjusts the limits downward. Sometimes defense costs do not reduce the limits for indemnity coverage. Higher dollar coverage is generally at a reduced premium because of the retention of a significant dollar amount of the risk by the insured. Membership in an organization (not an insurance carrier) that provides prepaid defenses, coupled with what is in essence catastrophic indemnity insurance, now appears to be the right step forward for the financial services industry and its personnel.

COVERAGE ISSUES

Usually, the named insured has a right to purchase an extended reporting period for an additional premium to cover claims made during a specified period of time after the normal termination date of the policy. Claims made and reported during this period are generally covered as long as the alleged acts giving rise to the claim occurred prior to the normal termination date.

Notice by the named insured to purchase this coverage, also referred to as “tail coverage,” usually must be given at least thirty (30) days after normal cancellation or expiration. The extended reporting period is not available where cancellation or non-renewal is due to non-payment of the premium.

The policy typically is in excess of other applicable insurance, “unless such other insurance is written only as specific excess insurance over the Limits of Liability of... [the] policy.”

Innocent insurers remain covered when the exclusion for fraudulent, dishonest or criminal acts applies. An innocent insured is one “who... did not personally commit or personally participate in committing such act; did not willfully violate the law; did not gain a profit or advantage, and did not personally acquiesce in or remain passive after having personal knowledge or becoming aware” of the misconduct. A showing of intent or willfulness should be required to defeat an insured’s status as an innocent insured.

Arbitration to resolve coverage disputes is sometimes provided for in the policy; however, usually the insured is forbidden from instituting any action or arbitration proceeding against the insurer unless as a condition precedent there has been full compliance with all the terms of the policy.

The policy is non-assignable and can be canceled by the “First Named Insured” on written notice and by the insurer typically on written notice not less than sixty (60) days after the insurer’s cancellation notice, except when there is non-payment of premium, and then the policy may be cancelled ten (10) days after notice. Some policies have a feature providing
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that if an individual insured continues paying premiums after cancellation of the policy, even if that insured is not the named insured, the policy will not be canceled as to that individual insured.

In sum, as discussed more fully in other sections, coverage issues typically arise when the exclusions in the policy preclude not merely indemnity coverage but also the insured's right to a defense because there is not a single covered claim in the pleadings.

APPLICABLE LAW AND ISSUES

As stated, the typical policy is a claims-made policy (as opposed to an occurrence policy) having a "double trigger," meaning that the policy provides coverage as long as the claim is both made against the insured and reported to the insurer during the policy period (with the acts sued upon occurring after the retroactive date, if the policy has a retroactive date). In Checkwrite Limited, Inc. et al. v. Illinois National Insurance Company, the Court observed "[t]he term 'claim' as used in liability insurance policies has generally been found by courts to be an unambiguous term that means a demand by a third party against the insurer for money damages or other relief owed." When the claim was made during the policy period and the alleged act giving rise to the claim occurred after the retroactive date (because there was "a written demand by a third party for monetary damages...[by] a demand for arbitration"), the policy's coverage was applicable.

The policy's coverage is triggered by the timely reporting of the claim to the insurer. To escape coverage, it is the insurer's burden to dispel any ambiguity in the language of the policy and show facts upon which a court would grant summary judgment in its favor that the acts and omissions are not within the insurer's scope provision and/or squarely within an applicable exclusion. In General Insurance Company of America v. City of New York, et al., it was held that "...[w]here an insurer seeks to escape coverage by virtue of an exclusion...the insurer will be relieved only where it can 'demonstrate that the allegations of the [underlying] complaint cast the pleading solely and entirely within the policy exclusions, and, further, that the allegations, in toto, are subject to no other interpretation.' " If the insurer disclaims and there is a judicial determination of coverage, the insured is entitled to his or her legal fees incurred in defending against the insurer's disclaimer action.

Some courts have considered an insurance policy to be a contract of adhesion. As noted in Castleberry, et al. v. Goldome Credit Corporation, et al.,

The rule in question exists within the context of insurance law and reflects the exigencies of insurance situations. "[I]ndustrial insurance policies, while contractual in nature, are certainly not ordinary contracts, and should not be interpreted or construed as individually bargained for, fully negoti-ated agreements, but should be treated as contracts of adhesion between unequal parties..." Courts have interpreted insurance contracts according to the rule of contra proferentem, resolving ambiguities against the insurer... 'Most American Courts apply a rule of construction that coverage terms are construed broadly and exclusions and limitations of coverage are construed narrowly'. In particular, an insurer's contractual duty to defend its insured is read broadly.

The rationale for the application of the traditional rules of interpreting any ambiguity in the policy in favor of finding coverage is that the insurance policy is generally an adhesion contract and therefore the insured has no ability to negotiate for or control the wording of the provisions contained therein. This liberal rule of construction is particularly appropriate in determining the insurer's duty to defend the insured from claims potentially with the scope of the policy coverage...

Thus, "[a]n insurer's duty to defend is triggered whenever the allegations in a complaint, liberally construed, suggest a reasonable possibility of coverage, or when the insurer has actual knowledge of facts establishing such a reasonable possibility. An insurer may be relieved of its duty to defend only if it can establish, as a matter of law, that there is no possible factual or legal basis on which it might eventually be obligated to indemnify its insured, or by proving that the allegations fall within a policy exclu-sion.

The duty of defense cannot be denied when "the underlying action against defendants, may be 'within the embrace of the policy ... [h]e plaintiff must defend defendants therein'" (emphasis added). As a matter of law, it is virtually impossible for an insurer to avoid its defense obligation if the allegations potentially fall within the coverage provided, 'or when the insurer has actual knowledge of facts establishing a reasonable possibility of coverage.'"

In Allianz Insurance Company v. Regina Heimer, et al., the United States Court of Appeals for the Second Circuit made it clear that even if the insurer is discharged from its duty to indemnify, it is not excused from the duty of defense. The Second Circuit held in this recent case as follows:

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Thus, for the Insurer to be relieved of their duty to defend, they bore the heavy burden of demonstrating that the allegations of the complaint cast the pleadings wholly within the exclusion, that the exclusion is subject to no other possible factual or legal basis upon which the insurer may eventually be held obligated to indemnify the insured under any policy exclusion.

The Court also held there must be a showing that “there is no possible factual basis” for inclusion in the policy’s scope. It is universal law in the United States that “an insurer’s duty to defend against liability under an insurance policy is surely broad.”

In New York a determination of an insurer’s duty to defend is not merely based upon, and is clearly not constricted by, the pleadings. In Burke et al. v. ULICO Casualty Company, et al., supra, it was held that “under New York law an insurer’s duty to indemnify is determined not only from the pleadings but from the actual facts” in the course of the litigation. As far as the duty to defend is concerned it is “broader than the duty to indemnify [and the] former duty may arise before facts are sufficiently developed to determine [the] latter duty.”

An insurance policy can have a fatal ambiguity that clearly works in the insured’s favor. Burke v. ULICO Casualty Company, et al., supra, further holds “(i)n the context of an insurance contract … New York law requires that any ambiguity with respect to an exclusionary clause must be resolved in favor of the insured as a matter of law.”

When there is a disclaimer (i.e., an upfront denial of defense, as well as indemnity) or when the insurer sends out a reservation of rights letter (i.e., undertaking the defense but advising there is a significant possibility of a denial of indemnity coverage because of an applicable exclusion), the language of the policy has to be carefully read not only in terms of the dictionary and plain meaning of the policy language, but in the context of the customs and practices of the securities industry. The law is clear that when there is a reservation of rights because of the conflicts of interest in the insured-insurer relationship, the insurer is entitled to choose counsel with the reasonable expense thereof to be borne by the insurer.

PRACTICAL ISSUES

Every professional liability policy presents issues because of the practical context in which the professional operates within his industry. It is certainly no different in the securities and financial services industry. What happens when the individual registered representative moves with his accounts from one introducing broker-dealer to another, all within the same clearing system, and the transfer of the accounts occurs merely when a letter of authorization (“LOA”) is executed by the customer without the re-execution of new account forms and agreements? Does a written agreement between the customer and the new Named Insured Broker-Dealer exist as the latter’s policy requires? If substantial losses occurred at the first introducing Broker-Dealer, does the new broker/dealer’s claims made policy preclude the losses, realized or unrealized, that occurred when the account was with the registered representative at the preceding broker-dealer? What is the unambiguous language of preclusion that cuts off a claim for preceding client loss? Is there an “other insurance” or an “excess insurance” clause, and what, if any, effect will that have in respect to the policy’s coverage?

If the Statement of Claim appears to allege claims against the insured registered representative that are exclusively within the policy’s exclusions, and the registered representative denies offering and selling the excluded products, is the insured’s right to a defense under the policy defeated? If the proposition is that the duty of defense is broader than the duty to indemnify, then how can the duty of defense not exist? How should the insured and his or her counsel approach such an issue? How could a duty of defense not exist in a context where a professional claims his or her innocence of the alleged misconduct? The innocent insured is protected when others within the scope of coverage are clearly implicated in wrongdoing and excluded by the policy. Similarly, a claim of innocence with respect to claims wholly within the exclusions should warrant defense coverage as well.

What happens if the insurer contends that the claim was not timely reported within the policy period? When is a claim reported? When it is transmitted by mail or received, and does it matter whether the insurer can show prejudice caused by the lateness in reporting? Claims and potential claims should be timely reported as coverage can be locked in even if a claim is not yet formally asserted. While absolute comfort cannot be drawn, and the better solution is to report even circumstances that could result in a claim, even though no claim has yet been asserted, the acceptable approach in reliance upon the applicable law is to report the claim “as soon as practicable within the policy period.” The law on this point can be summarized as follows:

If the insureds have to “report” claims in writing before the policy expiration, the term “report” should be given its dictionary meaning, i.e., “to give an account of; relate, tell; to serve as carrier of (a message); to prepare or present (as an account of an event)…[and] to make known to...” the insurer. “Report” denotes and connotes the communicator’s expression and not the listener’s or reader’s receipt of the information; it is the point of output and not input. It is well established that reporting occurs

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at the point of mailing. If the insurer has the envelope that transmitted the notice, the postmark should demonstrate that the “report” was made or not made before the policy’s expiration. If the insurer no longer has the envelope, which is the best evidence, it is not likely that any court or arbitration panel would rule in the insurer’s favor and permit the insurer to contradict the insurer’s testimony that the claim was timely reported. The insured should also send all written communications by fax and/or registered or certified mail, return receipt requested, to evidence the time when the notice is given.

Within the policy period, the claim has to be reported “as soon as practicable,” and that standard imports good faith and reasonableness. When written notice is an issue, make sure that the context of the notice demonstrates that a timely report “as soon as practical” was made, especially and even where no losses have, at the time, been realized. Take steps so that the insurer cannot argue that claim was not reported as soon as practicable.

It is also important in most states, in order to protect coverage, to establish that there was no prejudice to the insurer as there was no formal claim at the time of the report and that the insurer could not have eliminated or mitigated any cost or harm at this point. In this factual context, New York law, in contrast to other jurisdictions, traditionally does not require an insurer to show prejudice before a late notice claim can prevail. However, reference should be made to the case, Brandon v. Nationwide Mutual Insurance Company in which Chief Judge Judith Kaye of the New York Court of Appeals articulated when the “no-prejudice” rule (that it is anticipated the insurer will advocate) does not apply. The Court held:

Generally, one seeking to escape the obligation to perform under a contract must demonstrate a material breach or prejudice. By allowing insurers to avoid their obligations to premium-paying clients without showing prejudice ... [this Court in 1972] created a limited exception to this general rule. The rationale for this limited exception include the insurer’s need to protect itself from fraud by investigating claims soon after the underlying events; to set reserves; and to take an active, early role in settlement discussions.... Finding these factors inapposite ... we [decline] to extend the ... no prejudice exception ....

Notwithstanding the above quotation, the law now in New York generally is that coverage can be disclaimed absent a showing of prejudice. Most other jurisdictions, however, require prejudice and this appears to be the trend in New York based on the above-cited case.

For policies written by insurers governed by New York Insurance Regulations, 11 NYCR §73.3[3][1] accords an automatic sixty (60) day reporting period following termination of a policy, and accordingly the reporting of a claim, when made within the prescribed period of the State’s statute and/or rule setting a time mandate to report, arguably is deemed timely; even if the notice of the potential or actual claim is received on the day after the policy’s expiration. New York Insurance Regulations thus provides for an automatic sixty (60) day window so claims reported after the policy’s termination will receive coverage. Further the exception cannot apply when there were no actual losses and no formal arbitration claim was made until after the point in time when the notice was given, and received by the insurer as there is not even the remotest possibility of any prejudice at this point in time.

It is conceivable that a claim can be made shortly before policy expiration, timely reported, and there is language in the policy to the effect that notice of a claim is reported “upon receipt” by the insurer, and not received until after expiration. Construction of a policy, unless the language is manifestly unambiguous, must be made in favor of the insured.

Under such circumstances, regulators would and should question the disclaimer. Such a policy construction would lead to a practice in violation of Section 2601(a)(1) of the New York Insurance Law (i.e., “knowingly misrepresenting to claimants pertinent facts or policy provisions relating to coverages at issue”), and (2) (i.e., “failing to acknowledge with reasonable promptness pertinent communications as to claims arising under its policies”) as it would, without plain English disclosure, possibly construe the coverage that explicitly exists in the policy. This certainly would be to the detriment of the insured. Litigation, however, in this context has not created settled authority. In all circumstances, however, the earliest possible report of a potential or actual claim is the best practice.

OBSERVATIONS AND RECOMMENDATIONS

If the broker-dealer is dually registered as an investment advisor and if the customer-client has given the investment adviser/broker-dealer more than limited discretion pursuant to a written authorization in compliance with NYSE and NASD Rules, the coverage should not be excluded. In this instance negotiation with the insurer through the insurance broker for an appropriate endorsement should be pursued. Further, a mere “allegation” of the excluded activity or product should not automatically defeat coverage, both defense and indemnity, until arbitrators render a reasoned award specifically describing the product and the activity upon which the award was based. If no
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reasoned award is rendered, as is usually the case, the insurer is in a less defensible position on its denial of coverage, when any allegation has been made that is arguably within the scope of policy coverage.

A policy should also provide for defense coverage for alleged fraudulent conduct and indemnity for non-scienter fraud and/or breach of fiduciary duty, and coverage should not be restricted in essence to negligent conduct. Covered wrongful conduct should not be restricted to negligent acts or omissions, as in the securities context, non-scienter fraud, breach of fiduciary duty, and failure to supervise claims are fairly typical. Coverage should be provided whenever there is an act or omission that causes actual monetary harm – not specifically excluded.

Furthermore, the fraud-criminal conduct exclusions should only be invoked and properly applied when the panel enters a reasoned award that the wrongful conduct was intentional. Negotiate to make the scope paragraph apply to any wrongful conduct except intentional fraud. Otherwise, there is a risk of artificial apportionment of the damages based on the claims asserted.

CONCLUSION
Professional Liability Insurance for the Investment Professional should not be a take-it-or-leave-it proposition for the investment professional. There should be both negotiation of the forms and endorsements as well as effective advocacy on behalf of the insured when a coverage dispute arises with the insurer. Effective advocacy can oftentimes be more readily achieved when brokers and investment advisers have memberships in professional associations that, as part of their member benefits, provide prepaid defenses and attorney referrals utilizing a network of experienced securities counsel. In today's environment this is essential backup for the investment professional, especially where there is a reservation of rights by the insurer. Insurers working with such associations should also utilize organizations of forensic experts that can conduct periodic mock SEC- and NASD-like inspections to assess risk and manage those risks so that loss experiences can be minimized or prevented.

ENDNOTES
1 If "negligent acts or omissions "is in the language of the scope provision it is too restrictive. The provision should just refer to an act or omission that causes economic harm. The exclusions then strike a proper balance and the scope paragraph will not be restrictive or deceptive.
2 Utilizing an exclusion to preclude defense coverage and not merely indemnification is a substantial dilution of the professional liability insurance policy and the purpose for which the insured pays their premiums.
20 Id.
21 Id.
The Sentinels, Madoff And Dodd-Frank Reform

By Norman B. Arnoff, Esq.*

INTRODUCTION & STATEMENT OF PURPOSE

This article in respect to Madoff’s fraud is not intended as a criticism of the SEC, the legal or accounting profession, or those who invested and traded through private equity and hedge funds. Nor is it the author’s intention to ascribe responsibility for the fiasco to one group or organization as opposed to others. The purpose is to achieve through an analysis a fair perspective of the systemic problems in our law and practices which allowed the Madoff Ponzi scheme to continue for the extraordinary length of time that it did. Hopefully in this manner we can take and continue to take such remedial steps as will avert such devastating frauds in the future.

Reform on Wall Street cannot come about by demonstrations, but by careful analysis of systemic problems and the vigilant responsibility it hopes to achieve. Lawyers and accountants serve as our sentinels to preserve the integrity and transparency of our capital markets and ultimately the protection of public investors. In virtually every high profile and complex securities proceeding, whether in the civil litigation or regulatory contexts; professional responsibility and liability is an issue. The role of the auditor as a sentinel in our financial markets is an important piece of the whole and will be the focus of this article.

Generally, the courts have addressed auditor liability, with respect to the hedge funds that invested their client funds through Madoff by declining to extend auditor’s responsibility beyond the feeder fund financial statements, i.e., no liability for transactions by and between the feeder fund and third parties (e.g., custody arrangements).

Adherence to the privity rule, which restricts liability to only those who were engaged by contract, avoids subjecting the accounting professional to indeterminate liability to an indeterminate group. Functional privity or “near privity” improves protection for those who depend on the accountants and their work and services, if the accountant knows who will be relying on the financial statements in respect to specific transactions. If, however, the authoritative literature prescribes certain audit procedures that are not followed, and it is apparent that investors will be harmed thereby, then there should be liability. The law is still developing and certainly Dodd-Frank will impact that development.

The Accountant’s Role

Judge Henry J. Friendly, commenting on the role of the legal and accounting professions, wrote:

‘In our complex society the accountants’ certificate and the lawyer’s opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar. Of course, Congress did not mean that any mistake of law or misstatement of fact should subject an attorney or an accountant to criminal liability simply because more skillful practitioners would not have made them. But Congress equally could not have intended that …{persons} holding themselves out as members of these ancient professions should be able to escape criminal liability on pleas of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.’ (Emphasis Added)

In light of what transpired in respect to Madoff and the lessons learned, as well as the legislative, organizational, and professional reforms that are being put in place, it is hoped and expected that the professions, the regulators and the courts, will no longer “shut their eyes to what …{is} plainly to be seen.”

In reviewing a series of cases involving the fraud perpetrated by Bernard Madoff, using a series of feeder funds in order to pass investors’ funds into the fictitious accounts of his colossal Ponzi scheme, it is clear, in this author’s view, that most of our courts have not placed the responsibility they

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should upon the auditors and accountants for the feeder funds. In consequence, this has dramatically diminished the ability of investors to pursue a viable recovery source.

This systemic weakness in the law of professional liability, especially as it should apply in our capital markets and to the financial services industry, lets the insurance carriers off the hook in not merely having to compensate investor loss but also virtually eliminates a level of effective self-regulation through the insurer’s underwriting practices. Where there is no recognizable risk of liability, there is no need of insurance and the underwriting by the insurers that can achieve loss prevention.

The law is moving away from “privity” and “near privity” to known reliance on an accountant’s work and services in establishing liability. Assessing the accountant’s awareness of who is relying upon the financial statement may be a prudent and fair means to define the accountants’ professional liability risk in commercial lending and private securities transactions, when defined and relatively limited groups are dependent and/or rely upon the accountants’ services and work product. Such assessments are not and will not be a fair and effective way for the law to establish what the accountants’ professional liability risk should be in other contexts, such as what occurred in regard to the Madoff fraud. When the public interest is so important a factor, there has to be a different basis for determining liability.

Auditors of public issuers, broker-dealers, and investment advisors are integral to the integrity of the markets. It is the premise of this article that more progress in the law has to be achieved through the recognition that self-imposed professional standards are the best way to resolve professional liability issues. In that regard, the Dodd-Frank Wall Street Reform And Consumer Protection Act (“the Dodd-Frank Act”) has made significant advances to assure against audit failures and make it clear our accountant watchdogs and other gatekeepers cannot any longer avoid their responsibilities.

**The Madoff Accounting Litigation**

The Madoff accountants’ liability litigation that has taken place in our state and federal courts in the last three years should be given important consideration in now setting the parameters of professional liability risk. *Baker v Andover Associates Management Corp. et al* [2] is, and it describes, the prototypical Madoff - Accountants’ case as follows:

The action seeks to address losses sustained by an investor as a result of the Ponzi scheme run by Bernard L. Madoff. Here, plaintiff-investor seeks to recover her losses from the investment group to whom she entrusted her money and from the group’s auditors. The investment group served was one of the funds which fed investors’ money to Madoff and the entities he controlled.
**Privity and Near Privity**

The accounting firm in *Baker* responded to Plaintiffs’ allegations that they were not engaged by Plaintiff and that she could not be a third-party beneficiary of their engagement between the accountant and the feeder fund. Plaintiff did not make any allegations that she reviewed or relied upon the financial statements for which the accountants were responsible and certainly there was no awareness of or acknowledgment by the accountants of such reliance. Accordingly, the Court held Plaintiff did not satisfy “the elements necessary to plead a near privity relationship with the accountants.”

The Court adopted the accounting firm defendants’ argument. In the absence of a formal client relationship, the plaintiff had to establish that the accountants were aware that the plaintiff, or a defined group in which the plaintiff was a member, would be relying upon the financial statements that they audited or reviewed in connection with a particular transaction.

The Court dismissed Plaintiff’s complaint in *Baker* for negligence and negligent misrepresentation on traditional privity grounds.

In *Hecht v Andover Associates Management Corp et al* [3] a derivative action was brought on behalf of a limited partnership that was the conduit to place the investors’ funds with Madoff. In this case, however, the negligence and negligent misrepresentation causes of action were not dismissed. Clearly the limited partnership was within the parameter of professional liability risk, if it and not the investors brought the case. The Court’s analysis was as follows:

The threshold question in any negligence action is whether defendant owes a legally recognized duty of care to the plaintiff... The duty is defined “by balancing several factors, including the reasonable expectations of the parties and society generally, the proliferation of claims, the likelihood of unlimited or insurer like liability, disproportionate risk and reparation allocation, and public policies affecting the expansion or limitation of new channels of liability... Foreseeability alone does not define duty - it merely determines the scope of the duty once it is determined to exist. The injured party must show that a defendant owed not merely a general duty to society but a specific duty to him or her, for without a duty running directly to the injured person there can be no liability in damages, however careless the conduct or foreseeable harm. (Emphasis Added)

The broad formulation stated above goes beyond the narrow criteria of “privity” or “near privity” and therefore is helpful. There is little precision to the Court’s analysis, however; and it is easy to see in the context of today’s financial marketplace that the necessary guidance to determine the accountants’ professional liability risk is not provided. Professional standards have to and should be looked to in making a correct analysis of the accountants’ liability exposure, both in respect to professional malpractice, but fraud claims as well. This method can fairly define risk, justly compensate loss, and deter negligence and misconduct. It is the balance that needs to and can be achieved.

The Court in *Hecht* held:

Accounting malpractice contemplates a failure to exercise due care and proof of a material deviation from recognized and accepted professional standards for accountants and auditors. Plaintiff must establish that defendant departed from generally accepted accounting principles and the departure was the proximate cause of plaintiffs’ injury... Giving plaintiff the benefit of every possible inference, the Court must assume that an audit of Andover Associates’ investments conducted pursuant to generally accepted auditing procedures would have uncovered Madoff’s fraud. Although ...(the accounting firm) was retained after plaintiff invested in Andover Associates, the Court must assume that a proper audit would have provided Andover with the opportunity to liquidate its investment... Thus, plaintiff has sufficiently alleged that... (the accounting firm’s) departure from generally accepted auditing procedures was the proximate cause of the loss of Andover’s investment. (Emphasis Added)

Analysis of the two cases shows that the progress in the law will be better achieved by moving away from the formalities of a contractual or quasi-contractual relationship as a way of defining the accountants’ professional liability risk to the more rooted and definitive standards established by the accounting profession itself.

Other cases also show the limitations of not paying sufficient attention to professional standards to define the parameters of the accountant’s liability risk. Illustrative of the foregoing proposition is *In re Tremont Securities Law, State Law and Insurance Litigation 4]. There, the Court held, merely “alleging a shoddy audit in violation of GAAS does not establish the intent to defraud required to maintain a claim for securities fraud.” Further, as to the negligence and negligent misrepresentation claims, the Court rejected the “plaintiffs’ proposed inference that the auditors did not comply with GAAS because they ignored the ‘red flag’ warnings and... {thereby} failed to uncover the Ponzi Scheme.”

According to the Court’s flawed logic, the better explanation “as to why Madoff’s fraud went undetected for two decades was his proficiency in covering up his scheme and eluding the SEC and other financial professionals.” This is troublesome, because our capital markets are not wastelands with the regulators and self-regulators being the only responsible parties to prevent fraud and other forms of financial wrongdoing. It is precisely the professional’s standards of care, adopted reflectively, that anticipate the risks that must be avoided; those standards, if disregarded, should serve as a basis for a fair liability.

The Court in *Tremont* also went on to restrict liability on formal contract principles, as follows:

But most critically, the auditors were never engaged to audit Madoff’s...
businesses or to issue an opinion on the financial statements of BMIS [Bernard L. Madoff Securities LLC]. The auditor’s only role is that they audited the financial statements of the… Funds... The notion that a firm hired to audit the financial statements of one client... must conduct audit procedures on a third party... that is not an audit client... on whose financial statement the audit firm expresses no opinion has no basis. To impose liability on the auditors would expand their limited circumscribed duty impermissibly... (Emphasis Added).

This aspect of the holding is also flawed, because an audit of the feeder funds is not being extended to an audit of Madoff’s broker-dealer and/or investment advisor, only to the investment transactions and custodial arrangements between the entities that materially impact the financial statements the accountant is being called upon to audit. Looking at the accountants’ professional standards, however, would not be an impermissible expansion but the fairest and most appropriate means to define the scope of the professional’s responsibility and liability.

**Statutory Preemption of Professional Malpractice Claims**

In New York it is also settled law that professional malpractice and constructive fraud securities law claims are subject to Martin Act Preemption pursuant to N.Y. Gen. Bus. Law 352-c(1), i.e., the New York Attorney General has “sole authority to prosecute state law claims involving securities and sounding in securities fraud that does not require proof of intent to defraud or “scienter” 5). In essence, preemption operates as a ‘qualified immunity,” because it is obvious the Attorney General does not have the resources to pursue civil recoveries for public investors on a broad basis sustaining loss by reason of non-intentional fraud and/or professional malpractice in connection with securities transactions.

**VIOLATION OF PROFESSIONAL STANDARDS AND RED FLAGS**

Insulation from professional malpractice liability in this context relies upon a combination of the following legal conclusions: (1) “red flags” as to possible violations of professional standards and a disregard of the profession’s authoritative texts, in and of themselves, do not establish “scienter” or recklessness; and (2) in any event, no duty exists upon the part of the feeder fund auditors to verify whether in fact Madoff was actually making legitimate investments and whether the performances being reported were truthful. 6]

Stephenson v Citco Group Ltd. et al 7] addresses the issue of GAAS and GAAP violations. The Court held that failure “to adequately investigate does not satisfy the scienter element of plaintiff’s fraud claim” and even “in the accounting context ‘failure to identify problems with the… {client} company’s internal controls and accounting practices does not constitute recklessness’ …” However “GAAP violations and investigatory failures … can when combined with allegations that the auditor ignored red flags” be legally sufficient. This is problematic because of the uncertainty of when the threshold is met.

The bar is also too high in Stephenson. Only “complaints alleging that an auditor had actual knowledge of and/or consciously disregarded red flags may have been found to be sufficient to plead “scienter” (Emphasis Added). Besides the GAAS and GAAP violations, there must be “additional facts showing that there were numerous red flags that… [the] [auditor-defendant] must have been aware of, if it were conducting any kind of audit’ sufficient to create… [a] strong inference of reckless behavior.” A plain disregard of clear professional standards, however, even on one occasion, is intentional or certainly reckless conduct.

Since the complaint did not allege “whether or how … {the accounting firm} acquired knowledge of most of these red flags,” the complaint was dismissed.

**POLICY CONSIDERATIONS FOR LIABILITY EXPOSURE**

Fairfield Retirement Programs et al v NEPC, LLC et al 8] correctly articulated the policy of what must be considered in setting the parameters of professional liability risk and, in so doing, did not dismiss the plaintiff, investor-limited partners’ complaint. The case does hold the auditor did have a specific and independent duty to the limited partner-investors, because the audit reports were specifically addressed and sent to the investors directly. However, the fortuity of this holding is not really an indication that the law is meaningfully moving in the right direction, because, absent the auditor’s communication to the limited partners, the complaint may have been dismissed.

In respect to the policy considerations concerned, the Court in Fairfield...
Retirement Programs explained:
Duty is not sacrosanct in itself, but is only an expression of the sum total of those considerations of policy which lead the law to say that the plaintiff is entitled to protection… The problem for the law is to limit the legal consequences of wrongs to a controlled degree. The final step in the duty inquiry, then, is to make a determination of the fundamental policy, as to whether the defendants’ responsibility should extend to such results. (Emphasis Added)

The Court held:
…[T]he test for the existence of a legal duty of care entails (1) a determination of whether an ordinary person in the defendant’s position, knowing what the defendant knew or should have known, would anticipate that harm of that general nature suffered was likely to result, and (2) a determination, on the basis of a public policy analysis, of whether the defendant’s responsibility for its negligent conduct should extend to the particular consequences or particular plaintiff in the case…The first part of the test invokes the question of foreseeability and the second part invokes the question of policy…[W]e are not required to address the first prong … if we determine, based on the public policy prong, that no duty of care existed.

The Court’s decision did alight upon the important policy considerations in judging professional liability in today’s financial marketplace that hopefully will and should push the law in the right direction. What the courts should consider in more depth is that the best source of duty and the liability that ensues is the accountants’ own self-imposed standards of care.

The Court in Fairfield Retirement Programs addressed the most important consideration of market integrity as follows:

…In the wake of the Madoff morass, many fortunes were ventured and lost… Retirement funds previously believed to be conservatively invested were built upon sand, not rock. The role of the accounting profession has increased in importance as the number and complexity of both securities instruments and securities transactions has increased. As was noted by the Second Circuit, in an era long before the Madoff Ponzi: ‘In our complex society the accountants’ certificate and the lawyers’ opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.’ (Emphasis Added)

Criticism And Further Analysis
The cases and the analysis that they represent are in a dynamic and now uncertain tension. The law legitimately should eliminate the professionals’ liability risk of an indeterminate nature to unidentified groups for an extended series of transactions. However, defining the scope of the accountants’ liability by the formality of “privity” and “near privity” is too narrow and not realistic in terms of what we expect and face in our capital markets and from the financial services industry that serves it. Even making known reliance as the ultimate test will not be fully effectual, unless the courts recognize that implicit in the professional’s standards is not merely what procedures the professional has to follow, but who will be harmed if there is a breach.

Nor does creating statutory preemptions that foreclose certain private causes of action and conferring standing only upon the regulators and prosecutors make sense in view of the limitations of resources of government and regulatory authorities. This author believes that the accountants’ and auditors’ authoritative and textual professional standards will provide better answers for both the accounting profession and society to define the parameters of professional liability.

Two questions to be addressed arising out of the Madoff accounting liability litigation involving his feeder funds are: (1) did the courts correctly apply and should they have applied the “privity” and “near privity” standard to define the accountants’ liability exposure; and (2) would the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) if its enactment predated the Madoff fraud have made a material difference in judging the accountant’s liability exposure in the context of the Madoff fraud? In addressing these issues, we can determine how sweeping is the recently enacted reform legislation. As far as accountant’s liability in relation to the market activity of hedge funds and private equity funds that represent a significant percentage of the trading in our markets, the Dodd-Frank Act should have a positive and material impact.

In view of the lessons from such systemic failures as Madoff’s fraud the mandate is for more certain and better protection for the ultimate investors and as a result the Dodd-Frank Act has taken significant steps to protect the investing public. Progress should not stop because the costs to public investors of frauds of serious magnitude such as Madoff’s and the damage to the perceptions everyone must share, with respect to the integrity of the capital markets and the regulatory framework, are too great.

The AICPA Audit and Accounting Guide for Investment Companies
By assuming a private equity or hedge fund is an investment company but for the exemptions under sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (“40 Act”), one can look to the Audit and Accounting Guide for Investment Companies developed by the AICPA Investment Companies Guide Task Force as a useful source for GAAS and GAAP. The AICPA Audit and Accounting Guide (“Audit Guide” or “AAG”) describes “operating conditions and auditing procedures unique to the investment industry and illustrates the form and content of investment company financial statements and related disclosures. (Emphasis Added)

Chapter 2: Investment Accounts, Investment Objectives and Policies, Section 2.02, provides in pertinent part:
An investment company discloses the investment objectives adopted by its management and the strategies adopted to achieve them in its charter or partnership
agreement and in the documents such as registration statements, prospectuses, or offering circulars. Restrictions, statutory or otherwise, are also disclosed. Those restrictions may include specific limitations or outright prohibition of transactions… [Other] restrictions may include limitations on investing in unregistered securities, making short sales of securities, underwriting securities of other issues, acquiring securities of other investment companies, or using leveraging techniques, such as margin accounts, bank borrowing, and transactions in options and futures. (Emphasis Added)

There are other “specific limitations” and underlying records that will also be subject to audit and testing of whether the “specific limitations” are being observed. Section 31 of the ‘40 Act and the rules under that section require the following records be kept and be subject to audit: “(1) journals or other records of original entry showing all securities purchases, sales, receipts and deliveries, and collections and payments of cash for securities transactions; (2) a record showing the unit, quantity, price, and aggregate costs … for each position and each transaction, as of the trade date…[and] (3) a record for all orders for purchase or sale by or on behalf of the investment company…”

There can be no question that the auditor should consider reviewing the partnership and charter documents as well as the disclosure documents to ascertain the investment objectives, restrictions, organization structure and by necessity the quantity and type of investor class (i.e., members, limited partners, or shareholders).

Further, and especially significant to the Madoff fraud is Section 2.06, Custody of Securities, that in pertinent part states, “[t]he … ’40 Act and the related rules require that securities held in custody by a member of a national securities exchange be inspected at various times by the registered investment company’s independent auditor. The deposited securities are required to be physically segregated and subject to withdrawal only by duly authorized persons under specified conditions. (Emphasis Added).

Pre-audit the auditor must acquire an understanding of the entity and its environment and assess the risks of material misstatement, whether due to mistake or fraud, “and … design the nature, timing and extent of further audit procedures.” (Emphasis Added). Consideration of the possibility of fraud in the financial statement audit is essential to the “auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud…” The Audit Guide requires professional skepticism and the auditors have to consider the possibility of misstatement due to fraud. Two of the areas requiring skepticism are (a) “significant investments for which readily available market quotes are not available and inadequate procedures for estimating these “values” and (b) “unusual and considerable influence of the portfolio manager over pricing sources and fair valuation methodology used to value securities” (Emphasis Added).

A mandatory risk assessment is to be made by the auditor of the “susceptibility of assets to misappropriation… Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets” and is a result of the following:

a. Access to funds and securities and the accounting for them is directly controlled by the adviser, with inadequate segregation of duties (or no direct communication between custodian and accounting personnel) ...

b. Access to records, cash, and securities

c. Infrequent and incomplete reconciliation of securities holdings with the custodian...
obtain a sufficient understanding of the entity and its environment, including the entity’s internal control to assess the risk of material misstatement of the financial statements due to error and/or fraud, and to design the nature, timing, and extent of further audit procedures.” (Emphasis Added).

Applying these principles to feeder funds is revealing. If the feeder fund was dependent on Madoff, what controls existed in reference to what material risks? This consideration had to have and should have been evidenced in the accountant’s work papers or it can safely be concluded there was only a pretense of an audit and arguably then there would be auditor accounting fraud in which the accountant would be complicit. Certainly if these audit procedures are recklessly disregarded and not applied this has to be the case.

The controls that have to be considered are those (1) “covering the receipt of and payment for securities, delivery of securities, and control over cash received; (2) “for physically segregating and satisfactorily safeguarding the company’s securities., in the custodian’s vaults; (3) physical counts of securities and other procedures performed by the custodian’s internal auditors; (4) ... over securities held in central depositories and (5) over receipts of cash including dividend and interest payments”.

Section 2.197 provides “[i]f the custodian has engaged a service auditor to examine the custodian’s description of controls over custodial functions, the fund’s auditor should consider obtaining a copy of the service auditor’s report” and Section 2.198 provides that “[t]he auditor should obtain an understanding of the extent of inter-custodial responsibilities and rights under sub custodial agreements”. (Emphasis Added). What this signifies is that the feeder fund auditor must satisfy himself of the bona fides of the audit of the custodian; these standards predated Dodd-Frank.

Section 11.25 contains an illustration of what the auditor must report on in respect to internal control. The section has an illustrative report on internal control required by the SEC under Form N-SAR. Specifically “[t]he instructions to Form N-SAR further note that the internal control report is to be based on review, study, and evaluation of the financial reporting, including control activities for safeguarding securities.” (Emphasis Added)

The illustrative opinion and/or report states: “we considered the Company’s internal controls over financial reporting including controls over safeguarding securities, as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements.” (Emphasis Added).

Key to any audit are the company’s internal controls because “[a] company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting” and “includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail accurately and fairly reflect the transaction and disposition of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP ... and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of a company’s assets that could have a material effect on the financial statements.” (Emphasis Added).

If the standards set forth above pre-existed the Dodd-Frank Act, it is counter-intuitive to conclude the feeder fund and/or investment advisor auditor could not have discovered Madoff’s fraud. In any event, the Dodd-Frank Act does not merely rest upon the auditing profession’s self-imposed standards but establishes requirements so that the audits of the feeder funds, investment advisors, and broker-dealers will give greater assurance to the most important constituency, i.e., the public investors.

**THE DODD-FRANK ACT**

In respect to Dodd-Frank, Title II, Regulation of Advisers to Hedge Funds and Others, Section 401, (a)(29) states “[t]he term ‘private fund’ means an issuer that would be an investment company, as defined in Section 3 of the...[40 Act] but for section 3(c)(1) or 3(c)(7) of that Act and Section 403 most significantly eliminates by amendment the private adviser exemption (i.e. no registration required for advisers with 15 or fewer clients). Section 404(2) of the Dodd-Frank Act, Treatment of Records, provides “… [t]he records and reports of any private fund shall be deemed to be the records and reports of the investment adviser.”

Section 404(3) provides that “[t]he records and reports required to be maintained by an investment adviser and subject to inspection by the Commission under this subsection shall include investment: a description of “(A) the amount of assets under management and use of leverage including off-balance sheet leverage; (B) counterparty credit risk exposure; (C) trading and investment positions; (D) valuation policies and practices of the fund; (E) types of assets held; (F) side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors; (G) trading practices; and (H) such other information as the Commission, in consultation with the ...(Financial Oversight Council), determines is necessary and appropriate … for the protection of investors or for the assessment of systemic risk...”

Sections 404(4), Maintenance of Records, and 404(5), Filing of Records, requires maintenance of records by the investment adviser of the private fund as provided for by SEC rules and filing with the SEC “... reports containing such information as the Commission deems necessary and appropriate” for the protection of investors or for the assessment of systematic risk.” i.e. the auditor of feeder funds and their advisors will be subject to pro-active rule making. The Dodd-Frank Statute’s pertinent sections do not change what should be audited but only enhance and require further procedures making the audit more effective. This fact coupled with the elimination of the...
private adviser exemption creates far greater transparency.

**Any Kind Of Audit**
The fact patterns presented by the Madoff-accountant’s liability litigation show an actionable basis for investors in the feeder funds to sue the feeder fund auditors for accounting malpractice and fraud (whether it is securities fraud in connection with the initial purchase or subsequently for withholding information that should have been disclosed to the fund’s board and would have caused the investors to liquidate their investments). This is true whether the events predate or postdate Dodd-Frank.

The pertinent portions of the professional standards quoted above demonstrate there were definitive audit procedures with respect to (a) custodial arrangements, (b) specific buy and sell transactions and then pricing; (c) internal controls; and the possibility of fraud and misappropriation risk for funds and securities. The fact that the auditors in advance had to design audit procedures with respect to the risks and those procedures addressed a not insignificant quantity of specific detail demonstrates there were and still are duties to examine the transactions between entities, the pricing and the location of the funds and securities and who had custody. The supporting documentation compels the conclusion that if these procedures were not applied to Madoff in reality there was a mere pretense of an audit. “Any kind of audit” would have discovered the fraud, and that should have been the case even prior to the enactment of Dodd-Frank.

Madoff’s pricing and account values presumptively did not correlate with the true market values. Either there was an absence of the requisite documentation with the necessary detail and/or there would not be any match with what Madoff reported as the pricing and values that had to come to the auditor’s attention if an audit was performed.

In respect to the proposition that mere red flags and GAAS and GAAP violations do not satisfy the *scienter* element (i.e. actual knowledge or reckless disregard), the total incongruity of what Madoff recorded and reported and the real transaction detail should have been easily discoverable “in any kind of audit.”

In reality the transactions were not just between the feeder fund and Madoff, but the feeder fund with Madoff as a conduit and, third party securities traders and custodians. This is the case whether Madoff was acting as an investment adviser and/or broker-dealer. At a minimum there was reckless disregard, because “any kind of audit” would have discovered the fraud.

**The Privity Concept, An Anachronism**
On whether there is a sufficiently alleged accounting malpractice cause of action that can be maintained by the feeder fund investors, the “privity” or “near privity” threshold is easily satisfied. Certainly “near privity” exists if *White v. Guarante* [9] applies.

The case holds that the test is whether “plaintiff seeks redress, not as a mere member of the public but as one of a settled and particularized class.” The case held that the limited partners of a tax shelter limited partnerships which was a hedge fund had standing to sue the auditors who prepared and transmitted materially inaccurate K-1’s. There was “near privity,” because there was known reliance upon the financial statements and financial information by persons within a defined and limited group. There was not uncontrolled risk in respect to an indeterminate class.

In fact the limited partnership agreement should have been one of the first documents the auditor looked at in planning the engagement. In respect to feeder funds most likely they are limited partnerships or limited liability companies so the classes of investors suing are from a defined group evident to the auditor in the charter documents. If proper audit procedures are not followed, the privity concept should not preclude liability. In *Anwar v. Fairfield Greenwich Ltd.* [10] while the Court dismissed the fraud allegations against the auditors, it followed precedent that held:

Violations of professional auditing standards without more, do not constitute strong circumstantial evidence of conscious recklessness…” See: *Novak v. Kasaka,* 216 F.3d at 309. “[A]llegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim. Only where such allegations are coupled with evidence of corresponding fraudulent intent might they be sufficient. ’In re: Tremont Se Law State & Ins. Litg., 703 F.Supp 2d 362,371 (S.D.N.Y, 2010) … ([A]lleging a shoddy audit in violation of GAAS does not establish the intent to defraud required to maintain a claim for securities fraud”).

Based on the detail and clarity of the audit standards, the fraud allegations should have been sufficient. Coupled with “red flags” warnings, “a strong inference of conscious recklessness” should have been permitted. Violations of clear professional standards that do not allow for discretion in their application should establish at a minimum a refutable presumption of actual knowledge or reckless disregard. For any professional to deny that a breach of such standards does not create a foreseeable risk of harm to an investor or lender is to turn reality into fiction.

The Court, citing *White v. Guarante,* did not find there was intention upon the part of the auditor that a specific and known party was to rely on the financial reports. However, where there was reliance upon the financial statements in connection with particular transactions by a known group of investors that was held to be sufficient. The Court held:

...The ‘known’ parties’ prong of the Credit Alliance test does not require an auditor know a ‘particular’ third party by name. Rather it recognizes that, while an accountant does not owe a duty to members of an ‘indeterminate class…, an accountant owes a duty to [members] of a settled and particularized class among the members of which the report could be circulated’…

Thus, implicit in the procedures of what the auditor is required to do is definitely...
who may be harmed. When the public interest is so significantly involved as it was in the Madoff context and, because of the extent of the trading of hedge and private equity funds in our markets, the fair standard for judging liability and its extent is the content and clarity of professional standards.

In respect to the issue of whether the Dodd-Frank Act facilitates or impedes investor actions against feeder fund auditors by reason of the privity rule, most likely the investment vehicles will be limited partnerships or limited liability companies, so the class of investors suing would be from a defined group and the charter documents would be audit evidence of this fact. From this standpoint the statute is neutral.

“Near privity” is a hybrid of contract and tort liability. The auditor’s duties arise out of its contract of engagement and the audit and accounting standards that are both explicit and implicit promises of the engagement contract. The tort component comes from what is considered “reasonably foreseeable”. Based upon pre-existing standards as well as the Dodd-Frank Act, if a feeder fund auditor does not perform the audit as required, it certainly should be reasonably foreseeable that at a minimum the limited partners and LLC members can sustain economic loss and are within the defined group entitled to sue. Further the professional standards that the auditor undertakes to comply with should create no doubt as to the auditor’s liability risk. This risk is neither unfair nor unreasonable for the profession to assume as it is implicit in the profession’s own standards.

Dodd-Frank Reform

In another respect the Dodd-Frank Act facilitates investor actions. The private fund’s records are now explicitly deemed to be the records of the hedge fund and/or private equity fund advisers who now cannot rely upon the private advisor exemption from regulation and therefore are subject to audit and SEC inspections. Prior to the enactment of Dodd-Frank the adviser as an agent and by contract had to make available its records to the feeder fund auditor. Now the feeder fund’s records are deemed to be the adviser’s records and within the category of SEC required records. The records clearly are subject to both audit and SEC inspection.

Additionally, section 404(2) by including the records of the private fund as the adviser’s and Section 404(3) that details “required information” assures that the auditor and/or SEC examiner will be able to test the transactions and the fund and/or securities deposits the adviser has with a counterparty, whether the counterparty is a securities trader or custodian.

In the last analysis, in respect to the Madoff type fraud, Dodd-Frank does advance the public interest and make it less likely to occur. Further, a better appreciation and application of the accounting profession’s own standards coupled with the coverage provided by the statute will not allow the sentinels “to shut their eyes to what…is plainly to be seen” and will now lead to the reform necessary for the protection of public investors.

End Notes

1. United States v. Benjamin, 328 F.2d 854 (2d Cir. 1964)
10. 728 F. Supp 2d 372 (SDNY 2010)

Don’t Have Too Much Confidence in Confidential Sources.

Securities plaintiffs’ counsel sometimes find themselves relying on confidential sources to assert the specific allegations of scienter needed to maintain a claim under the heightened pleading standards of the Private Securities Litigation Reform Act. If one does so, however, it is advisable to confirm the accuracy of the source through counsel’s due diligence, as one law firm found to its chagrin. Early this year, the U.S. District Court for the Northern District of Illinois dismissed a securities fraud class action after plaintiffs’ confidential source denied making the statements or having the knowledge attributed to him. It turned out that plaintiffs’ counsel relied entirely on their own investigator’s notes of her interview with the source. The Court found that the purported information was “at best unreliable and at worst fraudulent,” no matter whether it was the source or the investigator who lied, and noted that the problem “could have been avoided by reasonable inquiry on the part of plaintiffs’ counsel,” before the filing of the amended complaint that relied on the statements.

Case Summaries from Securities Litigation Alerts
SLAs 2011-07 through 2011-12

Editor’s Disclaimer: The decisions summarized in these pages are often slip opinions when we review them and may never be approved for publication. They may also be amended by the issuing court or, subsequently changed on reconsideration, appeal, or review en banc. Readers are, therefore, cautioned to review local rules and to “shepherdize” these decisions before citing them or relying upon them in an actual litigation or arbitration. While our effort is to deliver current material and to record it in ways that will assist lawyers and others in their legal research, no reliance should be placed upon us to report when a decision has been disapproved for publication, overturned, amended, vacated, or otherwise changed. In our view, this is a professional responsibility that can only be adequately discharged at the time the decision is cited as precedent. Moreover, all synopses, commentaries and “tactical tips” should be viewed as general remarks and reportage and not as the rendering of legal advice. Any recommendations expressed here are made without an attempt to assay all relevant facts of either the case at hand or any other.

Absolute Activist Value
Master Fund Ltd. v. Homm,
No. 09 Civ. 08862 (GBD), 2010 U.S. Dist. LEXIS 137150 (S.D. N.Y., 12/22/10).
Derivative/Vicarious Liability (Conspiracy)* FRCP (Rule 12(b)(1) “Subject-Matter Jurisdiction”, Rule 12(b)(2) “Personal Jurisdiction”) * Fiduciary Standards (Hedge Fund Managers) * Jurisdictional Issues (Extraterritorial) * Market Manipulation (Dominion & Control; Pre-Arranged Trading/Wash Sales (PIPE Transactions); “Pump and Dump”) * Misrepresentations/Omissions * Pleading Requirements/Issues * 1934 Act (§10 Rule 10b-5). Under Morrison v. National Australia Bank’s “transactional test,” “F-Cubed” cases (i.e., foreign investors suing foreign (and American) defendants for misconduct relating to securities purchased on a foreign exchange) may now be swiftly dispatched with for lack of subject matter jurisdiction, even where there is some connection to the United States. Plaintiffs Cayman Island hedge funds that invested on behalf of investors located around the world, including the United States, sued Hunter World Markets, Inc. (“Hunter”) and other primarily foreign defendants who allegedly caused plaintiffs, in connection with a pump-and-dump scheme, to purchase nearly valueless penny stocks issued by companies that were registered with the SEC. Defendants caused plaintiff funds to purchase billions of essentially illiquid shares of these companies that were incorporated in the United States and whose shares were quoted on the OTC Bulletin Board or by the Pink OTC Markets, Inc. The shares were not sold on an exchange, but rather were purchased directly from the issuers pursuant to private placements. The alleged scheme of manipulating and artificially inflating the price of the penny stocks was accomplished, in part, by trading and re-trading the stocks many times between the funds. The scheme allegedly served to generate bogus commissions for defendants, including Hunter, a California FINRA-registered broker-dealer, and to artificially inflate the stock price to the point at which defendants were free to sell previously untradable shares and exercise certain warrants, which defendants then sold to the funds at a profit. Defendants moved to dismiss the amended complaint, which asserted 10b-5 and other claims for, among other things, failure to state a claim. Based on the Supreme Court’s subsequent decision in Morrison v. National Australia Bank (130 S. Ct. 2869), the Court determines, sua sponte as a threshold matter, that it lacks federal subject matter jurisdiction over the claims; as such, it refrains from opining on the various other grounds upon which defendants have moved to dismiss, and dismisses the complaint in its entirety. Although the companies that issued the penny stocks were registered with the SEC, their shares were not traded on a domestic exchange. Rather, the fraudulent scheme alleged involved PIPE transactions in which the plaintiff funds were caused to purchase the illiquid shares directly from the companies through private placements. The entire “market” alleged was the trading between the plaintiff funds based in the Cayman Islands and managed in Europe. Accordingly, the “transaction test” established by Morrison precludes this action: there was no sale of a security listed on an American exchange, as the PIPE transactions involved penny stocks that were purchased directly from the company, and no transaction occurred in the United States. Permitting this case to move forward on the theory that any trade routed through the United States meets the Morrison standard would be the functional antithesis of Morrison’s directive. (C. Asher.) (SLC Ref. No. 2011-07-09)

Akamai Technologies, Inc. v. Deutsche Bank AG,
Product/Sales Practice Issues (Auction Rate Securities) * 1934 Act (Rule 10b-5) * Fiduciary Standards * Damages Calculations (Economic Loss) * Control Person Liability * State Law Interpreted (Mass. G.L., ch 110A) * PSLRA (Applicability) * Pleading Requirements (Scienter) * FRCP (Rule 9(b)).

“This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.” —from the Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.
Any distinction between omissions and misrepresentations is illusory, where the broker-dealer owes a fiduciary duty to the client.

Defendant’s Motion to Dismiss Plaintiffs’ federal fraud claims, pursuant to Federal Rules of Civil Procedure 12(b)(6) and 9(b), are denied. Plaintiffs, Akamai Technologies, Inc. and Akamai Securities Corporation (collectively “Akamai”), allege that Deutsche Bank Securities, Inc. (“DBS”), the wholly-owned subsidiary of Defendant Deutsche Bank AG (“Defendant”), wrongfully invested $217 million in “toxic” auction-rate securities (“ARS”). According to Akamai, DBS, acting as Akamai’s investment advisor and broker, recommended and invested Akamai’s money in ARS, despite DBS’s knowledge that the illiquid nature of the investment run contrary to Akamai’s stated objectives. Moreover, DBS allegedly failed to disclose its role in secretly supporting ARS auctions, failed to disclose the illiquid nature of the investments and secretly worked to keep ARS interest rates artificially low. Akamai asserted claims against Defendant under section 20(a) of the Securities and Exchange Act of 1934 and Massachusetts General Laws chapter 110A, section 410(b). DBS moved to dismiss these claims, arguing that Akamai failed to plead the elements of its fraud claims, failed to plead its fraud claims with specificity, and failed to properly allege Defendant’s status as the controlling entity of DBS. In order for Akamai to state a claim under section 20(a) of the Exchange Act, it must “plead (1) an underlying violation of the same chapter of the securities laws by the controlled entity and (2) control of the primary violator by the defendant with culpable participation.”

The underlying violation alleged by plaintiffs was a violation of section 10(b) of the Exchange Act. The elements of such a claim are: “(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.” With regard to the first element, the Court finds that Akamai did not need to identify statements made by specific DBS employees in an omission case and that, in analyzing a motion to dismiss, it was reasonable to assume that any misstatements that might have been made were made by the DBS employees responsible for Akamai’s account. Notably, the Court also holds that “Defendant’s contention that it owed Plaintiffs no duty to disclose material facts does not excuse it, as Defendant in fact owed Plaintiffs a broad fiduciary duty.” With regard to the second element, the Court holds that, under section 20(a), the [Private Securities Litigation Reform Act of 1995’s] heightened “strong inference” pleading standard for scienter is inapplicable.” Under F.R.C.P. 9(b), Akamai is simply required to “set forth specific facts to make it reasonable to believe that defendants knew that a statement was fraudulent or misleading.”

The Court briefly addresses the sufficiency of Akamai’s pleading with regard to the third and fourth elements. With regard to the fifth and sixth elements, Akamai’s allegation that, “but for Defendant’s misconduct, Akamai would not have owned ARS when the ARS market froze,” sufficiently addresses the economic loss and causation pleading requirements. Finally, the Court finds that the question of Defendant’s actual control of DBS is, by law, a question of fact, not appropriate for analysis in a motion to dismiss. Accordingly, the Court denies Defendant’s motion to dismiss. (P. Michaels) (SLC Ref. No. 2011-11-10)

AMOROSA V. AOL TIME WARNER INC., No. 09-5270-cv (L), 2011 U.S. App. LEXIS 2149 (2nd Cir., 2/2/11).


Although the absence of loss causation is an affirmative defense to a Section 11 claim under the 1933 Act, a complaint may be dismissed pursuant to Rule 12(b) (6) if the loss causation defect is apparent from the face of the pleading.

Plaintiff Dominic F. Amorosa and his counsel, Christopher J. Gray, appeal, respectively, from the final judgment granting defendant Ernst & Young’s (“E&Y”) motion to dismiss securities law and other claims arising from allegedly fraudulent accounting practices at AOL and then newly-merged company AOL-Time Warner (“AOLTW”) and the District Court’s grant of E&Y’s motion for sanctions under Rule 11. In its Summary Order, the Second Circuit affirms the judgment and the imposition of sanctions in all respects. In the first instance, plaintiff failed to meet his burden of pleading loss causation for purposes of his 14(a) and 10(b) claims under the 1934 Act. The District Court correctly noted that plaintiff had not alleged any corrective disclosure regarding E&Y’s June 1999 audit opinion; none of the events identified as corrective disclosures by plaintiff in his complaint addresses AOL’s accounting practices or in any way implicates E&Y’s audit opinion. Thus, plaintiff cannot establish that any misstatement or omission in E&Y’s audit opinion was revealed to the market, resulting in a diminution in the value of the securities. Moreover, because plaintiff’s complaint fails to identify specifically any misstatements or omissions during the relevant time period to the auditor itself and, in turn, the risk that was thereby concealed, plaintiff has failed to establish loss causation on a “materialization of the risk” theory. Regarding his Section 11 claim under the 1933 Act, his claim is either time-barred or fails for lack of loss causation. The first disclosure - actual or constructive - reveals E&Y’s alleged fraud on January 12, 2001. Plaintiff did not file suit until May 29, 2003. Plaintiff argues that the statute of limitations was not triggered until the Washington Post published a series of articles in July 2002 that revealed AOL’s questionable accounting practices. If the...
A REPORT ON THE FINANCIAL CRISIS.

Phil Angelides, chair of the Financial Crisis Inquiry Commission, appeared before the U.S. Senate Banking Committee this past May to testify on what the Commission discovered about the causes of the recent financial meltdown and how to avoid it in the future. He urged full implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act as necessary to prevent a recurrence, but faulted the Act for not doing enough to regulate rating agencies. Angelides testified that the aggressive push for home ownership contributed to reckless speculation in home mortgages, but denied that Fannie Mae or Freddie Mac was a leading cause of the crisis. He did sharply criticize Federal Reserve Board Chairman Ben Bernanke, Ex-U.S. Secretary of the Treasury Henry Paulson and his successor, Timothy Geithner (then head of the Federal Reserve Bank of New York) for failing to predict and stop the crisis from happening.

Bureau had proposed a “fair price” for the debenture and the shareholders alleged this proposal was a misrepresentation. The jury returned a verdict in favor of the Plaintiffs and awarded them $31.7 million. This appeal was primarily based on the form of the jury instructions. Southern Farm Bureau argues that the jury instructions in the case were inappropriate for two reasons: First, the instructions advised the jury that they could find liability if Southern Farm Bureau had failed to disclose material information about the transaction to the shareholders, without including an instruction that the jury must find that there was a duty owed by Southern Farm Bureau, an arm’s-length purchaser in the transaction, to make a disclosure. Second, Southern Farm Bureau challenged the jury instructions, arguing that, even if a duty existed, there could be no liability for failing to make disclosures to the shareholders of the company that owned the debenture, as opposed to failing to disclose information to the company itself. With respect to the first of these arguments, the Court finds that a proper instruction should have advised the jury that they must find a duty of Southern Farm Bureau before they could find liability. However, since the attorneys for Southern Farm Bureau had not raised any objection on this ground to the jury instructions, the Court does not reverse the verdict on this ground. With respect to the second argument, the Court of Appeals finds that an attorney of the corporation that owned the debentures had been provided with the information that the shareholders claimed was not disclosed to them. Finding this to be the case and also determining that the law does not require any disclosure to the shareholders of a corporation, as opposed to the corporation itself, the Court finds merit on this argument of Southern Farm Bureau and reverses the judgment of the District Court. The Court of Appeals also notes that a representation by one party to an arm’s-length negotiation, that in its opinion a particular amount was a “fair” price, is not something that could be considered as a misrepresentation in an action under the federal securities laws or in an action for fraud.

(B. Wiand) (SLC Ref. No. 2010-40-07)
agreement with the “family of Carl J. Shapiro,” in which the Trustee recovered $550 million for the BLMIS estate. Petitioner Robert M. Jaffe, a son-in-law of Carl and Ruth Shapiro, was included in that settlement and the settlement agreement specifically allocated $38 million to the resolution of an adversary proceeding brought against Cohmad Securities and others, in which Mr. Jaffe was named as one who had allegedly engaged in fraudulent transfers, preferences, turnovers, and state law fraudulent conveyances and acted as transferees of funds in the Madoff Ponzi scheme. The Court approved the settlement in a December 21, 2010 order and, pursuant to that approval, the Trustee filed a Stipulation of Dismissal with Prejudice, dismissing the Trustee’s Amended Complaint in the adversary proceeding, as it applied to the Jaffe Defendants. Mr. Jaffe claims in this proceeding that the Court’s Order also barred the prosecution of several actions brought by third-parties against Mr. Jaffe and he asks the Court to enforce its Settlement Order in that regard. The Trustee weighed in and opposed the Motion, arguing that the Jaffe Defendants are no longer defendants in any proceeding before the Court and, thus, have no standing to invoke the Court’s jurisdiction. Under existing precedent, a federal court has jurisdiction to enforce a settlement agreement “only if the dismissal order specifically reserves such authority or the order incorporates the terms of the settlement.” Otherwise, enforcement of a settlement agreement is a matter for the state courts. The Settlement Agreement in the Shapiro matter contains an exclusive jurisdiction clause, which reserves all disputes regarding the Agreement for the Bankruptcy Court, but the Stipulation does not retain jurisdiction over the terms of the Settlement Agreement, no does it incorporate any of the Settlement’s terms. A dismissal with prejudice has the effect of removing jurisdiction from the court and “the district court cannot adjudicate disputes arising out of the settlement that led to the dismissal merely by stating it is retaining jurisdiction.” The Stipulation here fails even to reference the Settlement and that leaves little doubt that the Court lost jurisdiction with the dismissal of the Jaffe defendants from the Cohmad adversary proceeding. The Stipulation is a separate document from the Settlement Agreement and the former constitutes an order of the Court while the latter does not. Even if the Court were to rule on the merits, though, it would still deny the petition. As the Trustee has asserted that the settlement served to recover all customer property from the Jaffe Defendants that the BLMIS estate was due, none of the judgments obtained in the third-party actions would have any effect on the BLMIS SIPA Liquidation. Thus, there is no basis for injunctive relief. (SLC Ref. No. 2011-09-05)

BETZ v.
TRAINER WORTHAM & CO.,
No. 05-17054, 2010 U.S. App. LEXIS 13821 (9th Cir., 7/6/10).

**Timeliness Issues (Statutes of Limitation) * Federal Statutes Interpreted (28 U.S.C. § 1658(b)) * Duty of Inquiry (inquiry Notice) * Jurisdiction Issue (Appellate Remand).**

A remand to the district court is warranted in situations where the district court has procedures available to it relating to the scope of the record and the determination of the facts not available to the court of appeals.

We previously summarized three earlier decisions in this case (SLA 2007-25 (2x) & 2008-17). In an earlier appeal, the Court held that there was a genuine issue of material fact whether Betz’s securities fraud claim against Trainer Wortham is time-barred under 28 U.S.C. § 1658(b). Trainer Wortham sought review of the Court of Appeals’ decision though a petition for writ of certiorari filed with the United States Supreme Court. After deciding the related case of Merck v. Reynolds (130 S.Ct. 1784), in which the Supreme Court construed the statute of limitations in 28 U.S.C. § 1658(b) for the first time, the Supreme Court granted the certiorari petition, vacated the prior opinion and remanded with instructions to reconsider the appeal in light of the Merck decision. Appellees then filed a motion to remand to the district court, arguing that the Merck analysis of the facts of the case is an analysis that the district court is best situated to perform. The Court of Appeals agrees. The district court has procedures available to it relating to the scope of the record and the determination of the facts, which are not available at the appellate level. In addition, because appellees indicated that they planned to bring further dispositive motions, such motions would be within the province of the district court. (W. Nelson) (SLC Ref. No. 2010-39-10)

BILLITTERI v.
SECURITIES AMERICA, INC.,
No. 3:09-01568 (N.D. Tex., 2/18/11).

**Class Actions, Effects of (Settlement Approvals) * Settlement Issues * Simultaneous Proceedings * Injunctive Relief (Arbitration Stays) * Federal Statutes Interpreted (All Writs Act).**

The All Writs Act permits a federal court to enjoin pending arbitration proceedings, at least for TRO purposes, that might threaten approval of a class action settlement. This Court must deal with the administration of a class action lawsuit involving broker-dealer defendants who are engaged in defending hundreds of arbitration proceedings, while defending the allegations in this case. The central problem is that the arbitrations concern the same defunct issuers, Medical Capital Holdings and Provident Royalties LLC, as the class action and allege similar conduct by the brokerage firms that sold the securities in private placement offerings (Reg D offerings). The Court has obtained notice from settling parties that they have reached resolutions that could end the class action and result in payments to the class investors, but the parties have also sounded alarms about the ongoing arbitration proceedings. In a previous decision (SLA 2011-06), the Court agreed to stay a score of arbitration proceedings, while it considered a proposed settlement between the class Plaintiffs and CFS, one of the named broker-dealers that sold MedCap and Prudential investments. Believing that other broker-dealers might be ready to settle, the Court later suspended the class action proceedings, in a separate Order, while it considered the adequacy of CFS’s offer (SLA 2011-06). In this decision, the Court weighs Plaintiffs’ request for a TRO staying three named cont’d on page 15
arbitrations against Securities America, as those arbitrations are approaching an initial hearing date and Securities America has submitted a settlement offer that Plaintiffs have accepted. Plaintiffs maintain that allowing the arbitrations to proceed will permit the dissipation of assets, through the expenditure of defense costs and payment of possible monetary awards to the arbitrating class members, that would otherwise have been available to all class members as part of the settlement. To prevent the dilution of the settlement proceeds, the parties seek a preliminary injunction maintaining the status quo pending the Court’s final settlement approval determination, and enjoining all other parallel proceedings in the courts or arbitration. The All Writs Act permits a federal court to exercise its discretion and use its injunctive powers in aid of its jurisdictions and other courts have exercised that authority to stay proceedings elsewhere and bind non-parties when their actions, though not wrongful conduct, threaten the implementation of a court order “or the proper administration of justice.” The Court grants the TRO, ruling that it is necessary to restrain the individual arbitration proceedings “to ensure the conditions for reaching a Settlement Agreement remain in place as the Court considers the Motion for Preliminary Approval.” The injunction is temporary and will give the Court time to decide if it has the authority to enjoin an arbitration proceeding when the parties to that arbitration have agreed to resolve their dispute by means of arbitration. There is divided authority on this question and the Eighth Circuit in In re Piper Funds, Inc., No. 71 F.3d 298 (1995), has ruled against such authority.

BILLETTERI v. SECURITIES AMERICA, INC., No. 3:09-cv-01568-F (N.D. Tex., 3/7/11). Class Actions, Effects of (Settlement Objections) * Settlement Issues (Interveners) * Liability Issues (Co-Tortfeasors) * Contribution/Indemnification * FRCP (Rule 24 “Intervention”). Interveners who wish to object to a class action settlement must be unrepresented in the action and, yet, have an interest in the property or subject of the action that will be impeded or impaired by the Court’s approval of the settlement. The Bank of New York Mellon and Wells Fargo move to intervene in this class action, in which they are not parties or necessarily related to parties in the action. They are, however, in positions, given their status as Trustees of instruments (Medical Capital Holdings, now defunct) sold by the defendant broker-dealers, to pursue contribution claims against the Defendants. The impetus to intervene arises from a proposed settlement that the Court is considering, which Securities America has negotiated with the class Plaintiffs, that, if accepted, will release all claims against Securities America relating to, among other things, sales of Medical Capital Holdings interests to the Plaintiffs. The interests, called notes, were issued in series and each series of notes was associated with assets that were held in trust for the noteholders. The Trustees of those MedCap entities were the proposed bank intervenors. The bank Trustees face potential liability for their actions as trustees, just as Securities America faces liability in this and other actions for its actions as the seller of the MedCap securities. As intervenors believe the proposed settlement will release claims of contribution or indemnity they may have against Securities America, they seek the Court’s permission to intervene as of right, pursuant to FRCP 24, and object to the proposed settlement. Four criteria govern intervention as a matter of right, according to Fifth Circuit precedent, the Court recites: “(1) the application for intervention must be timely; (2) the applicants must have in interest [sic] relating to the property or transaction which is the subject of the action; (3) the applicants must be so situated that the disposition of the action may, as a practical matter, impair or impede their ability to protect that interest; and (4) the applicants’ interest must be inadequately represented by the existing parties to the suit.” The bank trustees meet all of these requirements, the Court finds, and if, therefore, grants the motion to intervene.

BILLYEU v. JOHANSON BERENSON LLP, No. 1:08-cv-02006 (W.D. La., 9/27/10). FRCP: Federal Rules of Civil Procedure (Rule 12(b)(6)) * FAA (§3 “Stay of Litigation”) * Appealability (Final Dismissal) * Scope of Agreement (Arbitration) * Breadth of Agreement (Non-Signatories). The preferred method of petitioning for enforcement of an agreement to arbitrate is to move pursuant to the Federal Arbitration Act, rather than to seek dismissal of all claims under the Federal Rules; dismissal, as opposed to a stay of litigation under Section 3, is only appropriate in special circumstances. In this dispute involving as Defendants a group known as the Johanson Defendants and Wachovia Securities LLC, the Court explores the difference between a motion to dismiss under FRCP 12 for failure to state a claim for relief and a motion to stay litigation pending arbitration, pursuant to Section 3 of the Federal Arbitration Act. The question is squarely before the Court because both sets of Defendants claim rights under arbitration agreements between them and the Plaintiffs and the

cont’d on page 16
Johanson Defendants have asked the Court to dismiss the claims against them pending arbitration, while Wachovia has made a more traditional Section 3 motion. Addressing only the Johanson Defendants’ request in this decision, the Court explains that Plaintiffs have objected to arbitration based both upon the scope of the proffered arbitration agreement and its enforceability as against some non-signatory parties. The Johanson Defendants urge the Court to follow the Fifth Circuit’s decision in Alford v. Dean Witter Reynolds, 975 F.2d 1161 (1992), where the Court held that, in the “proper circumstances,” a court might dismiss a case pending arbitration. Perhaps so, the Court responds, but such “proper circumstances” are “uncommon,” as Alford presented a straightforward dispute, with a well-developed record, and assertions by Plaintiff that were sufficiently frivolous to allow the Fifth Circuit “to discern prior to the commencement of proceedings on the merits that all of the issues among all of the parties were subject to arbitration.” In other words, Alford occurred in a situation where “retaining jurisdiction… [would] serve no purpose.” In the instant case, on the other hand, the record is not exceptionally well-developed, the facts are in dispute, and the agreement is contested. Moreover, neither in Alford, nor in two other cases Defendants were able to find, did the courts develop why dismissal was appropriate in the particular settings.

Finally, dismissal, even in the “proper circumstances,” is optional, “specifically when a court may determine a priori that ‘the entire matter is encompassed by the arbitration clause.’” Here, the Court believes that it may be necessary for the parties to return to the Court and “[d]ismissal now would obviously and needlessly complicate this process.” For these reasons, the motion to dismiss is denied “and the parties requested, if they wish to reurge the issue of compelling arbitration, to seek a stay rather than dismissal of these proceedings.”

**A brokerage account agreement to arbitrate disputes under “other agreements between us” extends to other related roles that a broker may play, e.g., as pension consultant.**

A governing board that authorizes its agent to complete an agreement for investment management services also, by implication, authorizes the agent to enter into agreements that will expedite that investment manager’s performance.

This decision of the Eleventh Circuit Court of Appeals reviews a previously reported decision (SLA 2009-30) of the United States District Court for the Southern District of Florida that denied a motion to compel arbitration of Citigroup Global Markets, Inc. The case arises from a consulting agreement between Citigroup and the Police and Firefighters’ Pension Fund of Delray Beach, pursuant to which Citigroup provided performance evaluation, consulting and other services for the pension fund’s investments. The pension fund was dissatisfied with its performance and brought an action against Citigroup. The agreement for consulting services between the pension fund and Citigroup did not contain an arbitration agreement. Thereafter, Citigroup suggested the appointment of a specific manager for a portion of the pension funds assets. The Board of the pension fund approved this action and authorized its Chairman to enter into the agreement with the money manager. As a part of entering into this agreement, the Chairman also executed brokerage agreements with Citigroup where the accounts managed by the new manager would be held. Those brokerage firm agreements did contain broad arbitration agreements. Before the District Court, the pension fund had argued that its Chairman was not given specific authority to enter into brokerage agreements and, since he was not specifically authorized to do so, any agreement to arbitrate was invalid. Both Florida State law requiring authorization of pension fund actions by the Board and the language of the consulting agreement

**Board of Trustees of the City of Delray Beach Police and Firefighters Retirement System v. Citigroup Global Markets Inc., f.k.a. Salomon Smith Barney, No. 09-13451, 2010 U.S. App. LEXIS 20880 (11th Cir., 10/8/10).**

**Agreement to Arbitrate (Arbitrability)**

* Contractual Issues (Implied Actual Authority; Apparent Authority) * Competing Agreements * Agreement, Scope of (Other Accounts) * Fiduciary Standards (Pension Consultant; Self-Dealing) * Disclosure Issues (Conflicts of Interest) * State Statutes Interpreted (Fla. Stats. §§ 175 & 185; Florida Sunshine Law) * Breadth of Agreement (Principal-Agent).

*A brokerage account agreement to arbitrate disputes under “other agreements between us” extends to other related roles that a broker may play, e.g., as pension consultant.**

A governing board that authorizes its agent to complete an agreement for investment management services also, by implication, authorizes

**INVESTORS IN MADOFF SCHEME PRESS PICARD TO PRODUCE REPORT.**

Irving Picard, liquidating trustee of Bernard L. Madoff Investment Services, LLC, the defunct firm and namesake of the notorious broker who used it to perpetrate the largest Ponzi scheme in U.S. history, faces demands from more than 1,200 of Madoff’s victims to produce a report on his investigation of Madoff’s fraud. The investors assert that the Securities Investor Protection Act requires Picard to produce a report containing information they alleged the trustee has already turned over to the Securities Investor Protection Corporation. The investors seek details on the findings and conclusions of the investigation, evidence in support of those findings and a description of how the fraud operated.

(indicating that it could not be changed without a duly authorized action of the Board) supported this view. The Court of Appeals first finds that, contrary to the decision of the District Court, general principles of administrative law govern the actions of the Board and those general principles permit the delegation of actions by the Board. Because no Florida law prohibits the sort of delegation at issue (i.e., the execution of contracts) the Board could delegate its authority. The Court rejects the assertion that, since the specific delegation of authority to execute the contacts was not published according to the Florida Sunshine Law that such action could not be valid. A Florida governmental agency cannot utilize its own violation of the Sunshine Law as a defense to obligations that were created through its own wrongdoing. The execution of the brokerage agreements was merely incidental to the authorized actions of retaining the money manager. The express authority to hire the named investment manager implied the authority to open an account through which the manager can perform the only job it was hired to perform. The Chairman of the pension board acted on behalf of the Board and the pension fund was bound by the plain meaning of the agreement entered into with Citigroup, including the arbitration clause. The decision of the District Court was reversed and the case remanded with the instructions that the District Court grant the motion of Citigroup to compel arbitration.

(B. Wiand: One interesting comment of the Court in this decision relates to the federal presumption of arbitrability. The Court notes that, prior to the finding that an arbitration agreement existed, no such presumption exists, as “arbitration is a matter of consent, not coercion.” However, once the arbitration agreement is found, then the federal presumption favoring arbitration applies in full force.) (SLC Ref. No. 2010-42-01)

**BRADY v. WILLIAMS CAPITAL GROUP, LP & AAA,**
No. 36 (N.Y., 3/25/10).

Employment Discrimination * Competing Agreements * AAA Rules (Employment Arbitration Procedures)
* Forum Costs * Green Tree Interpreted
* Enforceability (Vindication of Rights; Public Policy) * Contractual Issues (Severability of Arbitration Clause).

When a petitioner’s statutory rights are imperiled by the costs of arbitration, a court must determine whether to enforce the arbitration agreement and sever any fee-sharing provision or, in the alternative, give the petitioner the right to remain in court or pay the contracted-for costs and stay in arbitration.

We have followed this case from the trial court (SLA 2007-38), through the Appellate Division (SLA 2009-23) to the Top Court in New York. Appeal to the New York Court of Appeals was based upon a 3-2 dissent in the First Department decision. The Appellant in this appeal is Williams Capital Group, the former employer of Lorraine C. Brady, whom WCG terminated as a fixed income salesperson in February 2005. Ms. Brady was out of work for 18 months and during that period commenced AAA Arbitration under the forum’s Model Employment Arbitration Procedures and in accordance with her employment agreement with WCG. She sued for race and/or gender discrimination under three statutes, but the issue that has forestalled arbitration during the past five years and that has concerned these various courts has been the question of fees. The WCG pre-dispute arbitration agreement Ms. Williams signed indicated that the parties would split the cost of the arbitrator, but AAA Rules provide for the firm to pay those costs. The First Department agreed with WCG that the PDAA trumped the AAA’s Rules, but reversed on public policy grounds. An employee cannot be made to pay arbitration costs that effectively deter the vindication of her statutory rights. On that basis, the First Department ordered WCG to front the costs of the arbitration, with a right to request an allocation of costs by the Arbitrator at the conclusion of the arbitration proceedings. The Court of Appeals agrees with the analysis, but faults both the trial court and the First Department for skipping the required Green Tree analysis. Neither court considered all of the factors that must be evaluated in resolving the question of whether Ms. Brady was financially able to share the arbitration costs. The U.S. Supreme Court’s decision in Green Tree v. Randolph, 531 U.S. 79 (2000) did not set forth the factors, but it did prescribe a process. The Court reviews post-Green Tree decisions by the Fourth and Sixth Circuits and finds in that wisdom the following: the question of financial ability must be decided on a case-by-case basis and should weigh: “(1) whether the litigant can pay the arbitration fees and costs; (2) what is the expected cost differential between arbitration and litigation in court; and (3) whether the cost differential is so substantial as to deter the bringing of claims in the arbitral forum.” On remand, the trial court should apply these tests and, if it determines that the “equal share” provision is unenforceable, it must then decide whether to order arbitration and sever the fee provision or to allow Ms. Brady the choice of proceeding in court or accepting the “equal share” provision and continuing in arbitration.

(Ed: "The Brady decision has broad implications, taken to its logical limits. Recall that the Green Tree case concerned neither a statutory discrimination claim, nor an employee-employer dispute. Thus, statutory rights of all kinds can, in theory, trigger the “means” issue and a Green Tree proceeding (we checked; it does not appear there will be one on remand in this case). "An important question, not addressed in the Court’s decision, but answered by inference in the Appellate Division’s Opinion, relates to the timing of the “means” analysis. If the court fixes on the arbitration filing date, while the employee remains unemployed, it cuts one way. If the analysis fixes on the date that the court conducts the Green Tree proceeding, the employee may have become re-employed and a quite different outcome could obtain. "Tactical tip: Counsel wishing to avoid arbitration should consider these prospects: the availability of a statutory claim, the practicality of filing in court first, and, when in court, responding to a motion to arbitrate with a request for a Green Tree analysis.) (SLC Ref. No. 2010-40-01)
Securities Litigation Commentator

Case Summaries • SLAs 2011 • 07-12

BRAINTREE LABORATORIES v. CITIGROUP GLOBAL MARKETS, INC., No. 09-2540 (1st Cir., 10/12/10).

Appealability (Pendant Jurisdiction; Final Order) * Injunctive Relief (Mandatory vs. Prohibitory) * Products/Sales Practice Issues (ARS: Auction-Rate Securities) * Remedies (Consequential Damages; Prejudgment Interest) * Expert Testimony/Opinions * Jurisdiction Issues (Remand; Stay of Arbitration) * FAA (§16) * Judicial Authority, Scope of (Pre-Arbitration Relief) * Parallel Proceedings (Discovery).

If a trial court had meant to provide relief other than what was requested in the motion at bar, the presumption on appeal is that the court would have said so; thus, a court granting arbitration intended to stay the litigation, not dismiss it (thus thwarting an immediate appeal).

In response to Plaintiff’s claim that CGMI misrepresented the nature of the Auction-Rate Securities (ARS) it purchased in mid-2008, CGMI made a motion to compel arbitration and a stay of the litigation. Braintree opposed that motion and countered with a motion for preliminary injunctive relief in the form of an order requiring CGMI to rescind the transaction and refund the purchase price pendente lite.

To await a final adjudication, Braintree argued, would choke the lifeblood of its business and deprive it of critical research and development funds. As proof of the likelihood of success, it argued the post-ARS-freeze timing of the transaction and testimony of the CGMI broker that he knew the top priority his client placed on liquidity, that he had sold the ARS as a “money market alternative,” and that he had not even mentioned ARS during the sales conversation. Braintree had been purchasing ARS since 2001, but its claims in this lawsuit related to a series of transactions, totaling $41 million, made during June to August 2008. The trial court granted arbitration, but denied the preliminary injunction requested by Braintree. Braintree appealed both orders. On appeal, the First Circuit affirms the denial of injunctive relief. It agrees that the District Court had the power to issue injunctive relief in advance of an arbitration, but, focusing upon the mandatory, as opposed to prohibitory, nature of the injunctive request, it also emphasizes that “the exigencies of the situation [must] demand such relief.” The District Court relied upon the principle that prejudgment interest, upon success on the merits, is designed to compensate victims for the loss of use of money. Braintree argued the inappropriateness of an interest factor, as it might be difficult to determine retrospectively the magnitude of what was lost in terms of missed opportunities. The Appellate Court responds: “A need for liquidity is not irreparable harm. An asserted injury so ubiquitous cannot serve as the basis for the issuance of a preliminary injunction.” A “substantial evidentiary showing”would be needed; here, Braintree’s CFO testified to the need for the funds, but no expert analysis or specific proof backed the essentially conclusory evidence. Jurisdiction over the appeal of an arbitration-compelling order drives the discussion in the remainder of the Court’s Opinion. FAA §16 does not permit an immediate appeal generally, but Braintree argues that the District Court intended a “final” order, not an interlocutory one. The Court agrees that the trial court controls the appealability issue, as it “chooses to stay litigation pending arbitration or instead to dismiss the case entirely.” This District Court was silent on the issue, but, to decide the point, the First Circuit relies upon CGMI’s request for a stay. The District Court would not have been silent on the issue, if it meant to deny the requested relief, the Court reasons. Finally, the Court rejects Braintree’s pendent jurisdiction argument. It clearly had appellate jurisdiction over the injunctive issue, but to extend its jurisdiction to the arbitration question would require the issues be (1) inextricably intertwined or (2) necessarily decided together to “ensure meaningful judicial review.” Neither is the case in this matter.

**How did Braintree have the broker’s “testimony available to support its case for injunctive relief?”** The Court cites a deposition in a “related state action.” In this way, state regulators are able to aid the causes of state citizens. **Of note, the three-judge Panel included ex-Associate Justice of the U.S. Supreme Court David H. Souter, sitting by designation.** (SLC Ref. No. 2010-39-01)

CFTC v. BOLZE, No. 3:09 Civ. 088 (E.D. Tenn., 3/2/11).

Criminal Issues. Bankruptcy does not insulate fraudsters from responsibility to pay restitution and civil penalties that flow from their fraudulent activities.

In July, the Court declared the Defendants in default and granted judgment as to the liability of each defendant and entered injunctions against them. This decision, responding to the CFTC’s motion to enter judgment, enters the injunctive orders and issues the requested relief. Dennis R. Bolze, one of the Defendants, pled guilty to charges of wire fraud and money laundering, was sentenced to jail and ordered to pay restitution exceeding $13 million to customers he defrauded. The indictment in the criminal action alleged that Bolze masterminded a scheme to defraud investors of monies placed with his companies Centurion Asset Management, Inc. (“CAM”) and Advanced Trading Services, Inc. (“ATS”). He was convicted of soliciting millions of dollars in funds under false pretenses, failing to invest investors’ funds as promised, and misappropriating and converting investors’ funds to his own benefit without the knowledge or authorization of the investors. Mr. Bolze declared bankruptcy, but the bankruptcy court waived discharge of those debts. Thus, the Court observes, the monetary relief it grants in this enforcement action will not be subject to discharge either. In addition to the $13 million restitution figure, which the Court also assesses, Mr. Bolze is charged a civil penalty of $37 million. The National Futures Association

*Continued on page 19*
is appointed “Monitor,” in order to oversee the restitution payments. As Monitor, NFA will act as an arm of the Court and will be immune from suit for any negligent acts. It will be in charge of gathering the payments from Defendants and deciding an equitable distribution method for satisfying customer entitlements. The injunctions prevent the Defendants from transferring assets to family or others for the purpose of concealing assets from the regulators or creditors.

(SLC Ref. No. 2011-12-09)

CFTC v. HAYS,  
No. 09-259, 2011 U.S. Dist. LEXIS 9243  
(D. Minn., 1/27/11).  

CEA (Commodities Fraud; CPO/CTA Registration Issues) * Remedies (Disgorgement) * Judicial Authority, Scope of * Enforcement Practice/Procedure * Sales Practice/Product Issues (Ponzi Scheme).

District courts have the power to order disgorgement as a remedy for violations of the Commodities Exchange Act for the purpose of depriving the wrongdoer of his ill-gotten gains and determining violations of the law. This matter is before the Court on a Motion for Summary Judgment brought by CFTC in a case arising from a day-trading Ponzi scheme orchestrated by Hays through Crossfire Trading, LLC. On February 4, 2009, a criminal complaint and later a Criminal Information was filed against Hays, who entered into a plea agreement and pled guilty. Counts charged in the Information include mail fraud in violation of 18 U.S.C. § 1341; wire fraud in violation of § 1343 and structuring in violation of §§ 5324(a)(3) and (d)(2). Hays was sentenced to 117 months in prison, with three years supervised release, together with a special assessment of $300 and restitution of $21,601,065.87. CFTC filed a five-count civil complaint against Hays and Crossfire seeking injunctive and other equitable relief. The Court enters an ex parte Statutory Restraining Order, pursuant to § 6c of the CEA and a consent order for preliminary injunction. Defendants have not filed an answer to CFTC’s complaint, although they submitted an opposition to the Motion for Summary Judgment. Hays as the controlling person of Crossfire fraudulently solicited over $40 million from individuals for the purpose of trading commodity futures in a commodity pool. Hays misrepresented to prospective and actual customers that Crossfire operated a commodity pool that day-traded stock index and crude oil futures on behalf of pool participants and that the pool earned a 3% monthly return. Hays never registered with the CFTC in any capacity. Hays provided pool participants with false account statements showing that Crossfire had a commodities account with Dorman Trading, although it never had such an account. Summary judgment is proper if there are no disputed issues of material fact and the moving party is entitled to judgment as a matter of law and is designed to secure just, speedy and inexpensive determination of every action. A party opposing summary judgment may not rest on mere allegations or denials, but must set forth specific facts showing that there is a genuine issue for trial. Defendants failed to oppose CFTC’s allegations that they violated §§ 4b, 4o(1), 4m(l), 4k(2) and 13(b) of the CEA, nor did they oppose CFTC’s request for injunctive relief as to Crossfire, which is granted. Hays argues that a permanent injunction against him is overly broad, but the Court disagrees, finding that Hays conduct over the last 8 years, resulting in over $20 million in losses, shows what little regard Hays had for the futures market. Because restitution was ordered in the criminal case, there is no need to order the same in the civil case, although the Court awards disgorgement of $19+ million. District courts have the power to order disgorgement as a remedy for violations of the Act for the purpose of depriving the wrongdoer of his ill-gotten gains and determining violations of the law. Section 6c(d)(1) of the Act allows the CFTC to seek a civil penalty for each violation of the Act, which it does in the amount of $64+ million, even though the Court regards this as largely academic. (S. Anderson) (SLC Ref. No. 2011-08-07)

CFTC v. LAKE SHORE ASSET MANAGEMENT, LTD.,  
No. 07 CV 3598, 2010 U.S. Dist. LEXIS 65370  
(N.D. Ill., 6/30/10).  


A party that wishes to appeal an order approving a method of distribution from a common fund can ask the trial court to stay the order pending appeal or to set aside a reserve to enable its claim to be paid if it prevails on appeal. After entering default judgment against defendants in this civil action by the CFTC, the Court enters an order approving the receiver’s proposal to distribute recovered assets to defrauded commodity-pool investors under the so-called Rising Tide methodology. This order was entered over the objection of certain investors, who argued that the distribution should be made under a different methodology. One of those objecting investors, GAMAG Black & White, Ltd. (“GAMAG”), filed an appeal. GAMAG did not, however, ask the trial court to stay the distribution order pending its appeal or to create a reserve from the distribution. Thus, the receiver distributed the recovered assets to the investors pursuant to the Court’s order. Now before the Court are motions by the receiver to make additional distributions to certain parties based either on a calculation error by the receiver or clarification regarding transfers between certain family members. The additional distributions are to be made from a $1,000,000 fund set aside by the receiver for payment of professional fees. GAMAG objects to the receiver’s motion, asking that consideration of the motion be deferred until after its appeal, because otherwise there might not be sufficient funds to make an additional distribution to GAMAG should it prevail on its appeal. The Court refuses to stay consideration of the receiver’s motion. If GAMAG wanted protection of this nature, it should have moved the court to create a reserve (as another appellant did) or to stay distribution pending its appeal. It did neither. Therefore, GAMAG is not entitled to relief now that would effectively subordinate the claims of cont’d on page 20
other investors to its claim.  
(J. Komie) (SLC Ref. No. 2010-39-07)

CFTC v. PERKINS,  
No. 09-2507, 2010 U.S. App. LEXIS 13593 (3rd Cir., 7/1/10).  
CEA: Commodity Exchange Act (Commodities Fraud; Registration Requirements) * Statutory Definitions (“Commodity Pool Operator”). The purpose of the CEA would be undermined if one entity could escape regulation merely by having another entity execute its trades. This case is on appeal from the U.S. District Court for the District of New Jersey in which the court held that Appellant, a manager of an investment firm that did not execute futures trades and instead forwarded investment funds to an entity, Equity Financial, that in turn forwarded the funds to the ultimate trader, was a “commodity pool operator” (CPO) for purposes of the Commodity Exchange Act (SLA 2009-15). The manager appeals to the Third Circuit. In a prior case, the Court determined that the absence of a trading requirement is consistent with the purposes of the CEA, in that, when Congress defined the CPO term, it sought to regulate the solicitation of funds from customers and potential customers and it intended to protect them from fraudulent solicitation. The statute would be undermined if one entity could escape regulation merely by having another execute its trades. Allowing an investment manager to circumvent regulation merely by transferring funds from one account to another does not comport with Congress’ aim of protecting investors. The conflicting language of certain CFTC regulations does not change the Court’s conclusion that Congress intended broad definitions of “commodity pool” and “CPO.” The proximity to trading is not an important factor. If the pool is established with the purpose of trading in commodity futures, then the pool is a commodity pool for CEA purposes.  
(S. Anderson). (EIC: In an earlier decision, the Third Circuit upheld the District Court’s finding that Equity Financial, the middle “man” between Appellant and the trader, met the definition of a CPO. SLA 2009-31. Appellant argued that it was twice removed, but the Court’s rationale remained the same.) (SLC Ref. No. 2010-39-06)

CHAPPLE v. FAHNESTOCK & COMPANY, INC.,  
No. 03-4989 (E.D. N.Y., 8/5/10). Employment Disputes (Gender Discrimination; Sexual Harassment) * Parallel Proceedings * Evidentiary Standards (Motion in Limine; Hostile Work Environment). While evidence of a hostile work environment can extend to incidents not necessarily involving the plaintiff, evidence of other lawsuits filed against the defendants making similar harassment allegations are likely to be more prejudicial and speculative than probative. This decision is a ruling by Tucker L. Melancon, United States District Judge for the Eastern District of New York. The case involves claims of sexual harassment against a Fahnestock executive. The Plaintiffs had indicated in pre-trial disclosures that they intended to present evidence in the trial that three state court cases had been filed against the corporate executive involving sexual harassment and that his attorneys in those cases had sought to withdraw. The executive and Fahnestock filed a Motion in Limine to exclude this evidence. The Court indicates that, in a sexual harassment case involving a hostile work environment, a plaintiff may present evidence on the nature of the workplace environment as a whole and that instances of hostility need not be directed at the plaintiff in order to support her claim. Thus, the Court rules that the Plaintiff in this case will be allowed to call as witnesses other women to testify that they had been subjected to harassment by the executive. However, the Court finds merit in the arguments that evidence of other lawsuits or that the executive’s lawyers had sought to withdraw from those lawsuits should be excluded. The focus of the case before the Court should be on the facts of that case, not on the litigation history of other lawsuits. There is little probative value to the fact that other lawsuits have been filed and there is a significant danger of unfair prejudice if details of those lawsuits are presented to the jury. The circumstances of other lawsuits would be confusing for the jury, possibly resulting in prejudice with respect to evidence relating to the attempted withdrawal of the executive’s attorney in the other litigation. The Court believes that any such evidence would inevitably become the subject of wild speculation since evidence relating to the specific reasons for the withdrawal would probably be subject to the attorney/client privilege. Evidence merely of the request for withdrawal by counsel would be of little probative value. Weighing all of these factors, the Court grants the defendants’ Motion in Limine.  
(B. Wiand) (SLC Ref. No. 2010-41-03)

CHARLES SCHWAB CORP.  
SEcurities Litigation, IN RE,  
No. 08-cv-01510 (N.D. Cal., 9/13/10). Sales Practice/Product Issues (YieldPlus Mutual Funds) * Class Actions, Effects of * Scope of Class (Intermediary Accountholders) * Notice Requirements (Pendency; Settlement). Notice of the pendency of a class action, as well as the settlement terms proposed between the parties, must be provided to all class members, so that they have a reasonable opportunity to opt out of the class or object to the settlement before a release of claims is imposed upon them in exchange for settlement payments. This is a brief Court decision, most notable as an update on the settlement of this class action proceeding and the parties’ agreement to expand the scope of the class (as well as increasing the size of the settlement pot by approximately $2.8 million) to include additional accountholders. “Intermediary Accounts” that held YieldPlus Fund shares at broker-dealer intermediaries other than Charles Schwab were not notified of the settlement of the class action, even though some of those accountholders held YieldPlus Fund Shares during the class period from May 31, 2006 to March 17, 2008. A notice now needs to be sent to all broker-dealer intermediaries directing them to provide names, addresses and “all YieldPlus Fund transaction data, so that the appropriate notices can be sent to the customers, cont’d on page 21
along with proof of claim forms. Where transaction data becomes available to the Settlement Administrator, proof of claim forms will not be needed. Intermediary Account holders shall have at least 45 days from the date of notice in which to (1) provide notice of opt-out, (2) submit any objections to the settlement, or (3) if warranted, submit a proof of claim. The $2.8 million additional payment is designed to provide the same pro rata recovery to Intermediary Accounts as the other class members are due to receive. A hearing to consider any objections to the settlement is scheduled for December 2010. (SLC Ref. No. 2010-42-07)

CHYO V. NOPUENTE,
Award Challenge * Confirmation of Award * Arbitrator Misconduct (Material & Pertinent Evidence) * Prejudice to Party * Damages Calculations * Evidentiary Issues (Admissibility; Materiality).
A motion to vacate an award on the ground that the arbitrator(s) failed to admit material evidence will only be granted upon a showing of substantial prejudice. Isabelita Nopuente appeals from a lower court decision denying her motion to vacate an arbitration Award (FINRA ID #04-00772 (S.F., 4/16/09)) in favor of Tony Choy and H.D. Vest Securities. Nopuente, the claimant in the underlying FINRA arbitration, asserts that the Award should be vacated, pursuant to California Code of Civil Procedure 1286.2(a)(5), which permits vacatur “if the rights of the party were substantially prejudiced by the refusal of the arbitrator(s) to hear evidence material to the controversy.” Nopuente argues that she was prejudiced by the failure of the Arbitrators to admit two documents showing that she refinanced real estate that she owned. These documents were purportedly material, because she invested the proceeds into her securities account and thus, after subtracting the monies that she withdrew from the account, this evidence would have established her loss. The Court of Appeal affirms. The contention that an arbitrator excluded material evidence is one that could be made in most cases and, if not properly limited, this type of attack could swallow the rule that arbitration Awards are generally not reviewable on the merits. To address this concern, courts have required parties making such contentions to show at the outset a likelihood of prejudice to the outcome. In the typical arbitration, an arbitrator must make numerous decisions about admission of evidence and in doing so may exclude material evidence. No doubt there will often be aggrieved parties who believe that they have been substantially prejudiced. If the trial court must routinely review the arbitrator’s decision on materiality before reaching the issue of substantial prejudice, the legislative goal of arbitral finality will be unattainable. Instead of saving time and money, the arbitration will be supplemented by lengthy and costly judicial second-guessing of the arbitrator. Section 1286.2(a)(5) is a safety valve in private arbitration that permits a court to intervene when an arbitrator has prevented a party from fairly presenting its case. The reviewing court should generally focus first on prejudice, not materiality. To find substantial prejudice, the court must accept, for purposes of analysis, the arbitrator’s legal theory and conclude that the arbitrator might well have made a different award had the evidence been allowed. In the present case, regardless of whether the Panel erred in refusing to accept the proffered evidence, Nopuente has failed to show how it might have changed the outcome had the panel considered the excluded evidence. Her clearest argument on prejudice is that, because it decided not to receive Nopuente’s proffered evidence about the transactions, the Panel was unable to calculate how much money she gave to H.D. Vest and Choy and how much she recovered so that it could award her the deficiency. However, that argument fails to acknowledge that the Panel found no basis for a monetary award to Nopuente in any amount. If the Panel had found a basis for an award to Nopuente, the proffered evidence might have been relevant in determining the proper amount of the award, but Nopuente fails to explain how the excluded evidence might have affected the outcome absent any basis for liability under any of Nopuente’s causes of action. (P. Dubow) (SLC Ref. No. 2011-10-03)

CITGROUP SMITH BARNEY V. HENDERSON,
Arbitration Agreement * Breach of Agreement (Non-Signatory) * Enforceability (Waiver) * Equitable Doctrine (Estoppel) * FAA (Generally) * State Law, Applicability of (Fed v. State) * Account Administration * Liability Issues (Interpleader). *A non-signatory to a contract with an arbitration clause will be required to arbitrate a dispute arising from the contract, if the non signatory enjoys the benefit of the contract. **A New York court will determine whether a right to arbitrate has been waived only if the underlying contract provides that it will be enforced pursuant to New York law. ***Under the FAA, if an agreement is silent on whether a court or an arbitrator will decide the issue of waiver, then the default position is that the issue will be decided by the arbitrator. After client Lyle Henderson died, Citigroup attempted to disburse the proceeds of his IRA account. But it discovered that it had two conflicting forms designating the beneficiary under the plan. One form, which was dated, provided that the funds would pass to Madge Henderson, his second wife. The other form, which was not dated, provided that the funds would pass to his children by his first wife. Since Citigroup could not determine which beneficiary designation form was Mr. Henderson’s last wish, it wrote to the two groups urging them to resolve the problem and stating that it would file an interpleader if the dispute could not be resolved. The heirs failed to resolve the issue and so Citigroup filed its interpleader, requesting that the funds be deposited in court and that it be dismissed from liability. Both sets of heirs filed counterclaims asserting a breach of contract, because Citigroup could not honor the designation form that each favored and so they opposed the request for dismissal. Citigroup then filed a motion to compel arbitration. All the heirs opposed the motion on the ground
that Citigroup had waived arbitration by filing the interpleader. The children also opposed the motion on the ground that they were not bound to arbitrate, because they had not entered into any arbitration agreement with Citigroup. The trial court denied the motion. Citigroup appeals. The Court quickly disposes of the children's argument that they were not bound by the arbitration agreement. That argument runs counter to the well-established principle that a party who accepts a benefit from a contract cannot avoid an arbitration clause, even when the party is a non-signatory to the contract. With respect to the waiver issue, the heirs argue that the contract provided that it “shall be governed and construed in accordance with New York law,” that New York law provides that the issue of waiver shall be decided by the court, and that the trial court had ruled that Citigroup waived arbitration. The Court holds that this argument does not account for the distinction in New York law between the construction of provisions in an agreement and the enforcement of those provisions. The New York Court of Appeals has held that a provision requiring that a contract “shall be governed” by New York law did not express an agreement to have New York law govern the agreement’s enforcement. Waiver is an enforcement issue, not a construction issue. Only a provision selecting New York law to govern both “the agreement and its enforcement” would require a court to decide the threshold issue of whether Citigroup waived arbitration. The text of the agreement herein does not include the critical language pertaining to enforcement. The agreement does contain the additional language that it shall be “construed” in accordance with New York law, but “construed” does not mean “enforced.” Hence, the agreement is silent on the question of whether a court or an arbitrator shall decide the issue of waiver or any other enforcement issue. Both sides agree that the dispute involves interstate commerce and thus is covered by the Federal Arbitration Act. Where an arbitration agreement is silent on whether the court or an arbitrator should decide issues of waiver, the FAA supplies a default rule. It is presumed that waiver issues will be decided by the arbitrator. Since the court below decided the issue of waiver, not the arbitrator, its decision is reversed.

(P. Dubow) (EIC: This is an Oregon court interpreting New York law -- and it looks to us as though the Court got it right. Query, though, how likely is it an arbitrator will send this case back to court? What happens now, anyway? Will the trial court hold onto the interpleader side of the case, stay it and send the counterclaims to arbitration? Will FINRA accept the deposit of interpleader assets, if the lower court dismisses the interpleader action? The Appellate Court does not specify a result.) (SLC Ref. No. 2011-12-02)


Both Florida and Maryland law recognize that customer lists can constitute trade secrets.

Stifel Nicolaus and six brokers were named by Citigroup Global in this raiding dispute. CGMI sought injunctive relief from the Court, prefatory to proceeding in arbitration under the expedited procedures of NASD Rule 10335. CGMI stated in its filing papers that it had filed simultaneously with NASD, as the Rule requires, but in fact there was a week’s interval. Defendants oppose the motion for injunctive relief on numerous grounds, one of which is CGMI’s incomplete adherence to Rule 10335. The Court, though, rules that a simultaneous filing is not a “condition precedent” to its jurisdiction. Defendants also challenge standing, on the premise that the six broker Defendants were first Legg Mason employees, who were “acquired” in the merger with Citigroup/Smith Barney, and there is no proof that the contracts they signed with Legg Mason were assigned to CGMI. That the two companies merged is sufficient proof that the contracts transferred to CGMI, the Court finds; an actual assignment is not necessary. Several responses greet the unclean hands defense proffered by Defendants. The brokers assert that the customer information they took when they left CGMI duplicated their conduct when they left earlier employment and transferred their records and business to Legg Mason. The Court’s first response is that two wrongs do not make a right: “In essence, Defendants ask the Court to accept the cutthroat business practices as routine for the industry and put the law aside because inequity is inherent in the brokerage business.” That other courts have accepted this in pari delicto approach is rejected here, because there are distinctions. The defense requires proof that Plaintiff’s wrongdoing concerned the Defendants; that is not the case here. Stifel Nicolaus was not injured by the earlier transfers and, in any case, they occurred with regard to Legg Mason and before the merger. Defendants have not even shown that the client files they brought to Legg Mason were the same 1,400 accounts they took when they left CGMI. Testimony indicates there may only be a 40% overlap. Defendants also assert the “industry practice” argument with respect to the “likelihood of success” test that courts must weigh in considering injunctive relief. They charge that arbitrators understand industry practice and will not award damages or injunctive relief on the basis of the conduct alleged here. Maybe, the Court replies, but it will not “set aside legal judgment and surmise as to what an arbitration panel of industry representatives might do with these facts.” Defendant-brokers executed non-compete and non-solicitation agreements when they joined Legg Mason. The agreements are reasonable in scope and CGMI has the right to enforce them. Injunctive relief will issue for a period of 45 days or until the arbitration panel issues its own Order.

(ed: We did not get to see if the Stifel Defendants guessed right about what the Arbitrators would do, because the matter settled with an agreement to have the Panel impose a stipulated injunctive Order. ID cont’d on page 23)
failure to disclose certain facts was a result of wrongful intent, or scienter, even assuming defendants knew of the facts at issue. The Court limits its review to the question of scienter, which it defines as a “mental state embracing intent to deceive, manipulate, or defraud.” Plaintiff could show scienter by demonstrating that defendants intentionally or recklessly controlled or artifically affected the price of a security. However, under the recklessness standard, the defendant must make a “highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure” from ordinary care, about a fact of which they had actual or constructive knowledge. Under the PSLRA, “plaintiffs must state with particularity facts giving rise to a strong inference that the defendant acted” with scienter. That strong inference must be as likely or more likely than any other explanation for the statement or omission. Although defendants may have known about the change in Japanese regulations, the fact that Japanese sales were only moderately affected and that overall international sales continued to grow, made it reasonable for defendants to omit disclosure of this information in early 2007. It was not until later in the year, when the company admitted to diminishing per share revenue, that the regulations became a concern. Furthermore, the Court determines that one officer’s sale of 4% of the shares he owned was insufficient to show scienter. While the second officer’s sale of more than 20% of the shares he owned during the relevant time period may have hinted at scienter, without some allegation that such a sale was out of the ordinary for that officer, no strong inference of scienter could be drawn. Moreover, the value of the stock significantly recovered shortly after the period complained of by the plaintiffs. Accordingly, the Court finds that the plaintiffs fail to make a strong inference that the defendants had the necessary scienter under the PSLRA and affirms the trial court’s dismissal of plaintiff’s fraud claims.

(P. Michaels) (SLC Ref. No. 2011-08-03)
misrepresentations in order to determine a unitary burden of proof on the reliance issue. Here, the Court concludes that the allegations should be characterized primarily as misrepresentations. Plaintiffs failed to produce any evidence that they relied on the misrepresentations. Regarding the Kentucky Securities Act claim, the Court rules that plaintiffs failed to demonstrate the absence of a genuine issue of material fact as to Durham’s participation in the solicitation of the sale of securities. The term “offer or sale” is not so broad as to include professionals, such as attorneys or accountants, whose participation is confined to providing professional services. To impose liability, an attorney must do something more than act as legal counsel. He or she must have actively assisted in offering securities for sale, solicited offers to buy or actually perform the sale. Where an attorney drafted the PPM intended to solicit investors and then attended certain client meetings to answer legal questions, the content of the attorney’s answers and not simply the act of answering questions is the key factor in determining whether the attorney has attempted to effect the sale of securities. Here, Durham’s preparation of the PPMs falls squarely within the category of providing legal services, which does not constitute an attempt to effect the sale of securities. Likewise, his offer to speak with investors fails to demonstrate that he actively assisted in offering securities for sale. Plaintiffs failed to produce any evidence of the content of the specific conversations that Durham had with investors. As to the Tennessee Consumer Protection Act claim, the Court concludes that the practice of law does not constitute trade or commerce under the TCPA.

(W. Nelson) (SLC Ref. No. 2011-08-08)


Employment: Breach of Contract
* Fraudulent Concealment and Inducement
* Employment Discrimination (Racial)
* FRCP: Fed R Civ. Pro. 9(b) & 12(b)(6)
* Release
Effect of (Title VII; Public Policy)

* Waiver (Knowing & Voluntary)
* Compensation Issues (Severance Pay).

Defendant’s motion to dismiss Plaintiff-employee’s breach of contract claims is granted, where Plaintiff failed to execute a post-termination release, but denied, where Plaintiff has adequately pled employment discrimination claims.

Before the Court is Defendant’s motion to dismiss Plaintiff Cloke-Browne’s complaint pursuant to Federal Rule of Civil Procedure 12(b)(6). Plaintiff’s suit grew out of his employment by Defendant in 2006 as Senior Vice President of Defendant’s Portfolio Management Division for the Americas. Following Plaintiff’s professed struggles to complete financial transaction deals on Defendant’s behalf, Plaintiff was terminated in 2009, due to a purported “staff reduction.” Importantly, Plaintiff refused to execute a release and waiver requested by Defendant and covering, among other points, any racial discrimination claims that Plaintiff might have against Defendant’s firm. When Plaintiff failed to execute the release, Defendant withheld certain monies which otherwise would have been due Plaintiff in the form of severance. Shortly after his termination, Plaintiff filed suit, alleging a host of contractual, employment and discrimination-related violations, including breach of contract, fraudulent inducement and concealment, and violations of federal and New York state labor and civil rights acts. The Court now reviews Defendant’s motion to dismiss as it relates to each of the various counts asserted by Plaintiff, granting Defendant’s motion as to some counts, while denying it as to others. Accordingly, the Court grants Defendant’s motion to dismiss the cause of action asserting breach of express contract: noting that the express terms of Plaintiff’s employment provided for severance payments only upon Plaintiff’s execution of Defendant’s release. As the Court stresses, a corporate officer forfeits his right to severance pay by not executing a release required by his employment agreement. Moreover, the Court rejects Plaintiff’s arguments that, as the release would preclude Plaintiff from asserting racial discrimination claims, the requirement that it be executed as a condition precedent to receiving severance runs counter to public policy: waivers of rights under federal and state anti-discrimination laws are enforceable if knowing and voluntary. At the same time, after finding that Plaintiff’s allegation that he was terminated in retaliation for criticizing management’s business strategies in violation of Defendant’s own anti-retaliation policies, the Court denies Defendant’s motion to dismiss the breach of implied contract claim. Additionally, the Court grants Defendant’s motion to dismiss Plaintiff’s fraudulent inducement and fraudulent concealment claims, finding that Plaintiff failed to satisfy the heightened pleading requirements of Federal Rule of Civil Procedure 9(b): Plaintiff proffered no specification of the time and place that Defendant allegedly made fraudulent statements upon which Plaintiff relied in accepting employment with Defendant. Finally, the Court denies Defendant’s motions to dismiss Plaintiff’s discrimination claims, finding (as against the corporate Defendant) that Plaintiff has sufficiently pled facts giving rise to discrimination under applicable federal and state statutes.

(N. Sorkin) (SLC Ref. No. 2011-12-03)


Collection/Debtor Issues (“Lock-up Agreements”) * Declaratory Judgment * Margin Violations/Liquidations
* Account Administration (Securities Transfers) * Remedies * Judicial Authority, Scope of * Settlement Issues (Law of the Case).

Under Delaware Chancery Court Rule 60(b), where exceptional circumstances have deprived the parties of appellate review, the court may vacate a prior ruling, even after the case is settled. This action for declaratory relief presented the question whether plaintiff, Credit Suisse, had the right to liquidate shares pledged to it in violation of a lock-up agreement between the owner of the shares and defendant, West Coast. On motions for partial judgment on the pleadings,
the court found in favor of Credit Suisse on the lock-up issue, a ruling that West Coast initially appealed, but then settled. Following the settlement, defendant moved to vacate the judgment. As the Court notes, under Court of Chancery Rule 60(b), vacatur may be granted to prevent an unappealable judgment from obtaining “precedential or preclusive res judicata effect.” Where, however, the parties voluntarily surrender their right to such review through settlement, the Court should do so only in exceptional circumstances and the right to relief should be narrowly construed. During the pendency of the underlying action, two things had happened: (1) plaintiff had obtained a FINRA arbitration award for compensatory and punitive damages against the owner of the shares (and counterparty to West Coast in the lock-up agreement) for losses occasioned in the margin account with plaintiff; and (2) the Appellate Court had remanded the matter for consideration by the Chancery Court of two issues not considered by the Court which, no matter how they were eventually decided, effectively would have precluded appellate review of the adverse judgment.

Here, for those and other reasons, the Court concludes the case presents such exceptional circumstances. First, the parties had not sought to vindicate harm caused by the other, but only to protect legitimate business interests from harm caused by a third party (in the case of plaintiff, its right to margin collateral, and in the case of defendant, its lock-up rights) and plaintiff had been compensated for that harm through the arbitration award.

To establish harmful precedent against either on the lock-up issue would not seem just, especially since West Coast was still pursuing issues related to the lock-up agreement against the owner of the shares. Second, the questions on remand from the Appellate Court suggested that the Appellate Court may have affirmed or reversed on entirely different grounds, leaving the Chancery Court’s holding effectively unreviewable. And third, subsequent discovery and a more developed record suggested a different result on the underlying contract question, a good reason according to the Court to avoid the possible collateral estoppel effects of a judgment that was, perhaps, not well-founded. Thus, the Court concludes, this is “one of those very few, unusual cases where vacatur is appropriate.”

(D. Franceski: While the ultimate outcome is cloaked in Delaware Chancery Court procedure, it seems more a matter of the Court having realized, with some guidance on remand, that its interpretation of the lock-up agreement was not legally or equitably sound, and may have ultimately absorbed the real wrongdoer of a fraud.)

(Davis v. Karl, No. 10-875, 2010 U.S. Dist. LEXIS 85318 (E.D. La., 8/19/10).

FRCP: Federal Rules of Civil Procedure (Rule 12(b)(6) and Rule 9(b)) * 1933 Act (§ 12(a)(2)) * State Statutes Interpreted (Louisiana Unfair Trade Practices Act) * Private Right of Action (Civil Conspiracy) * Fiduciary Standards (Broker) * Timeliness Issues (Statute of Limitations; Peremptive Periods). Civil conspiracy claims must plead all elements of the underlying tort in which defendants conspired; statutory rights of action under the Securities Act of 1933 do not permit a conspiracy claim.

Plaintiff sufficiently pled claims for fraud, violations of the Louisiana Unfair Trade Practices Act (“LUTPA”), conspiracy to violate LUTPA, and conspiracy to commit fraud, but claims for conspiracy to violate §12(a)(2) of the 1933 Securities Act and conspiracy to commit breach of fiduciary duty were dismissed, because there is no federal cause of action for a conspiracy to violate §12(a)(2) and the claim for conspiracy to commit breach of fiduciary duty lacked an essential element of the underlying tort. Unbeknownst to Plaintiff, Defendants were not licensed to provide security advice. Defendants filed a motion to dismiss pursuant to Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure, alleging plaintiff failed to state a claim for fraud, civil conspiracy, and unfair trade practices. Defendants also contended Plaintiff’s LUTPA claims were untimely under the LUTPA peremptive period. The Court holds that Plaintiff satisfied Rule 9(b)’s requirement that a fraud claim must allege with particularity the circumstances constituting fraud. Plaintiff’s pleading stated claims for fraudulent misrepresentation and fraud in the inducement by alleging Defendants intentionally misrepresented that: (1) they were licensed to provide securities advice and services; (2) $500,000 withdrawn from Plaintiff’s account had purchased certain securities when in fact the money had been paid to Defendant Karl; and (3) investments in certain securities were exempt under the Securities Act of 1933 when they were not. As for Plaintiff’s claims that Defendants violated the LUTPA, which prohibits “unfair methods of competition and unfair deception or deceptive acts or practices in the conduct of any trade or commerce,” the Court holds that Plaintiff has sufficiently asserted the elements of “fraudulent misrepresentation, deception or other unethical conduct” that amount to unfair trade practices under the LUTPA, based upon adequately pled claims for fraudulent misrepresentation and fraudulent inducement. Furthermore, because Plaintiff asserted that the Defendants committed various torts throughout the course of their relationship, the allegations could rise to a continuing violation of the LUTPA, which would toll the LUTPA’s one-year peremptive period. As for Plaintiff’s conspiracy claims, the Court holds that, while Plaintiff has sufficiently alleged a conscious agreement among the Defendants, only the conspiracy claims for violations of the LUTPA and conversion are sufficiently pled. Because there is no federal cause of action for conspiracy to commit a violation of § 12(a) (2) of the 1933 Securities Act, Plaintiff’s claim for conspiracy to commit a violation of that statute fails. Finally, the Court holds that Plaintiff’s claim for conspiracy to breach a fiduciary duty should be dismissed, because, under Louisiana law, a breach of fiduciary duty arises only in contract; Plaintiff’s claim for conspiracy to breach a fiduciary duty therefore lacks an essential element of conspiracy, the underlying tort.

(J. Ballard) (SLC Ref. No. 2010-38-08)

Detroit General Retirement System v. Medtronic, Inc., cont’d on page 26
No. 09-2518, 2010 U.S. App. LEXIS 19379 (8th Cir., 9/16/10).

Class Actions, Effects of * PSLRA: Private Securities Litigation Reform Act of 1995 (Pleading Requirements) * FRCP: Federal Rules of Civil Procedure (Rule 12(b)(6) “Claim for Relief”) * 1934 Act (§10 “Rule 10b-5”). Plaintiffs alleged that the letter to doctors “falsely reassured” investors that the failures were due to implantation errors. However, the Court finds it difficult to see how a letter disclosing a possible problem and announcing an investigation into that problem was materially misleading. Additionally, the plaintiffs had no evidence that the statements in the letter were false when made. Although the company was in the process of collecting and examining data that eventually led to the recall, there was no evidence that any conclusion was drawn prior to the date the recall was issued. Finally, the company and the FDA both agreed that the available statistics did not require such action. Because the plaintiffs failed to offer evidence of a material misrepresentation, their causes of action are dismissed. (J. Ballard) (SLC Ref. No. 2010-42-06)


Award Challenge * Modification of Award (Partial Vacatur) * Exceeding Powers * Arbitrator Misconduct * Discovery Issues (Confidentiality) * State Law, Applicability of * Constitutional Issues (Freedom of Speech) * State Statute Interpreted (Mass. UAA, M.G.L. c. 251) * Public Policy * Injunctive Relief (Permanent Arbitral Relief) * Authority, Scope of (Arbitrator) * Scope of Agreement * Statutory Definitions (“State Action”). Enforcement of a confidentiality order contained in an arbitration Award invokes the Court’s enforcement powers and, therefore, represents “state action;” endorsing such an order when it broadly and without sufficient justification restricts conduct, and possibly speech, offends public policy. Neither side in this action for vacatur challenges the substance of the underlying FINRA Award, styled Oppenheimer & Co. v. Jesup & Lamont Securities, ID #08-00912 (Boston, 10/27/09). Instead, this post-Award dispute concerns, as the Court broadly puts it, “the legality of a permanent confidentiality provision in an award made by an arbitrator.” That confidentiality order from the Panel is described as follows in the Award: “During the hearing, [Respondent] Dever requested that certain documents be de-classified as confidential. [Respondent] Dever’s request for de-classification of documents ruled by the Panel as confidential is denied. Further, the testimonies, hearing transcripts, and the arbitration proceedings (including confidential documents) are ruled as confidential and are to remain so.” The Panel also issued a “gag order” during the proceedings, “…prohibiting the parties and their counsel from discussing the case with the press or anyone else,” but that order was lifted by the Panel in issuing its Award. Mr. Dever seeks a ruling from the Court modifying the Award and invalidating the confidentiality order, charging that it will prevent him from defending himself in the “court of public opinion” and inhibit his efforts to maintain a clean “public rating with the Central Registration Depository system.” Oppenheimer asserts the privacy of arbitration proceedings and seeks continuation of the order, to restrict disclosure of “embarrassing personal matters” The Court weighs the requests under the State’s Uniform Arbitration Act, M.G.L. c. 251 and reviews the grounds upon which it may vacate or modify an arbitration Award. Among other things, it states that public policy violations may warrant judicial intervention and that errors by arbitrators may be corrected, but only if they fall outside the limits of the arbitrators’ powers. Certainly, confidentiality may be expected as part of the discovery process and, in this case, the parties actually protected certain disclosed documents with a confidentiality agreement. Here, though, the Arbitrators made that relief permanent and did so very broadly in a “blanket order.” FINRA itself has warned arbitrators against imposing broad orders and asks that such orders be narrowly fashioned. FINRA has also cautioned firms against entering into confidentiality agreements that have the effect of impeding investigations or enforcement.
actions. This order offends public policy, because of its sweeping and permanent restrictions; no evidence establishes, for instance, that the order does not cover oral expressions, but only prohibits document disclosures. The Court invokes freedom of speech at this juncture and supports that overlay with the observation that, upon confirmation, this Award “would then become enforceable as any other judgment.” It concludes: “I am satisfied that the confidentiality provision in this case violates public policy, is contrary to legal and constitutional mandates, and exceeds the powers accorded to this panel. The offensive language is excised and the Award is otherwise confirmed.

(ed: *While lifting of the Panel’s confidentiality order, the Court maintains an impoundment order that the parties entered into at the outset of the court proceedings for 45 days “to give the parties an opportunity to bring further motions to impound specific documents before the session judge, or to seek appellate remedies.” Oppenheimer did, in fact, seek specific protection for some of the impounded documents, which led to the decision covered below. **The arbitration proceedings also favored Mr. Dever, as the Arbitrators granted a monetary award on a counterclaim of $74,939 and pre-Award interest of $11,830.24. Stuart D. Meissner, a New York attorney, represented Mr. Dever in the underlying arbitration and fought the battle for relief from the confidentiality order.*) (SLC Ref. No. 2011-07-03)

DEVER v.
OPPENHEIMER & CO., INC.,
Award Challenge * Modification of Award (Partial Vacatur) Injunctive Relief (Document Impoundment) * Discovery Issues (Confidentiality; Reg S-P) * Judicial Authority, Scope of * Privileges/Immunities (Attorney-Client; Regulatory).
Impoundment of documents is the courts’ way of protecting documents produced in litigation from becoming publicly available, where the documents are proprietary in nature, are covered by a privilege, or, if made public, would invade the privacy of an individual.
In a prior decision (SLA 2011-07), this Court modified this FINRA Award (#08-00912), at the request of Mr. Dever, to delete an arbitral direction preventing the parties from revealing information about the arbitration proceedings. The language excised from the Award upon the order of the Court, stated: “Further the testimonies, hearing transcripts and the arbitration proceedings (including confidential documents) are ruled as confidential and are to remain so.” In order to preserve the integrity of the Arbitrators’ order, while the Court was considering its legitimacy, the Court impounded all documents submitted by the parties. After the Court essentially vacated that order as overbroad and beyond the Arbitrators’ authority, Oppenheimer sought to invoke the Court’s powers to preserve confidentiality of the documents. It submitted to the Court, in addition to that which was already filed and impounded during the proceedings, “two hefty binders containing 1651 pages of proprietary and customer/employee-related documents produced during the discovery phase of the FINRA arbitration.” In this way, Oppenheimer sought to make the documents part of the Court’s record and obtain impoundment of “this much larger universe of documents....” The Court, acting, as it says, as a “Special Master, spent seven hours with the parties reviewing virtually every page of the “universe” in a closed hearing, “so that counsel could argue freely and a complete and comprehensible transcript of the proceedings could be made for appellate review.” In this decision, the Court rules what documents will be impounded following this review and explains its basis for ordering impoundment. The bases for impoundment are the proprietary nature of the documents, their privileged nature (either as attorney-client communications or communications with regulators), or regard for the privacy of customers or employees. The Court impounded a score or more proprietary documents, but rejected impoundment of documents based upon claims of attorney-client or regulatory privilege. It also redacted account numbers, social security numbers, client names, and other customer information from numerous documents that would not be impounded on grounds of customer privacy. Documents relating to charges of employee misconduct and Oppenheimer’s investigations of such claims are released, as the investigations are complete and a “fair picture of the allegations” can be shown. “This may cause embarrassment to certain individuals, but embarrassment,” the Court observes, “is no grounds for impoundment.”
(ed: Impoundment, the Court writes in a footnote, should not be viewed as a broad order of confidentiality, such as the Panel imposed. “An impoundment order is directed to the clerk of the court not to the parties. Oppenheimer was not authorized by this court to seek to restrain the communications of plaintiff Dever....” **The Court agreed to only a 24-hour hold on the released documents before disclosure, noting that the Boston Globe had signaled interest, even asking for open hearings on the impoundment proceedings. “[T]he public interest in the matter is high, and the public ought not be further delayed.” ***The Globe, indeed, was interested. We found a long news article reviewing the 1600+ released documents on the paper’s WebSite (11/18/11; “Opco fight....” by Beth Healy.)) (SLC Ref. No. 2011-07-04)

DRONSEJKO v. GRANT THORNTON,
Claims of accounting irregularities or violations of GAAP support a claim of scienter only when coupled with evidence that the violations or irregularities are the result of the defendant’s fraudulent intent to mislead investors.
In these consolidated appeals, plaintiffs challenged the district court’s dismissal of the second amended complaint for failure to properly plead scienter under the PSLRA and from the district court’s denial of a Rule 60(b) motion in which cont’d on page 28
plaintiff sought the opportunity to file a new amended complaint to incorporate newly-discovered evidence. Regarding the former, under the PSLRA, the complaint must state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind. Here, although Grant Thornton’s interpretation of an AICPA rule concerning revenue recognition may have been incorrect or even negligent, the complaint does not establish that Grant Thornton’s conduct was an extreme departure from the standards of ordinary care. Claims of accounting irregularities or violations of GAAP support a claim of scienter only when coupled with evidence that the violations or irregularities are the result of the defendant’s fraudulent intent to mislead investors. Regarding the latter, the newly-discovered evidence consisted of two orders entered by the Public Company Accounting Oversight Board, which imposed sanctions on two representatives of Grant Thornton for their role in the underlying audit at issue on appeal. The Court of Appeals affirms the district court’s denial of the Rule 60(b) motion for relief from the dismissal, noting that the PCAOB orders were of dubious weight, because respondents stipulated to the allegations and did not contest the resulting sanctions. Moreover, plaintiffs failed to establish that they met the requirements of Rule 60(b), specifically why they could not have discovered the evidence earlier had they acted with proper diligence.

(W. Nelson: Regarding scienter, the 10th Circuit acknowledged that other circuits have developed a recklessness standard specifically for §10(b) claims against outside auditors. Under that standard, outside auditors act recklessly only when accounting practices were so deficient that the audit amounted to no audit at all, or to an egregious refusal to see the obvious or investigate the doubtful or that accounting judgments which were made were such that no reasonable accountant would have made the same decision presented with the same facts. The Court concludes that it need not decide whether to adopt an auditor-specific standard for recklessness under §10(b) claims, because the second amended complaint was deficient under the existing PSLRA heightened pleading requirements.) (SLC Ref. No. 2011-07-08)

**FARBER v. GOLDMAN SACHS GROUP, No. 10 Civ. 873, 2011 U.S. Dist. LEXIS 16673 (S.D. N.Y., 2/16/11).**


In a Rule 12(b)(6) motion to dismiss, plaintiff’s obligation is to provide proof of his entitlement to relief, which requires more than labels and conclusions and a formulaic recitation of the elements of a cause of action.

Plaintiff asserts six claims against defendants in relation to an auction rate security (“ARS”) it purchased from non-party E*Trade Securities. Defendants move to dismiss pursuant to FRCP Rule 12(b)(6) on the basis that a FINRA arbitration Panel previously dismissed these same claims. ARS are debt instruments with long-term nominal maturity for which the interest rate is regularly reset through Dutch auctions. According to plaintiff, defendants were one of the principal developers of the multi-billion dollar ARS market. Beginning in 2005, institutional purchasers, who were the backbone of the ARS market, began to leave the market. According to plaintiff, defendants falsely marketed ARS as cash equivalents and recruited thousands of new retail purchasers to replace the institutional purchasers who were fleeing the market. In 2007, plaintiff was approached by an E*Trade salesman who solicited a $1 million purchase of the Mass. Health & Education Facilities Authority ARS, which he did, relying on prior oral and written misrepresentations of defendants regarding the value of all ARS. Only after defendants and other major broker-dealers stopped supporting the market for ARS did defendants admit that ARS were not cash equivalents and that there is no guarantee that there will be liquidity. In August of 2008, defendants entered into a settlement with the N.Y. Attorney General, agreeing to pay a fine of approximately $22.5 million and agreeing to buy back approximately $1 billion in unmarketable ARS from customers who purchased their ARS directly from defendants. The settlement did not cover any amounts from purchasers who bought from other broker-dealers. Plaintiff filed a Statement of Claim with FINRA against Goldman Sachs & Co. and E*Trade under §10(b) of the 1934 Act, § 36b-29(a)(2) of the Connecticut Uniform Securities Act, for breach of fiduciary duty, and for aiding and abetting a breach of fiduciary duty. Goldman Sachs moved to dismiss pursuant to FINRA Rule 12504(a)(6)(E), which provides for dismissal where the moving party had no contact with the accounts, securities or conduct at issue. The FINRA panel dismissed all of plaintiff’s claims on the grounds that Goldman was not connected to the account at issue and that plaintiff did not purchase the securities from defendants. Plaintiff then filed this action, asserting the previous four claims and § 20(a) of the 1934 Act, and added Goldman Sachs Group as a defendant but did not name E*Trade. Defendants move to dismiss under Rule 12(b)(6), pursuant to which plaintiff must assert enough facts to state a claim that is plausible on its face. Issues of collateral estoppel and res judicata may be decided on a motion to dismiss. Res judicata applies in federal courts to bar the assertion of claims that were adjudicated or could have been raised in a previous proceeding, where the parties or those in privity with them were involved in the proceeding. The FINRA Panel ruling is entitled to preclusive effect under collateral estoppel, which prevents a party from re-litigating an issue that has been previously decided against him in a proceeding in which he had a fair opportunity to fully litigate the point. That the arbitration panel did not include a detailed examination of each element of plaintiff’s claims does not mean the decision was not on the merits, where a ground for the panel’s decision can be inferred from the facts of the case. Nothing in the Panel’s order indicates that its scope is limited to the procedural question of whether plaintiff’s case was arbitrable. Although Goldman Sachs Group was not cont’d on page 29
a party to the FINRA arbitration, it is in privity with its wholly-owned subsidiary, Goldman Sachs & Co. Plaintiff’s two new claims were or could have been raised in the FINRA arbitration and are barred by res judicata.

(S. Anderson) (EIC: The finality of the Panel’s Order and its dispositive nature, fully dismissing Goldman from the arbitration, makes this Order an “Award” in our view. Yet, FINRA will not make that Order public, because it is not, in FINRA’s view, an “Award.” As a consequence, if the Farber claim against E*Trade settled, as it appears it has, FINRA will not list this Order on the Arbitrators’ disclosure sheet and future parties will not be advised by FINRA that Goldman won a Panel dismissal in the underlying arbitration. ARBchek searches will reflect this “Award.” A copy may be viewed in the ARBchek Award Library, www.ARBchek.com, under FINRA ID #09-02371.) (SLC Ref. No. 2011-10-02)

FORAGAZZO v. LEHMAN BROS., No. 03 Civ. 5194 (S.D. N.Y., 2/23/11).

Class Actions, Effects of (Settlement Approval) * Attorney Fees (“Common Fund Doctrine”) * PSLRA (Fee Determinations) * Judicial Authority, Scope of * Damages Calculations (“Lodestar” Method; “Percentage” Method).

In a class action, any percentage award of attorneys’ fees will be assessed for reasonableness using the Goldberger criteria, which include the time and labor expended by counsel, the magnitude and complexities of the litigation, the risk of the litigation, the quality of representation, the requested fee in relation to the settlement and public policy considerations.

Lead plaintiffs brought this securities class action on behalf of a class consisting of all who purchased or otherwise acquired RSL Communications, Inc. common stock between April 30, 1999 and December 29, 2000. Lead plaintiffs and defendants Morgan Stanley & Co. and Goldman Sachs & Co. have agreed to a cash settlement in the amount of $6,750,000. Class Counsel now moves, pursuant to PSLRA, for an award of attorneys’ fees of $2,250,000, which is 1/3 of the $6.75 million settlement fund, plus reimbursement of litigation-related expenses of $211,596.69. Class Counsel diligently litigated plaintiffs’ claims for seven and one-half years and prevailed on defendants’ motion to dismiss the amended class action complaint and on both motions for class certification. Class Counsel conducted substantial merits discovery and obtained expert opinions regarding the issues of loss causation and damages.

In addition, Class Counsel defended the four lead plaintiffs at their depositions, as well as plaintiffs’ loss causation expert. Class Counsel accrued $4.3 million in legal fees, exclusive of costs. This lodestar figure represents 64.4% of the Settlement Fund. If Class Counsel receives a fee-award of 1/3 of the Settlement Fund, it will only recover 51.6% of the accumulated lodestar expended on this litigation. Counsel’s request for a fee award of 1/3 was disclosed in the Notice of Pendency of Settlement sent to prospective class members and no objections were received. Courts have two methods used to calculate fees: the percentage method and the lodestar method. Under the percentage method, the court awards counsel a reasonable percentage of the recovery as a fee. The lodestar method requires the court to scrutinize the fee petition to ascertain the number of hours reasonably billed, then multiply that figure by an appropriate hourly rate. The trend in this Circuit is toward the percentage method, with the lodestar method serving as a “cross-check” for the percentage method.

Any percentage award will be assessed for reasonableness using the Goldberger criteria, which include a number of factors. In this Circuit, courts have held that the level of risk is often the “most important” factor. Where the total award computed under the percentage method is significantly less than the lodestar figure, a higher percentage may be warranted. Class Counsel expended 10,989.60 hours in this litigation. Plaintiffs alleged that, during the Class Period, the price of RSL’s common stock was artificially inflated as a result of untrue or materially misleading statements and omissions made by defendants in their equity research reports. Thus arose substantial and complex issues of loss causation, defendants’ non-compliance with SEC rules and regulations, damages and scienter. The risk of dismissal and, hence, non-recovery was a very possible outcome under the PSLRA’s heightened pleading standards. The litigation risk supports a 1/3 fee award on a contingent fee basis. The quality of representation is beyond reproach and the requested fee is reasonable in relation to the settlement. Counsel may be entitled to a “multiplier” of their lodestar rate to compensate them for the risk assumed by them, the quality of their work and the result achieved for the class. The lodestar rate here is almost twice the amount of fees requested. Thus, the lodestar “cross-check” unquestionably supports a percentage fee award of 1/3.

(S. Anderson) (SLC Ref. No. 2011-12-06)


The SEC reporting requirements applicable to institutional investment managers under § 13(f) of the 1934 Act regarding proprietary securities positions do not compel speech in violation of the First Amendment; nor do they constitute an uncompensated taking in violation of the Fifth Amendment.

Full Value, a hedge fund and institutional investment manager under the 1934 Act, appeals from the SEC’s denial of its requests for a permanent exemption from, or temporary confidential treatment of, its § 13(f) quarterly reporting requirements under the Act, 15 U.S.C. § 78 (f) (1). Full Value sought relief from the reporting requirements, which otherwise would make public certain of its securities holdings, on the ground that such public disclosure would drive up stock prices, thereby making it more difficult to pursue proxy contests or effect other management changes in the companies it held. The cont’d on page 30
SEC had denied Full Value’s requests on the ground that it had not yet made a good faith request for confidential treatment under § 13(f)(3), denial of which was a prerequisite for an exemption under § 13(f)(2), because it refused to support the request with sufficient investment information from which the Commission might make an informed decision. Full Value refused to do so because, had the Commission denied Full Value’s requests, it would have been required by law to publicly disclose the information which Full Value sought to keep confidential.

On appeal, Full Value attempts to avoid this “catch-22” by asserting that the Act’s disclosure requirements (1) compel speech in violation of the First Amendment, and (2) constitute an uncompensated taking of its trade secret, proprietary trading and investment strategies in violation of the Fifth Amendment both as to the ultimate disclosures to the public and as to its preliminary disclosures to the Commission in support of its exemption and confidential treatment requests. The Court rejects both constitutional challenges and affirms the Commission’s order. As to public disclosure, the Court concludes that the constitutional issues are not yet ripe, because the Commission “may yet grant Full Value an exemption,” if Full Value submits the requisite information to support confidential treatment or an exemption in the future. And as to preliminary disclosure to the Commission, the Court concludes, with respect to the First Amendment, that the statutory requirements are a “rational means” of the Commission fulfilling its goals, similar to other disclosure obligations to the government, such as income tax filings, and with respect to the Fifth Amendment, that the regulations requiring disclosure do not go “too far,” even assuming Full Value has a protectable proprietary interest in its investment positions. Finally, with respect to Full Value’s concern that denial of its requests would lead to mandatory public disclosure, the Court notes that Full Value will be able to seek judicial review of the Commission’s decision before its filings become public.

(D. Franceski) (SLC Ref. No. 2011-11-07) **Genworth Financial v. McMullan,** No. 09-CV-1521 (D. Conn., 6/10/10). Federal Statutes Interpreted (Computer Fraud and Abuse Act) * Unfair Competition (Raiding/Recruiting “Protocol for Broker Recruiting”) * Injunctive Relief (Irreparable Harm) * Misappropriation/Conversion (Trade Secrets). * Misappropriation of trade secrets by a competitor is not necessarily irreparable harm, because the misappropriator is likely motivated to protect the secret to serve its own purposes. **Injunctive relief may be warranted in cases where there is a danger that, unless enjoined, a misappropriator of trade secrets will disseminate those secrets to a wider audience or otherwise irreparably impair the value of those secrets.**

Defendants were employees of Genworth in its private client group serving high net worth investors. Genworth’s private client group provided investment strategies based upon asset allocation models from Brinker. Genworth filed this action for injunctive relief against the individual defendants, alleging that, prior to making staggered departures from Genworth, defendants copied Genworth’s database which contained client names, phone numbers, contact information, portfolio management history and client notes. Genworth further alleged that the defendants formed TJT Capital and used confidential client data to solicit and divert Genworth clients to the newly formed entity. After an evidentiary hearing, the Court enters an injunction against defendants, finding that Genworth has demonstrated a likelihood of success on the merits. The information at issue was not generally known outside of Genworth’s business and Genworth took reasonable steps to maintain its confidentiality, including the use of restricted access and password protection to the databases. The information had high economic value. The Court rejects defendants’ explanation that the customer lists were created from memory by noting that the typographical errors in those lists were direct matches to typographical errors found in the Genworth database. Regarding irreparable harm, a rebuttable presumption of irreparable harm is warranted in cases where there is a danger that, unless enjoined, a misappropriator of trade secrets will disseminate those secrets to a wider audience. Where a misappropriator seeks only to use those secrets without further dissemination or impairment of value in pursuit of profit, no such presumption is warranted because an award of damages will provide an adequate remedy. Here, however, Genworth introduced evidence showing that defendants not only used the information to establish TJT Capital, but they also used information regarding Genworth’s operations and relationship with Brinker to discredit the utility of those services. In addition, defendants disseminated the confidential information to counsel for a class action pending against Genworth. The Court finds that the information “pervades the class action complaint,” demonstrating that defendants were motivated to impair the value of Genworth’s reputation and the exclusivity of the information in question.

(W. Nelson) (SLC Ref. No. 2010-41-02)


Petitioners sought judicial review of a SEC order sustaining sanctions imposed on them by the NASD for violations of §10(b) of the Securities Exchange Act. The sanctions imposed barred petitioners from associating with any NASD member and fined each of them $114,022. In denying the petition for review, the Court holds that the SEC properly applied a preponderance of evidence standard in finding them guilty of fraudulent conduct. The Court rejects petitioners’ argument that NASD was required to prove the charges under Cont’d on page 31
a clear and convincing evidence standard, applying Steadman v. SEC (450 U.S. 91). It also rejects petitioners’ argument that they were improperly denied the use of subpoenas in the original NASD proceeding and that the SEC erred in finding that they were not harmed by any error committed. Petitioners failed to show that their inability to obtain testimony from two witnesses harmed their defense in the underlying case. Finally, the Court rejects petitioners’ argument that the sanctions were excessive, finding that the SEC’s conclusion was that the misconduct was egregious and that conclusion was well-supported by the evidence.

(W. Nelson) (SLC Ref. No. 2011-12-08)

GRAND v. NACCHIO, No. CV-09-0317-PR, 2010 Arizona LEXIS 35 (Ariz., 8/5/10). State Statutes Interpreted (A.R.S. §§ 44-1991(A); 44-201(A) & 44-2003(A)) * Private Cause of Action * Statutory Interpretation * Fraudulent Inducement * Statutory Definitions (“Participated in” the Sale; “control person”). One may simultaneously induce and participate in an illegal securities sale; however, participation and inducement involve separate factors and are not coterminous.

Nacchio and McAllister, both officers of Qwest Communications, were also the Chairman of the Board and CEO, respectively, of a Qwest joint venture, KPNQ. Plaintiff purchased 30,000 shares of KPNQ stock on the IPO and an additional 255,000 shares in the after-market. After KPNQ failed, plaintiff commenced this action alleging common law claims and violations of state and federal securities laws. As a result of motions practice and after remand, plaintiff filed a third amended complaint, which alleged only state securities law claims and sought only rescissionary damages. In response to defendants’ motions to dismiss, plaintiff acknowledged that the third amended complaint abandoned any claims that defendants had induced the after-market purchases and instead relied entirely on the theory that the defendants were liable under A.R.S. § 44-2003(a) because they had participated in the stock sales. The trial court granted the motions to dismiss with respect to all after-market purchases and plaintiff dismissed with prejudice its claims concerning shares purchased in the IPO. The Court of Appeals affirmed and the Supreme Court granted plaintiff’s petition for review. The issue before the Court was whether the third amended complaint sufficiently alleged participation in the sale of the after-market shares. Plaintiff argued that, because defendants induced the purchase of the after-market shares, they must also have participated in the sale. The Supreme Court disagrees. While one may simultaneously induce and participate in an illegal sale, participation and inducement involve separate factors. If all inducers were also automatically participants, the use of the term “induces” in the Arizona statute would be unnecessary. Here, the conduct alleged in the third amended complaint does not describe participation in the illegal sales. Rather, the complaint alleges that, through their acts and omissions, the defendants encouraged plaintiff to buy stock from others in the after-market. This is classic inducement. Plaintiff also fails to make a claim for secondary liability as a control person, because KPNQ, the controlled entity, did not participate in any of the allegedly illegal after-market stock purchases.

(W. Nelson) (SLC Ref. No. 2010-40-08)

GRANT v. HOUSER, No 10-1919 (E.D. La., 1/10/11). Agreement to Arbitrate * Arbitrability * Equitable Doctrine (Estoppel) * Contractual Issues (Assignment) * Breadth of Agreement (Non-Signatory). Court denying brokerage firm’s motion to compel arbitration of customer claims based on firm’s failure to supply sufficient evidence of assignment of arbitration agreement and upon a determination that equitable estoppels did not apply to compel arbitration.

In 2004 Plaintiff opened a brokerage account with Brecek&YoungAdvisors, Inc. (“BYA”). BYA’s registered representative, Kevin Houser (“Houser”), was in charge of Plaintiff’s account. In connection with the opening of the account at BYA, Plaintiff signed a New Account Form containing a broadly worded arbitration clause. In 2008, Securities America, Inc. (“Securities America”) acquired 100% of BYA’s shares. In connection with the acquisition, BYA allegedly assigned all of its assets, accounts and contractual rights and obligations to Securities America. In 2010, Plaintiff filed suit against Houser and Securities America, alleging breach of contract and tort claims relating to a 2009 investment that was allegedly mishandled by Houser. Defendants filed a motion to compel arbitration, arguing that Securities America could enforce the arbitration agreement in the New Account Form as BYA’s assignee. Defendants also argued that equitable estoppel prevented Plaintiff from denying that he was bound by the arbitration agreement. The Court first determines that the Federal Arbitration Act applies to the matter and that state law applies to the determination of whether a party is bound by or can enforce an arbitration agreement. The Court rejects Securities America’s argument that it is entitled to enforce the arbitration agreement based on the BYA assignment, finding that Securities America failed to provide sufficient evidence of the contractual assignment. Specifically, the Court determines that Securities America’s generic affidavit claiming that BYA assigned all of its contracts, without documentary evidence of such a transaction, was insufficient proof of the alleged assignment. The Court also rejects Securities America’s argument that arbitration was required under the principle of equitable estoppel, finding that the Plaintiff’s claims for fraud and unfair trade practices against Securities America were separable from the claims that were arbitrable under the contractual language in the New Account Form.

(J. Ballard) (SLC Ref. No. 2011-09-02)

Underwriting Issues (Due Diligence) * Pleading Requirements (“Shotgun Pleading”) * Liability Issues (Principal-Agent) * FRCP (Rules 9 “Particularity” & 15 “Leave to Amend”).

“Shotgun pleading,” or the practice of naming numerous defendants and then making allegations of misconduct that are attributable to all of them without distinction, is not an appropriate form of pleading, especially when the particularity requirements of FRCP Rule 9(b) are involved.

This case arises from a claim brought in the United States District Court for the Southern District of Florida by Great Florida Bank, seeking damages based upon losses incurred by Great Florida Bank due to the purchase of securities backed by non-conforming loans. Great Florida Bank alleged that Countrywide Home Loans, Inc. and its affiliates failed to disclose that they did not perform appropriate underwriting of the securities and that two agents of Countrywide Securities failed to provide or give access to appropriate information so that the loan portfolio could be evaluated. The Complaint of Great Florida Bank had been dismissed two times previously and, in this decision, the Court considers the Third Amended Complaint. It focuses on three aspects of the Defendant’s Motion to Dismiss: first, that the Complaint is deficient because it constitutes “shotgun pleading;” second, the failure of the Complaint to properly allege agency of the two agents of Countrywide Securities Corporation to act as agents of Countrywide Home Loans, Inc.; and, finally, that the Complaint makes numerous allegations on the basis of “information and belief.” First, with respect to “shotgun” pleadings, Judge Huck notes that the Eleventh Circuit has on numerous occasions indicated that such “shotgun” pleading is inappropriate. He points out that in this case it is particularly inappropriate, because the Plaintiffs aggregate all of the Defendants as “Countrywide” and it is impossible to tell in the Complaint what entity or person is responsible for what actions. Thus, the Court directs that the Complaint be dismissed, because of the inappropriate method of pleading.

Second, the Court focuses sua sponte on the allegations that the two agents of Countrywide Securities Corp. were agents of Countrywide Home Loans, Inc. Even though the Defendants in the case did not object to the characterization, the Court rules that it is necessary to allege underlying facts to establish that agency; he also dismisses this case on those grounds. Finally, the Court focuses on the allegations that are based on “information and belief.” Many of these allegations relate to the knowledge of the two agents of Countrywide Securities Corporation that the underwriting of the securities had not been properly performed. The Court indicates that, under FRCP 9(b), the general pleading of knowledge on information and belief without any specific facts to show that these agents actually had knowledge of these facts is improper. Having reached these conclusions, Judge Huck dismisses the plaintiff’s Complaint for a third time, but does say without prejudice; this allows the plaintiff’s to amend their Complaint, to add specificity and remove the “shotgun” pleadings if they so desire. He indicates that a Fourth Amended Complaint will be the Plaintiff’s last opportunity to plead their case.

(B. Wiand) (SLC Ref. No. 2011-11-09)

**GUNNALLEN FINANCIAL, INC,** IN RE: GUNNALLEN v. U.S. SPECIALTY INS. CO., No. 8-10-cv-2855, 2011 Bankr. Lexis 334 (M.D. Fla., 2/3/11). Bankruptcy/Insolvency Issues * Insurance Issues * Settlement Issues (Fairness Approval). Settlement of the Liquidating Trustee’s claims against one of Debtor’s liability carriers for the balance of policy limits, on condition of a bar order which extends to claims against non-debtors as well, is not fair and equitable to claimants and will not be approved over their objections.

The Liquidating Agent for defunct broker-dealer GunnAllen sought approval of a settlement with one of the Debtor’s pre-petition liability insurers. The insurer offered to contribute to the debtor’s estate the entire $1.7 million balance of the policy limits in exchange for a bar order that would cover claims against both debtor and non-debtor insureds alike, leaving claimants with a fractional distribution of less than 25% on their claims. Both the SEC and Securities Claimants in the bankruptcy whose claims against non-debtors would have been barred opposed the motion. Based on its conclusion that the settlement would not be fair and equitable, the Court denies the motion and refuses to approve the settlement. Though the settlement provides the debtor’s estate with the maximum recovery remaining under the policy, and also avoids the further exhaustion of policy proceeds in defense costs, the bar order deprives claimants of any additional recovery outside the bankruptcy against non-debtors. Thus, the Liquidating Agent is settling claims that are not those of the liquidating estate. According to the Court, the true beneficiaries of the settlement would not be the Securities Claimants, but the numerous individuals accused of unauthorized trading, churning, fraud and unsuitability, who caused claimants’ losses and bankrupted GunnAllen. At the same time, it adds little value beyond distributing in some orderly fashion the settlement proceeds. That decision, however, belongs to the Securities Claimants. And though the insurer’s offer does satisfy its duty to try to settle as many claims as possible within policy limits, and therefore protects it from a bad faith claim, it is not fair and equitable to the claimants and will not be imposed over their objection.

(D. Franceski) (SLC Ref. No. 2011-10-05)


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Claims based on control person liability for an underlying primary violation of fraud must satisfy the pleading particularity requirements of Rule 9(b) and the PSLRA; conclusory allegations of participation as a “control person” or seller will not suffice to state claims for relief under the 1933 Act, 1934 Act or state statutory or common law.

In this putative class action for losses incurred in this alleged Ponzi scheme involving the sale of interests in phony telecommunications companies, defendant Questar Capital, one of several brokerage firms with which the alleged Ponzi schemer had been associated as a registered representative, moved to dismiss on these grounds: (1) that plaintiffs’ federal securities fraud claims had not been pled with sufficient particularity; (2) that plaintiffs’ state securities law claims for sale of unregistered securities failed adequately to allege that Questar was a seller; and (3) that plaintiffs’ state common law claims fail for various similar reasons. The Court agrees and grants the motion. With respect to each of plaintiffs’ claims rooted in control person responsibility for the broker’s fraud, the Court concludes that, because Questar’s 1934 Act liability is contingent on an underlying primary violation of fraud, the heightened pleading requirements of Rule 9(b) and the PSLRA apply to the element of control as well. The same goes for control person liability under the 1933 Act in this case, because the 1933 Act claims are grounded in fraud.

Further, Questar cannot have vicarious liability that plaintiffs’ common law fraud, breach of fiduciary duty and unjust enrichment claims are not preempted by Michigan statutory law, those claims rooted in fraud fail under Rule 9(b) pleading standards; the accounts which were non-discretionary cannot give rise to a fiduciary duty or breach and plaintiffs’ unjust enrichment claims do not pass muster under Twombly and Iqbal.

(D. Franceski) (SLC Ref. No. 2011-12-05)

HAGMAN v.
CITIGROUP GLOBAL MARKETS, INC.,
No. BS128800 (Cal. Super. Ct., Los Angeles Cty., 2/9/11).

Award Challenge * Evident Partiality * State Law, Applicability of * Waiver (Due Diligence) * Vacatur of Award * Arbitrator Misconduct (Postponement, Refusal of; Material & Pertinent Evidence) * State Statutes Interpreted (Cal. CCP §§ 1281 & 1286.5 “Impression of Possible Bias”) * Disclosure Issues (Arbitrator).

An arbitrator who fails to disclose his involvement in litigation that pertains to subject matter similar in nature to the assigned dispute provides grounds under California law for vacatur on evident partiality grounds. This Award (FINRA ID #09-03251 (Los Angeles, 10/6/10)) garnered considerable media attention when it first issued -- including a New York Times exclusive -- not only because of the size of the amount awarded ($11.5 million), but also because of the famous Claimant (Dallas’ Larry Hagman). The punitive-damage award of $10 million was also unique, because it directed Citigroup (CGMI) to make the payment to a charity of Mr. Hagman’s choice. It appears that CGMI did some extra homework after the Award issued and discovered that one of the Arbitrators on the Panel, in fact, the Chair of the Panel, was engaged in two undisclosed lawsuits within the past five years that CGMI alleged “involve(s) the same subject matter.” CGMI also charged that the Panel as a whole improperly refused a postponement of testimony, so that a material witness could testify. Citing California law and FINRA disclosure standards, the Court examines the items that were not disclosed and weighs whether disclosure “could cause a person … to reasonably entertain a doubt that the proposed neutral arbitrator would be able to be impartial.” FINRA forms prompted disclosure, if the Arbitrator or “any member of [his] immediate family, close social or business associate, [was] involved in the last five years in a dispute involving the same subject matter” as the assigned case. As to one lawsuit, the Court labels “not the same” an “elder abuse action” in which the Arbitrator, in his capacity as a trustee, was a party. The other, though, did “involve the same subject matter” and should have been disclosed. Both matters involved breach of fiduciary duty claims regarding a person with expertise and mismanagement of the investment involved. The investments were different, as was the nature of the mismanagement alleged, but the earlier action, in which the Arbitrator was a plaintiff, was not “remote in time” (two years prior) and generally involved similar allegations. This was a case, in the Court’s view, where disclosure was required. That Citigroup might have discovered the existence of the prior litigation from the public records does not dissuade the Court. The burden lies with the Arbitrator. The need to disclose is paramount in that balance and “the proper salve for this particular societal ill is to encourage complete disclosure before the matter is heard…” With disclosure, “would-be-after-the-fact attackers” will be forced to object or waive before the matter is heard. The Court gives full consideration to the misconduct charge as well, because the witness in question was allegedly one of Hagman’s “personal financial advisors” and her inability to testify was simply a scheduling problem. Ultimately, though, CGMI was permitted to question the advisor for a full day, albeit after the record was first closed. That allowance eliminated “substantial prejudice,” in the Court’s view, even assuming an abuse of discretion in the original ruling. Thus, the Court grants vacatur on one ground only. (ed: An appeal was taken by actor Larry Hagman, challenging the vacatur decision On the legal side, we are interested in the waiver question, which the Court addressed in its Opinion, and the question of whether FAA vacatur standards should apply, which it did not address.) (SLC Ref. No. 2011-07-02)

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Hansalik v. Wells Fargo Advisors, LLC, No. BS128947 (Cal. Super. Ct., LA Cty., 2/7/11).


The law disfavors default judgments and that principle requires strict interpretation of notice requirements, even in arbitration settings; inadequate notice leads to vacatur of this Award.

The Court issues its decision to vacate a FINRA Award, ID #09-04860 (Los Angeles, 4/28/10), under a tentative, written “Notice of Ruling,” calling the Award set-aside something it is “inclined” to do. The Award is subject to being set aside, the Court writes, because of inadequate service, both under California arbitration law and under constitutional requirements of due process. According to the Court, California Code of Civil Procedure §1282.2 calls for notice to all parties to the arbitration either personally or by certified mail, absent a waiver of such notice “in their arbitration agreement.”

The agreement before the Court indicates that notice will be given at the party’s residence or place of work. Notice was not given to Mr. Hansalik of Wells Fargo’s claim against him for $1.24 million on a note case that proceeded under the default procedures of Section 13801 at his actual residence, but at his last known residence. In fact, he had moved to Switzerland before that notice was sent to his last known residence. Wells Fargo’s counsel did serve notice of the claim at Mr. Hansalik’s place of work, but the statute states that “the arbitrator” is to serve notice, not one of the parties. Thus, service is ineffective under both the arbitration agreement and the California statute. Furthermore, the Court writes, an arbitration Award that issues without proper notice and an opportunity to be heard violates due process and is void. Petitioner did not waive this right to notice and, to the extent he may have agreed to constructive notice, such waiver is ineffective, as the agreement’s terms were not complied with, i.e., service via notice “at his residence or office by the Director.” Mr. Hansalik claims not to have had notice of the proceedings at all until November 2010, six months after the Award issued. Respondent claims actual notice may have occurred earlier, as it sent e-mails and a FedEx package that were not returned, but the Court sides with Petitioner. Absent proof of actual notice or notice in accordance with the agreement or statute, other attempts at notice are not persuasive. Any determination by the Arbitrator that notice was adequate may be disregarded, as arbitrators may not issue Awards without notice.

(ed: *The Court is impressed with the quickness with which Mr. Hansalik reacted to the initial collection efforts by Wells Fargo and that fact influences the conclusion that actual notice of the claim and the hearing did not occur until November. It also appears to influence the Court’s evident allowance of some form of equitable tolling, relative to the time to move for vacatur, but that is not discussed directly in the Opinion. **Courts generally disfavor default judgments in litigation; this Court’s attitude toward this default Award is evident in its disregard for the many attempts that were made to notify Petitioner during the proceeding and also by its final observation, analogizing this case to a default in a civil case: “… although a default can enter in a civil case when notice is properly served in a manner reasonably calculated to provide notice, that default can be set aside by a defendant who establishes service did not result in actual notice.”) (SLC Ref. No. 2011-10-04)


This case from the Court of Appeals of Michigan arises from an action filed by the Hantz Group, Inc., against Joseph Haney, Paul Mattes and Sterling Agency, Inc. The Hantz Group is an insurance and financial services company that owns a professional soccer team, the Detroit Ignition. Defendants Sterling Agency is a property and casualty insurance agency and is a competitor of the Hantz Group. Defendants Mattes and Haney are officers of Sterling. The Defendants were members of Our Lady Star of the Sea, a Catholic parish and school located in Grosse Pointe Woods, Michigan. In October of 2007 the Detroit Ignition attended “Harvest Night,” a fund-raising event sponsored by the parish and school. As part of the Detroit Ignition’s participation in Harvest Night, they passed out questionnaires and made arrangements for members of the parish to be solicited for financial services by the Hantz Group. Members of the Hantz Group also called the night receptionist for the parish and arranged to participate at future events and give financial seminars for students at the school and also provide financial information at other church functions. When Mattes and Haney learned that the Hantz Group was using the soccer team to sell financial products and had made arrangements with the parish to engage in marketing activities with the parishioners, they wrote letters to the parish priest advising him that the Hantz Group was a high-pressure outfit that had been brought up on charges a few times and that Sterling had caught agents of Hantz on occasions impersonating customers in order to attempt to get personal financial information. The letters stated that they had been brought up on charges for fraud and fined $750,000 by the NASD. Upon learning of this letter, Hantz demanded a retraction and the Sterling Group forwarded a letter to the parish priest, indicating that they had only been expressing their opinions and that their statement that the Hantz Financial Group had been brought up on charges was based upon an NASD release indicating that Hantz Financial

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SECURITIES SUITS RISE IN THE FIRST QUARTER OF 2011.

A new study of securities cases filed in the first three months of 2011 indicates that, if the remainder of the year keeps the same pace, the number of cases filed in 2011 will rise by 12% over 2010. During the quarter analyzed, securities fraud cases, including enforcement actions, led all categories, accounting for a full 35% of all securities cases. Breach of fiduciary duty suits closely followed, at 33%. Financial services firms were the largest industry section targeted, defending in 34% of the cases, while information technology companies comprised another 17% and health care and consumer discretionary companies, 12%. Settlements averaged $21.2 million overall, but class actions averaged $54.6 million.

Plaintiff alleged that, prior to his making his investment, one of the founders and managing directors of The Carlyle Group traveled to Plaintiff’s home in Boston and represented the fund as a conservative, lower risk investment vehicle that would suit Plaintiff’s investment philosophy. Plaintiff then executed a subscription agreement and committed to purchasing shares of the fund for $20 million. The subscription agreement contained a forum selection clause which provided: “The courts of the State of Delaware shall have exclusive jurisdiction over any action, suit or proceeding with respect to this Subscription Agreement...” In March 2008, the fund, which was heavily leveraged (despite representations to Plaintiff that its investment strategy avoided “overleverage”), defaulted on its loans and went into liquidation. On July 13, 2009, Plaintiff brought suit in Massachusetts state court, alleging claims for (1) violation of the Massachusetts Blue Sky law; (2) misrepresentation; and (3) a violation of the Massachusetts consumer protection act. The Defendants removed the case to federal court and moved to dismiss all claims based on the forum selection clause in the subscription agreement. The district court granted the motion and dismissed all claims without prejudice. On appeal, Plaintiff argued that his claims are not “with respect to” the subscription agreement and easily encompassed only claims “to enforce or be satisfied it would wear well if the clause encompassed only claims ‘to enforce or for breach of’ this agreement;” however, the clause “by its terms reaches any claim ‘with respect to’ the agreement and easily invites a broader application.” Further, the misrepresentations at issue are actionable only because they caused Plaintiff to enter into an agreement whereby he made an unfavorable purchase. Each cause of action asserted has as a prerequisite the loss that flowed from the subscription agreement. Thus, the claims arise “with respect to” the agreement. The forum selection clause satisfies the grounds for enforceability as articulated by the U.S. Supreme Court in *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972), particularly in that it does not contravene Massachusetts public policy. According to the First Circuit, the Massachusetts Blue Sky Law simply creates a cause of action making liable – for any material misrepresentation causing loss – a person who offers or sells a security in Massachusetts, without requiring that such action be brought in Massachusetts. Accordingly, the First Circuit affirms the dismissal of Plaintiff’s claims, holding that the forum selection clause is enforceable and that Plaintiff’s claims can only be brought in Delaware. (*P. Michaels*) (SLC Ref. No. 2011-12-10).


Injunctive Relief * Evidentiary Issues/ Standards * Unfair Competition (Non-Compete; Non-Solicitation) * Raiding/ Recruiting Issues * Fiduciary Standards (Financial Adviser). A financial advisor whose fiduciary duty requires consideration of the whole of a client’s assets does not violate a written non-solicitation agreement by contacting former clients about assets which include those still managed by the former employer. Plaintiff ING obtained a temporary order restraining a group of departing brokers from soliciting customers for whom the defendant brokers provided a host of financial advisory services, both before and after their affiliation with ING. The services included life and disability insurance, long term care planning, college savings plans, 401(k)s and New Jersey Alternative Benefit Program Plan (“ABP”) accounts. Following a hearing nine days later, the Court denies the request for injunctive relief as unlikely to succeed on the merits and dissolves the TRO. (D. Franceski) (SLC Ref. No. 2010-39-04).

Iowa Public Employees’ Retirement System v. MF Global, Ltd., No. 09-3919-cv, 2010 U.S. App. LEXIS 19138 (2nd Cir., 9/14/10).


A statement of confidence in a firm’s operations may be forward-looking – and thus insulated by the “bespoke caution” doctrine – even while statements or omissions as to the operations in place (and present intentions as to future operations) are not.

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Plaintiffs appeal from the judgment dismissing their class action complaint for failure to state a claim arising from alleged misstatements and omissions in defendant MF Global Ltd.’s prospectus and registration statement in violation of §§ 11, 12(a)(2) and 15 of the 1933 Act. Following the announcement that MF Global was responsible for settling trades, in which it absorbed $141.5 million in losses speculating in wheat futures due to its rogue trader, Evan Dooley, MF Global stock price severely dropped resulting in a two-day market capitalization loss exceeding $1.1 billion. 

Plaintiffs asserted, among other things, that the firm’s risk-management system was responsible for settling trades, to which bespeaks caution does not apply. The applicability of the firm’s risk-management system protocols and procedures did not apply insofar as those characterizations communicate present or historical fact as to the measures taken. Neither the rogue trading incident nor subsequent events revealed to the public that anyone with the password could access client accounts and trade at will therein, as plaintiffs alleged. This allegation concerns a security risk of client fund misappropriation -- not the sort of risk made plain by and after the rogue trader’s losses. It is therefore apparent on the face of the complaint that the stock price decline (and plaintiffs’ resulting losses) cannot be attributed to the prospectus’s failure to disclose that alleged fact and the allegation was properly dismissed.

\[ \text{(C. Asher)} \text{ (SLC Ref. No. 2010-42-05)} \]


**Employment Discrimination**

**Evidentiary Issues/Standards**

**Federal Employment Statutes (Retaliatory Discharge; Title VII)**


**Culpability Standards (Discriminatory Animus).** *While the duties and responsibilities of similarly situated employees need not be identical in order for a Title VII plaintiff to demonstrate discrimination or disparate treatment, they must be similar in all material respects.* **Stray comments by the very individual who took steps to protect plaintiff’s job are not sufficient, in the context of the totality of the evidence, to demonstrate discriminatory animus.**

Plaintiff, who joined defendant ABN Amro as a secretary, worked her way up over the course of the next 11 years to Director of Financial Operations and Chief Compliance Officer and Chief Administrative Officer of an affiliated joint venture. When she was terminated in the course of a reduction in personnel, she sued under Title VII for pay, gender and age discrimination, and retaliatory discharge. On defendant’s motion for summary judgment, the Court dismisses the federal statutory claims and declines to exercise its supplemental jurisdiction over the remaining state law claims. Each of plaintiff’s Title VII claims is subject to the McDonnell Douglas burden-shifting framework, whereby a prima facie showing by plaintiff of discrimination or retaliatory discharge establishes a presumptive violation, which then shifts the burden to the defendant to articulate a legitimate reason for termination, which in turn shifts the ultimate burden of persuasion of discrimination or retaliation back to plaintiff. On the pay discrimination claim, the Court concludes that plaintiff failed to establish that she was “similarly situated” to the others with which she compared herself, and therefore failed in her prima facie case. According to the Court, there was “a clear qualitative difference” between the sales, compliance, and operational responsibilities assumed by plaintiff and those performed by others. On the sex and age discrimination claims, the Court finds that, while plaintiff stated a prima facie case, the termination of 168 employees to eliminate redundancies following a related acquisition, and the opposition to termination voiced by the very supervisor who ultimately had to terminate her, shifts the burden back to plaintiff to demonstrate discriminatory animus, a burden which she has not met. Finally, as to the retaliatory discharge claim, the Court concludes that plaintiff failed to adduce any evidence that, prior to her termination, plaintiff had complained of age, sex, or pay discrimination in a way that would have constituted “protected activity” under Title VII.

\[ \text{(D. Franceski)} \text{ (SLC Ref. No. 2010-40-03)} \]

**Kirschner v. KPMG LLP,** Nos. 151 & 152, 2010 N.Y. LEXIS 2959 (N.Y., 10/21/10).

**Liability Issues**

**Secondary Actors**

**Standing/Privity Issues**

**Bankruptcy Trustee**

**Bankruptcy/Insolvency Issues (Wagoner Rule)**

**Estates/Trusts/ Receiverships (Powers)**

**Pleading Requirements**

**Principal & Agency**

**Imputation of Knowledge; Adverse Interest**

**Equitable Defenses (In Pari Delicto; Public Policy)**

**Culpability Standards (State of Mind).** *The adverse interest exception, blocking imputation of knowledge of fraud from controlling corporate officers to the* 

\[ \text{cont’d on page 38} \]
corporation (thus preventing application of the in pari delicto defense), applies narrowly to the circumstance where the corporation is actually a victim of the insiders' wrongdoings.

We covered the federal court decisions in this case, where the District Court dismissed this bankruptcy trustee action (SLA 2009-26) and the Second Circuit, on appeal of that ruling, certified a pivotal question of state law to the New York Court of Appeals (SLA 2010-37). The Trustee in this case is dismantling Refco, Inc., a commodities futures commission merchant that succumbed to fraud engineered by its own controlling-officer-shareholders – Bennett, Grant, Trosten and Maggio. According to the Trustee’s Complaint, these individuals conspired to falsely represent Refco’s performance, so as to sell their shareholdings at an inflated price. In addition to the four company officers, the Refco Trustee also named numerous third-party advisors, including Credit Suisse Securities, Banc of America Securities, Deutsche Bank Securities, and various others. Both sides agree that, if the Wagoner Rule applies (See, Shearson Lehman Hutton v Wagoner, 944 F2d 114, 118 [2d Cir 1991] [bankruptcy trustee does not possess standing to seek recovery from third parties alleged to have joined with the debtor corporation in defrauding creditors]), the Trustee will lack standing to pursue the stated claims. However, Plaintiff clings to the narrow “adverse interest” exception. That exception operates when the rogue officer, purporting to represent the corporation, nevertheless, is acting in his/her own self-interest to a degree that his/her actions are not properly attributed to the corporation. In this case, though, the District Court concluded, the Complaint was “saturated by allegations that Refco received substantial benefits” from the alleged wrongdoing. The insiders’ subjective intent was not the measure; rather, the effect on Refco was. And the fraud was not a product of embezzlement or theft of assets from Refco, but, instead a fraud upon new shareholders of Refco securities. On appeal to the Second Circuit, that Appellate Court recognized the closeness of the question regarding intent as a factor in determining adverse interest and queried the New York Court of Appeals. The New York Court responds to the certification inquiry by exploring the roots of the in pari delicto doctrine and finding its underpinnings grounded in public policy considerations. The principle applies most forcefully where the wrongdoer seeks damages from a negligent party, but it also protects defendants where both parties engaged act willfully. “Indeed,” the Court emphasizes, “the principle that a wrongdoer should not profit from his own misconduct is so strong in New York that we have said the defense applies even in difficult cases and should not be ‘weakened by exceptions’…. It becomes unfair to extend this principle, however, to the instance where the errant employee is acting entirely for his own or another’s purposes and has abandoned his principal’s best interests. This “adverse interest” exception operates where the corporation is actually the victim of the employee’s bad acts. The exception has been interpreted narrowly in New York, because principals are best positioned to monitor the conduct of their agents and public policy encourages principals to select their agents with care. In the cases presented, the adverse interest exception would not apply.

(ed: Justifying its position further, the majority notes that, from a liability standpoint, “outside professionals -- underwriters, law firms and especially accounting firms -- already are at risk for large settlements and judgments in the litigation that inevitably follows the collapse of an Enron, or a Worldcom or a Refco or an AIG-type scandal. Indeed, in the Refco securities fraud litigation, the IPO’s underwriters, including the three underwriter-defendants in this action, have agreed to settlements totaling $53 million (www.refcosecuritieslitigation.com).” **Thus, the in pari delicto defense remains strong in New York. Indeed, the Court points out that the doctrine is less strong in the adjoining states of New Jersey and Pennsylvania: “Alternatively, the Litigation Trustee urges us to take the approach to in pari delicto and imputation adopted by the New Jersey Supreme Court in 2006 (NCP Litig. Trust v. KPMG LLP, 187 NJ 353, 901 A.2d 871 [NJ 2006]) or the Pennsylvania Supreme Court earlier this year (Official Comm. of Unsecured Creditors of Allegheny Health Educ. and Research Fund v. PricewaterhouseCoopers LLP, 989 A2d 313 [Pa 2010] [AHERF]).*** Our sister states fashioned carve-outs from traditional agency law in cases of corporate fraud so as to deny the in pari delicto defense to negligent or otherwise culpable outside auditors (New Jersey) and collusive outside professionals (Pennsylvania). Thus, the adverse interest exception, while not abolished, is again rendered beside the point.” ***The dissent best summarizes the Court’s holding, albeit pejoratively: “these simplistic agency principles as applied by the majority serve to effectively immunize auditors and other outside professionals from liability wherever any corporate insider engages in fraud.” Judge Ciparick disagrees with nuances of the majority’s analysis in a number of respects, but, ultimately, she dissents on the belief that important public policy concerns militate against immunizing outside professionals from liability; they play a critical “gatekeeper” role and investors rely heavily upon the information they provide. “Strict imputation rules” merely encourage such gatekeepers to neglect their protective roles -- see our feature article (Arnoff) on this issue.) (SLC Ref. No. 2010-42-04)


An appeal of arbitrability automatically divests the district court of jurisdiction over the underlying claims and requires a stay of the action unless the district court certifies the appeal as frivolous or forfeited.

This action arises from the district court’s holding that certain disputes between Alms and Levin were not subject to mandatory arbitration. Following the filing of this appeal, Appellants asked this Court to stay the district court proceedings on the underlying claims pending resolution of the cont’d on page 39
appeal. This Court issued an interim one-judge order staying proceedings pending resolution of the motion. Beginning in 2004, Alms provided financial services to Levin and the parties entered into CFO Advisory Agreements, which governed the relationship and payment of fees. Levin asserts that the relationship was plagued by irregularities, including investments in two real estate entities for which Alms failed to disclose that they were paid consultants. Alms also allegedly failed to disclose that the entities were having financial troubles as early as 2005. In 2009, Levin filed suit against Alms for negligence, negligent misrepresentation, violation of the Investment Advisors Act of 1940 and breach of contract. Alms moved to dismiss the action or to stay the proceedings pending arbitration. The district court ruled that the arbitration agreement did not cover claims prior to 2007, but ordered the parties to arbitrate claims after the date of the CFO Advisory Agreements. Alms then appealed. The FAA authorizes an appeal from a district court’s denial of a petition to stay an action pending arbitration under § 3 of the Act. Alms’ motion asks the court to decide whether the general rule applies in an appeal under § 16(a)(1)(A) to divest the district court of jurisdiction over the proceedings relating to the underlying claims. The Third, Seventh, Tenth and Eleventh Circuits have held that an appeal regarding arbitrability does divest the district court of jurisdiction over those claims, as long as the appeal is not frivolous. The Second and Ninth Circuits have held that no such divestiture occurs. This Court decides to join the majority of the circuits. The core subject of an arbitrability appeal is the challenged continuation of proceedings before the district court on the underlying claims. Permitting discovery to proceed is one of those aspects of the case involved in the appeal of which the district court lacks jurisdiction. The Court holds that an appeal of arbitrability automatically divests the district court of jurisdiction over the underlying claims and requires a stay of the action, unless the district court certifies the appeal as frivolous or forfeited. Given that the district court specifically held that the appeal was not frivolous, a stay of the action during the pendency of this appeal was required. The Court of Appeals reviews the district court’s findings concerning arbitrability de novo. Whether a party has agreed to arbitrate is a matter of contract interpretation. Due to the heavy presumption of arbitrability, when the scope of the arbitration clause is open to question, a court must decide the question in favor of arbitration. Here, the integration arbitration clauses may easily be read together to state that the agreement encompasses and embodies all terms, understandings and agreements between the parties and that any dispute shall be submitted to arbitration, which would include disputes prior to 2007 when the 2007 CFO Agreement was entered into.

(S. Anderson) (SLC Ref. No. 2011-11-01)

Litwin v. Blackstone Group, LP, No. 09-4426-cv, 2011 U.S. App. LEXIS 2641 (2nd Cir., 2/10/11). Class Actions * FRCP (Rule 8 “General Rules of Pleading;” Rule 12(b)(6) “Claim for Relief”) * Disclosure Issues * Materiality * Misrepresentations/ Omissions * Negligence, Actionable * 1933 Act (§§ 11, 12 & 15 “Control”)) * Public Offering Issues * Pleading Requirements/Issues. It is only when there is both materiality and a duty to disclose that a company may be held liable for omitting information from a registration statement or prospectus. Plaintiffs appeal from a judgment of the District Court, dismissing a putative class action complaint, pursuant to FRCP 12(b)(6), for failure to state a claim. The Court concludes that the District Court erred in dismissing the complaint, because plaintiffs plausibly allege that material information was omitted from or misstated in defendants’ IPO registration statement and prospectus, in violation of §§ 11, 12(a)(2) and 15 of the 1933 Act. Blackstone is a leading global alternative asset manager and provider of financial advisory services and one of the largest independent alternative asset managers in the world. In 2007, just prior to the IPO, Blackstone was formed as a Delaware Limited Partnership. Blackstone receives a substantial portion of its revenues from two sources: (1) a 1.5% management fee on its total assets under management; and (2) a performance fee of 20% of the profits generated from the capital it invests on behalf of its limited partners. Under certain circumstances, when investments perform poorly, Blackstone may be subject to a claw-back of already-paid performance fees. Plaintiffs allege that, at the time of the IPO, two units of Blackstone were experiencing problems, that Blackstone was aware of this, and that these problems subjected it to a claw-back of performance fees, thereby materially affecting its future revenues. In 2003, a consortium of investors, including Blackstone, purchased an 88% interest in FGIC Corp., a monoline financial guarantor, from GE for $1.86 billion. FGIC is the parent of Financial Guaranty, which primarily provides insurance for bonds. In the years leading up to the IPO, FGIC began writing insurance on collateralized debt obligations (“CDOs”), including CDOs backed by sub-prime mortgages to higher-risk borrowers. By 2007, FGIC was exposed to billions of dollars in non-prime mortgages. In 2006, Blackstone invested $3.1 billion in Freescale Semiconductor, Inc., which lost an exclusive agreement to manufacture wireless 3G chipsets for its largest customer, Motorola. Plaintiffs allege that Blackstone was required to disclose this material adverse development in its Registration Statement. Plaintiffs also allege that the Registration Statement made material misrepresentations concerning trends in the real estate market, it violated GAAP and materially overstated the value of Blackstone’s real estate investments. Notably, the complaint does not allege fraud, but rather alleges negligence in preparing the Registration Statement; as such, it is not subject to the heightened pleading requirements of § 9(b). Plaintiffs need only satisfy the basic notice pleading requirements of Rule 8 and so long as they plausibly allege that Blackstone omitted material information it was required to disclose or made material misrepresentations in its offering documents, they meet the relatively minimal burden of stating a claim pursuant to §§ 11 and 12(a), under which Blackstone’s liability as an issuer is absolute. Case law does not

cont’d on page 40
support the sweeping proposition that an issuer of securities is never required to disclose publicly available information. The relevant question under Item 303 is whether Blackstone reasonably expects the impact to be material. Materiality is satisfied when plaintiff alleges a statement or omission that a reasonable investor would have considered significant in making an investment decision and that would have altered the total mix of information made available. A reasonable investor would almost certainly want to know information related to that segment that Blackstone reasonably expects will have a material adverse effect on its future revenues. The motion to dismiss should have been denied. (S. Anderson) (SLC Ref. No. 2011-12-04)

In order for red flags to create a strong inference of scienter in securities fraud claims against outside auditors, they must be in the nature of an egregious refusal to see the obvious or to investigate the doubtful. **Accounting errors alone cannot support a plausible inference of scienter under Tellabs.**

This appellate decision addresses whether the dismissal of a putative class action against defendant Ernst & Young (“E&Y”) for securities fraud, decided under the Sixth Circuit’s more stringent pre-Tellabs pleading standard, should stand under Tellabs. Though E&Y had also been sued for accounting malpractice by its client, and though the company’s stock had dropped 44% in one day when the understated allowance for doubtful accounts was first reported, the Appellate Court concludes that the complaint does not adequately allege the critical element of scienter and affirms the district court judgment. Hoping to create a plausible inference of scienter from allegations of motive and opportunity, plaintiffs based their claims against E&Y on (1) E&Y’s use of stale and incorrect data, (2) numerous alleged “red flags” that should have placed E&Y “on notice of financial improprieties” and (3) E&Y’s alleged expectation of higher fees if the acquisition they were auditing was completed. Under Tellabs, in order to survive a motion to dismiss, the inference of scienter must be “cogent and at least as compelling as any opposing inference.” Though the district court made reference to a more demanding standard—that the inference of scienter be the “most plausible” inference—the Appellate Court characterizes that as dictum, concludes the lower court actually applied the Tellabs standard, and finds that the facts alleged here fall short of that standard. As the Court notes, scienter requires more than a misapplication of accounting principles. Unfortunately for plaintiffs, both PWC and Deloitte issued unqualified audit opinions during the same general period of time in which neither found evidence of an inadequate allowance for doubtful accounts. Similarly, the “red flags” alleged by plaintiffs were not obvious or egregious, but rather conclusory and devoid of fact, and the magnitude of the alleged fraud, by itself, cannot establish scienter; otherwise the well-established principle that scienter cannot be based on accounting errors alone would be eviscerated. With respect to plaintiffs’ allegation of motive, the promise of future business, without more, from a client whose fees were not alleged to be more significant than others, cannot support a plausible inference of scienter. Finally, because plaintiffs failed, beyond mention of the request in supporting briefs, to formally move to amend, the Appellate Court affirms the lower court’s dismissal without leave to replead. (D. Franceski) (SLC Ref. No. 2010-41-05)


Sales Practice/Product Issues (Commodities Futures) * Venue Issues (Forum Non Conveniens) * Forum Selection Clause.
A court case will be stayed under the doctrine of forum non conveniens if there is a suitable alternate court and the private interests of the parties and the public interests in litigating the case are preserved. The fact that the law of another forum is less favorable to a litigant is of no weight.

Between 2003 and 2005, plaintiffs opened securities accounts with Michael Chen. They accepted Chen’s recommendation that they invest 20% of their funds in commodities. Because Chen could not execute commodities transactions directly on an exchange, he opened accounts with defendant FCStone LLC, an Illinois corporation whose only office was in Chicago. Plaintiffs signed account agreements with FCStone, which provided that any disputes would be litigated or arbitrated in Illinois. In 2008, Chen committed suicide after some of the plaintiffs attempted to withdraw their funds. Plaintiffs then discovered that Chen had invested all of their funds with FCStone, then withdrew the monies, forged plaintiffs’ endorsements, and deposited the monies into his own bank account. The FCStone accounts were entirely depleted. Plaintiffs thereupon sued FCStone and others in California, alleging securities fraud. The defendants moved to dismiss or stay the lawsuit on the ground of forum non conveniens, citing the account agreements’ forum selection clause. The court stayed the lawsuit and plaintiffs appeal. The Court of Appeal affirms. A court ruling on a motion to stay or dismiss an action on forum non conveniens grounds engages in a two-step analysis. First, the court must determine whether there is a suitable alternative forum. A forum other than California is suitable if and only if the defendant is subject to jurisdiction in that forum, the statute of limitations in that forum would not bar the action, and the action would be adjudicated by an independent judiciary respecting the due process of law. The fact that the law of another forum is disadvantageous to the plaintiff or that the
论坛在加利福尼亚不可提供一种有效的补救手段。第二步是考虑当事人的具体利益和公众利益在诉讼中在加利福尼亚的利益。利益因素包括确保当地社区的事务不受影响，以及保持司法裁决的尊重。进一步，原告自己利益在加利福尼亚的律师需要做出决定时，也应考虑到当事人自己的利益和公众利益。如果这些因素都存在，法庭将考虑是否应执行论坛的选择条款。

民事诉讼与债权债务人。一项合同义务包括提供AAA级证券。一项合同义务应提供AAA级证券给投资者则不能构成信用质量。在这些条款中，证券仅是一种关于提供AAA级证券的担保。

MBIA INSURANCE CORP. v. MERRILL LYNCH INTERNATIONAL, No. 4163 (N.Y. App., 1Dept., 2/1/11).

FRAUDULENT INDUCTION (DISCLAIMERS) * RELIANCE/TRANSACTION CAUSATION (JUSTIFIABLE) * SOPHISTICATION, EFFECT

1934 ACT (SECURITIES FRAUD) * COLLATERAL ESToppel/Res Judicata (Claim Preclusion) * RE-LITIGATION ISSUES (FULL FAITH AND CREDIT ACT) * RELEASE, EFFECT OF.

Objecting to a class action settlement does not prevent it from having a preclusive effect, once approved, upon the objector’s ability to re-litigate the issue in another forum.

The Third Circuit Court of Appeals affirms the dismissal of federal securities fraud claims brought by plaintiff stockholders, holding that plaintiffs, as members of a class in a state court class action concerning the same operative facts, were bound by a state court judgment approving a settlement and release in that action. Plaintiffs were owners of seats on the Philadelphia Stock Exchange, which, until recently, was a mutual organization. In 2003, the Exchange proposed a demutualization plan, which was approved by its members. Under the plan, the Plaintiffs received 100 shares of Exchange common stock for each seat they held previously owned. Later, the Exchange entered into separate transactions with so-called Strategic Investors; as a result of the transactions, the Strategic Investors–Citadel Derivatives Group, Citigroup, Credit Suisse First Boston, Merrill Lynch, Morgan Stanley and UBS Securities – obtained 45% of the outstanding stock in the Exchange, a figure that was later increased to 89.4%. In the end, Plaintiffs were left with approximately 10% of the Exchange’s common stock and a smaller amount of the Exchange’s equity per share than they had prior to demutualization.

In June of 2006, a different, named plaintiff initiated a state court action in the Delaware Court of Chancery, asserting state law fiduciary claims against the Exchange, its Board, and the Strategic Investors. The Delaware court eventually certified a class of “all Class A common stockholders” of the Exchange, a group which included Plaintiffs. Shortly after the state court action was filed, Plaintiffs filed suit in the District Court for the Eastern District of Pennsylvania against the Exchange’s Board, two Exchange officers and the Strategic Investors for their involvement in the demutualization
of the Exchange. Plaintiffs asserted claims arising under SEC Rule 10b-5, including an allegation that “demutualization and the investment by the Strategic Investors decreased the value of [Plaintiffs’] ownership interests” in the Exchange. On the eve of the Delaware state court trial, the parties to that case settled. In exchange for compensation, the settlement class—which included Plaintiffs—agreed to a broad release that covered all claims arising out of or relating to, among other things, demutualization. The trial court approved the settlement over the objection of several class members, including Plaintiffs. The Delaware Supreme Court affirmed the trial court’s approval of the settlement. Prior to the state court settlement, the District Court dismissed the federal case, on other grounds, for failure to state a claim. Plaintiffs appealed. The appeal focuses on a single, narrow issue: whether the state court settlement and release bars the claims asserted in the federal action. The Third Circuit holds that it did, finding it to be “indisputable” that the demutualization claims arose “out of the common nucleus of operative facts asserted in the [state court] complaint.” The Third Circuit agrees with the assessment of the Delaware Supreme Court, which had opined that “demutualization was not a transaction that was ‘unrelated’ or ‘tangential’ to or ‘remote’ from the conduct that form[ed] the basis for the specific claims for relief asserted” in the state court action; rather, it was at their core. Plaintiffs were members of the state court class and all members of the class were bound by the settlement, the release and the ensuing state court judgment. Further, the Full Faith and Credit Act applies to the federal action, and, there being no applicable exception to that Act, Plaintiffs were precluded from bringing the federal action. (P. Michaels) (SLC Ref. No. 2010-39-02)

MERRILL LYNCH AUCTION
Class Actions, Effects of * Product/ Sales Practice Issues (ARS: Auction


Court granted Defendant’s Motion to Dismiss, ruling that Plaintiff’s complaint did not sufficiently allege any misrepresentations or omissions and that it failed to adequately plead scienter. Plaintiff bank filed suit against Defendant brokerage firm for violations of federal securities laws and a variety of state law claims. The claims arose out of Plaintiff’s purchase of auction rate securities (“ARS”) in a private placement offered by Defendant. Plaintiff alleged that Defendant violated Section 10(b) of the Securities and Exchange Act and SEC Rule 10b-5 for both pre-purchase omissions and post-purchase misrepresentations. As for the pre-purchase omissions, Plaintiff alleged Defendant did not disclose: (1) Defendant’s bidding practices and the ability of Defendant to submit support bids or affect the clearing rate, (2) the liquidity risks in the ARS market, and (3) the various potential conflicts of interest. The Court finds that the complaint does not point to any misrepresentations or omissions prior to the purchase of the ARS. In any case, a presentation made by Defendant to Plaintiff adequately disclosed these alleged omissions. The presentation disclosed that: (1) Defendant may submit bids to support the auction to ensure it is successful, while it was under no obligation to do so; (2) there is a risk of illiquidity if there are more sellers of the ARS than buyers; and (3) there was a potential for a conflict of interest by Defendant, as the market structure of the ARS made it apparent. Therefore, Plaintiff’s complaint relating to the pre-purchase omissions was dismissed. Plaintiff also alleged that Defendant made several post-purchase misrepresentations, which induced Plaintiff to remain invested in the ARS. Specifically, Plaintiff alleged that: (1) Defendant represented that the ARS were liquid and suitable for Plaintiff; (2) Defendant continued to aggressively market and sell the ARS to Plaintiff; and (3) Defendant issued internal research reports several months prior to the ARS market failure, stating that the ARS failures were rare. The Court rules that Plaintiff’s bare allegations are insufficient to demonstrate that its reliance on Defendant’s statements and internal report was reasonable. The disclosures in both the presentation and the private placement memorandum fully covered the omissions and misrepresentations contained in Plaintiff’s complaint. The Court also finds these statements to be mere puffery and not actionable. Even if Defendant made the alleged omissions and misrepresentations, Plaintiff failed to adequately plead scienter. Therefore, Plaintiff’s complaint relating to the post-purchase misrepresentations must be dismissed. The Court also dismisses Plaintiff’s state law claims for misrepresentation, breach of fiduciary duty, and breach of good faith and fair dealing. No fiduciary duty exists between a broker and its client under Kentucky state law. The Court also finds no existence of a contract between Plaintiff and Defendant and, because of its absence, no duty of good faith and fair dealing exists under Kentucky state law. Plaintiff’s complaint in its entirety does not contain sufficient factual matter, which if accepted as true, would state a claim for relief that is plausible on its face. Therefore, the Court grants Defendant’s Motion to Dismiss. (P. Michaels) (SLC Ref. No. 2011-10-07)

A party moving to compel arbitration must show that the other party is bound by the arbitration clause at issue. Plaintiff, as beneficiary of the Leonardo Cabrera Trust (the “Trust”), brought an action against Defendant UBS Trust
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Company of Puerto Rico ("Defendant") for breach of fiduciary duty and duty of loyalty, in violation of Puerto Rico tort and contract law, 31 L.P.R.A. §§ 3052, 5141-5142. Defendant moved to dismiss for failure to join an indispensable party and, in the alternative, to compel arbitration. On or about June 16, 2005, Plaintiff’s brother created the Trust, naming Defendant as Trustee and Plaintiff as beneficiary. The Trust stated that the investment of the assets would be handled through UBS Financial Services, Inc. of Puerto Rico ("UBS Financial") or any other securities broker that the founders of the Trust indicated in writing. Defendant executed an agreement (the "Agreement") with UBS Financial establishing a brokerage account for managing the investment of the Trust’s assets. The Agreement contained an agreement to arbitrate any dispute arising out of the Agreement. Plaintiff alleged that Defendant directed UBS Financial to invest all of the Trust’s assets in Bank of America Corp. Plaintiff further alleged that the value of the Trust, which at its peak reached $300,000, eventually dwindled to approximately $75,000 as a result of the risky investment in Bank of America. Plaintiff instructed Defendant to initiate legal proceedings against UBS Financial. Plaintiff claimed that Defendant’s refusal to do so constituted a breach of its fiduciary duty and duty of loyalty. Defendant argued that UBS Financial was a required party under Fed. R. Civ. P. 19(a). However, Defendant maintained that joinder was not feasible, because UBS Financial was likely to successfully compel arbitration of any claims, which Defendant maintained was a winning objection to venue under Fed. R. Civ. P. 19(a)(3). The Court notes that Plaintiff did not seek to enforce the Agreement or claim any right to enforce it. Since Plaintiff’s claims center around Defendant’s conduct as Trustee, and not around UBS Financial’s investment conduct, UBS Financial does not have any interest in the suit. Therefore, the Court holds that UBS is not a required party under Rule 19(a)(1). In support of its motion to compel arbitration, Defendant argues that, under the doctrine of equitable estoppel, a nonsignatory can be bound by an arbitration provision in a contract executed solely by others. Defendant argues that, pursuant to InterGen N.V. v. Grina, 344 F.3d 134 (1st Cir. 2003), a party may be estopped from asserting that the lack of his signature on a written contract precludes enforcement of the contract’s arbitration clause when he has consistently maintained that other provisions of the same contract should be enforced to benefit him. InterGen, 344 F.3d at 145. In addition, a third-party beneficiary of a contract containing an arbitration clause can be subject to that clause and compelled to arbitrate on the demand of a signatory. Id. at 146. The Court holds that neither the passive benefit Plaintiff derived from the Agreement, nor his indirect attempts to enforce it, amounts to "exploitation" necessary to trigger equitable estoppel. Similarly, the Court rules that Defendant failed to establish that Plaintiff is entitled to sue under the Agreement. Plaintiff’s relationship to the Agreement was different from that of a third-party beneficiary. The difference is clear from the fact that Plaintiff’s ability to enforce the terms of the Trust and agreements related to it are governed by trust law, which limits Plaintiff’s relationship beyond ordinary contract principles. Therefore, Defendant’s motion to compel arbitration is denied. (P. Michaels) (SLC Ref. No. 2011-09-03)


Broker-Dealer is successful on a motion for a preliminary injunction, enjoining customer from proceeding with FINRA arbitration where customer had filed several previous suits arising out of the same set of facts. Morgan Stanley & Co., Inc.’s motion for a preliminary injunction filed with the Southern District of New York in this action is the next segment of a nine-year legal battle consisting of three separate cases involving identical facts and claims asserted against Morgan Stanley. By way of background, in 1999, several hedge funds run by Conrad Seghers opened accounts at Morgan Stanley. In 2001, Seghers accused Morgan Stanley of committing serious errors related to how activity in the funds’ accounts was reflected on account statements and blamed these errors for large losses in the funds’ value. An investor in Seghers’ hedge funds then sued him, his business partners, and the funds in Texas state court for fraud. Several of the funds proceeded to sue Morgan Stanley in a separate suit in Texas state court and that suit was compelled to arbitration. In 2006, Seghers sued Morgan Stanley in the Southern District of New York, alleging fraud arising out of the same alleged errors and misrepresentations in the account statements. Morgan Stanley was successful on a motion to dismiss, asserting that Seghers’ claims were time-barred by the four-year statute of limitations for fraud claims. In 2007, Integral Hedging Offshore, Ltd., one of Seghers’ funds whose assets had been traded at Morgan Stanley, filed an arbitration against Morgan Stanley based on the same facts as the 2006 Southern District of New York action. Morgan Stanley successfully petitioned the New York Supreme Court to stay and dismiss this arbitration. In 2010, Seghers commenced a FINRA arbitration, alleging facts identical to those asserted in the 2006 Southern District of New York action and the Integral Hedging Offshore, Ltd. arbitration. Morgan Stanley proceeded to file the complaint in the present action with the Southern District of New York, seeking a declaratory judgment that Seghers waived any right to arbitrate his claims by litigating them in an earlier lawsuit and that Seghers’ claims were barred by the doctrine of claim preclusion. Morgan Stanley also sought an injunction enjoining Seghers from pursuing the 2010 arbitration. The Court finds that Morgan Stanley meets all of the factors for issuance of injunctive relief. First, Morgan Stanley can show likelihood of success on the merits of its claim that Seghers waived cont’d on page 44
any right to arbitrate his claims by filing the 2006 Southern District of New York action, which proceeded to final judgment and which was filed four years prior to the 2010 arbitration. Second, Morgan Stanley can show that it will suffer irreparable harm if injunctive relief does not issue. As FINRA does not allow motions to dismiss, Morgan Stanley would be unable to show the finality of the 2006 action. Third, the balance of hardships and public interest tip in favor of Morgan Stanley because Morgan Stanley would have to expend time and resources in an arbitration that it could not move to dismiss. The Court grants Morgan Stanley’s motion for a preliminary injunction.

(P. Michaels) (EIC: This is the first case we can identify in which a respondent in arbitration has successfully resorted to court action in the face of an inability to seek relief from the arbitrators, as a consequence of the new rules restricting pre-hearing motions to dismiss. It occurs in circumstances where parties have traditionally turned to the courts -- to manage conflicting proceedings – but the Court’s analysis of the need for injunctive relief is aided here by the impossibility of obtaining relief from the arbitration panel.) (SLC Ref. No. 2010-42-03)

MORGAN STANLEY MORTGAGE PASS-THROUGH CERTIFICATES

LITIGATION, IN RE,

Capital Formation Issues (Structured Finance/CDO) * Class Action, Effects of * Derivative/Vicarious Liability (Control Person) * Duty of Inquiry * FRCP (Rules 12(b)(1) “Subject-Matter Jurisdiction”, 12(b)(6) “Claim for Relief”, 15 “Relation Back”) * Jurisdiction Issues/Federal Question) * Misrepresentations/Omissions * Pleading Requirements/Issues * PSLRA (Generally) * 1933 Act (§§ 11 “Registration Statement”, 12(a)(2) “Prospectus, Oral Communication”, 13 “Limitations”, 15 “Control”) * Standing Issues (Case/Controversy) * Timeliness Issues (Statute of Limitations) * Transaction Causation/Reliance * Sales Practice/Product Issues (Subprime Mortgages “MBS”). That a suit may be a class action adds nothing to the question of standing, for even named plaintiffs who represent a class must allege and show that they personally have been injured, not that injury has been suffered by other, unidentified members of the class to which they belong and whom they purport to represent.

Defendants Morgan Stanley & Co., Incorporated and individual and other affiliates moved to dismiss the consolidated amended complaint by Public Employees’ Retirement System of Mississippi (“PERS”) and West Virginia Investment Management Board (“WVIMB”), asserting Sections 11, 12(a)(2) and 15 of the 1933 Act, on behalf of purchasers, for false and misleading statements, in connection with the marketing and sale of mortgage-backed security pass-through certificates issued by Morgan Stanley Capital I Incorporated and several Morgan Stanley Mortgage Loan Trusts. PERS had purchased certificates from one such trust, 2006-14SL, and WVIMB purchased trust certificates from 2007-11AR. The trust certificates for 2006-14SL and 2007-11AR were related in that they shared a common shelf registration statement. WVIMB filed the complaint concerning these two certificates, although the complaint only identifies WVIMB as a named plaintiff. The Court adopts defendants’ argument that plaintiffs lack standing to prosecute claims concerning trust certificates they did not own and that the Court therefore lacks subject matter jurisdiction of those additional claims. It also rules that the complaint fails to state claims upon which relief may be granted, because WVIMB’s claims are untimely and because the complaint is legally and factually insufficient. Accordingly, the Court denies, with prejudice, WVIMB’s claims relating to the 2007-11AR trust; denies, without prejudice to renewal, PERS’ claims relating to the 2006-14SL trust; and grants leave to plaintiffs to amend the complaint to demonstrate PERS’ standing with respect to claims that have been dismissed pursuant to 12(b)(1), and to augment and clarify the pleading of the complaint asserted by PERS. WVIMB’s reliance on allegations concerning the originators, service providers and rating agencies and the alleged falsity of prospectus and supplement disclosures precludes its argument that it can demonstrate standing to sue on behalf of the holders of trust certificates of which WVIMB was not a purchaser. The timeliness allegation of the complaint is plainly insufficient to address the requisite issue of time and circumstances. It is equally plain that, unless the claims first asserted in WVIMB’s original complaint can be deemed to relate back to PERS’ original filing date, any amendment of the timeliness allegations as to the WVIMB claims would be futile.

(C. Asher) (SLC Ref. No. 2010-41-08)

MUNICIPAL DERIVATIVES ANTITRUST LTGN.,
IN RE: HINDS COUNTY, MS v. WACHOVIA BANK, NA,
No. 08 Civ. 2516, 08 MDL 1950 (S.D. N.Y., 3/1/11).

Class Actions, Effects of (Regulatory) * Settlement Issues * Parallel Proceedings * Enforcement Practice/Procedure * Sales Practice/Product Issues (Municipal Securities).

Class actions seeking damages and regulatory settlements seeking restitution may conflict, requiring judicial intervention to weigh the public interest in allowing one or both to go forward.

Bank of America (BofA) is one of the Defendant banks in this multi-district litigation on behalf of purchasers of municipal derivatives. Plaintiffs allege that, between January 1, 1992 and the present, Defendants engaged in a widespread price-fixing and bid-rigging conspiracy in the multi-billion dollar municipal derivatives industry. BofA has also been the subject of investigations by DOJ, SEC and many of the nation’s state attorneys general concerning the same conduct. Bank of America has entered into a settlement agreement with many of the investigating regulators, which provides for partial restitution (“the State Agreement”). If the municipalities opt in to the State Agreement, lead plaintiffs complain, it could threaten the class action litigation and it might extinguish
the claims of a portion of prospective class members, at least those lodged against BofA. According to Plaintiffs, notice packets regarding the State Agreement have been prepared and are ready to be sent to eligible plaintiffs, which will require accepting entities to release BofA from liability on claims that could include those involved in the instant action. Plaintiffs ask the Court to (1) enjoin BofA from proceeding with these “opt in” offers; (2) supervise the communications with putative class members regarding the State Agreement; (3) subject the State Agreement to fairness proceedings; and (4) require the Settling States to join the class action litigation as necessary parties. The Court chooses to do the “minimum necessary” at this juncture to protect its jurisdiction and the interests of the putative class members, which entails BofA submitting the notice packets or other communications with putative class members for the Court’s approval. The Court also directs BofA to affirm that it has not been threatened or coerced by the Settling States to enter the State Agreement. It wants to assure that adequate information is provided to claimants in “clear, concise and neutral terms” that presents the remedies available to them and the consequences of elective to opt in to the State Agreement. The Court promises to render its conclusions on such submissions in a future decision.  

New Jersey Carpenters Health Fund v. Residential Capital, LLC; New Jersey Carpenters Vacation Fund v. The Royal Bank of Scotland Group, PLC, Nos. 08 CV 8781, 08 CV 5093, 2011 Dist. Lexis 4343 (S.D. N.Y., 1/18/11). 1933 Act (§§ 11, 12, 15 “Control”) * Class Actions, Effects of (Class Certification; Lead Plaintiff/Lead Counsel) * FRCP (Rule 23) * Misrepresentation/Omissions. Class Plaintiffs’ Section 11, 12(a)(2) and 15 1933 Act claims for misrepresentations about loan origination guideline compliance in the offering materials of mortgage-backed securities fail the class certification requirements of predominance and superiority under Rule 23(b). Having survived motions to dismiss (see SLA 2010-16), plaintiffs in these putative class actions against issuers of mortgage-backed securities now seek class certification for their 1933 Act, Section 11, 12(a)(2) and 15 claims. Plaintiffs based their claims on allegedly misleading statements in offering documents about whether the residential mortgages underlying the securities followed proper loan underwriting guidelines. Though satisfied that plaintiffs meet the requirements of Rule 23(a), the Court ultimately denies class certification, because plaintiffs fail to prove either predominance or superiority under Rule 23(b). Though plaintiffs did not identify numbers of proposed class members by tranche, neither that, nor the sophistication and resources of the class, overcomes the presumption of numerosity, issues of commonality and adequacy of class representative are easily satisfied, and the typicality prong of Rule 23(a) “is not demanding.” Therefore, Plaintiffs satisfy the requirements of Rule 23(a). Turning to Rule 23 (b) and the predominance requirement, the Court concludes that, because many putative class members are sophisticated, and because, over time it became known among certain purchasers that loan originators were loosening standards, leading to different levels of knowledge among class members, individualized issues of knowledge predominate. Similarly, with respect to superiority, where, as here, the proposed class consists of large, institutional and other sophisticated investors with substantial financial resources and incentives to pursue their own claims, and where significant individualized evidence on, among other things, each purchaser’s knowledge and damages, some with competing interests, will be required, class treatment is not superior. As a result, plaintiffs’ motion fails under Rule 23 (b). (D. Franceski) (SLC Ref. No. 2011-08-04) 


Newman and Register sued First Montauk and certain individuals, alleging violation of North Carolina law arising from a failed investment in Parcel Leasehold Interests in a Texas shopping center. The defendants and third-party plaintiffs sued certain attorneys, McLamb and Edward Jones for indemnity or contribution. McLamb and Edward Jones moved to compel arbitration and to dismiss or stay the proceedings against them. The offering memorandum for investors in the private placement in a Texas mall required that the sales be made by a registered broker-dealer and required that the purchaser of a parcel leasehold interest sign a questionnaire stating that the interest is a suitable investment for the purchaser. McLamb contacted First Montauk about the investment and was allegedly told that it was the best product on the market, which he conveyed to plaintiffs. Plaintiffs sold their property for $2+ million and invested $2 million in the private placement, purchasing 64 parcel-leasehold-interest units and assuming $1+ million in mortgage debt. Plaintiffs allege that First Montauk had a conflict of interest with the sponsor of the private placement and that First Montauk made misrepresentations in connection with the sale to plaintiffs. Defendants filed a third-party complaint and McLamb and Edward Jones filed a motion to compel arbitration and either to dismiss the claims cont’d on page 46
against them or stay the proceedings pending arbitration. FINRA Rule 13200 provides that a dispute must be arbitrated under the Code, if the dispute arises out of the business activities of a member or associated person and is between or among members; members and associated persons or associated persons. The FINRA manual constitutes an agreement in writing under the FAA, which binds third-party plaintiffs, McLamb and Edward Jones, as FINRA members or associated persons, to submit an eligible dispute to arbitration. Although the Fourth Circuit has not expressly interpreted an arbitration provision including the phrase, “arises out of the business activities of a member or associated person,” as used in FINRA Rule 13200, this Circuit has consistently interpreted similar language in favor of arbitration. Accordingly, the Court considers Rule 13200 a broad arbitration clause and applies the Fourth Circuit’s “significant relationship” test. In opposition to the arbitration request, third-party plaintiffs contend that their claims do not arise out of Edward Jones’ and McLamb’s business activities and urge the Court to narrowly construe the arbitration clause. They cite a California case holding that disputes must arise out of the business activities of an individual as an associated person to fall within the scope of Rule 13200’s arbitration clause; however, the Court holds that the claims do not relate to side business, but to the business activities of member firms and their associated persons. Nor is there an exchange-relatedness requirement, because FINRA has a broader regulatory mandate than NASD and NYSE before it. The third-party claims are significantly related to the parties’ roles as members and associated persons and the claims fall within a valid arbitration agreement, requiring the Court to grant a stay pending arbitration. Possible inefficiency may occur because the relevant federal law requires piecemeal resolution when necessary to give effect to an arbitration agreement.

(S. Anderson) (SLC Ref. No. 2010-41-01) 

**Northstar Financial Advisors, Inc. v. Schwab Investments, No. 09-16347, 2010 U.S. App. LEXIS 16706 (9th Cir., 8/12/10). Federal Statutes Interpreted (Sudan Accountability and Divestment Act) * ICA (§13 “Safe Harbor”) * Private Right of Action. The fact that the Sudan Accountability and Divestment Act of 2007, which was codified in part as Section 13(c) of the Investment Company Act, gave investment companies a safe harbor from lawsuits arising from the divestiture of Sudanese related investments, does not mean that there is an implied private right of action under Section 13(a) of the Investment Company Act.

In this case, the Ninth Circuit reverses the District Court and rules that there is no private right of action under Section 13(a) of the Investment Company Act of 1940. Section 13(a) prohibits an investment company from deviating from its policy in respect of concentration in any particular industry or group of industries as recited in its registration statements, where the policy is changeable only if authorized by shareholder vote. The District Court’s opinion was based on language in the Sudan Accountability and Divestment Act of 2007 (“SADA”). That statute was enacted in reaction to atrocities committed by the Sudan government in Darfur and barred United States citizens from doing business with certain Sudanese companies. It contained a safe harbor, found in Section 13(c) of the Investment Company Act, which provided that, “notwithstanding any other provision of federal or state law, no person may bring any civil, criminal, or administrative action against any registered investment company….solely upon the investment company…divesting from…investments in business operations in Sudan.” The District Court reasoned that this language would have been unnecessary if there were no private right of action under Section 13(a), but the Ninth Circuit disagrees. The structure of the Investment Company Act does not indicate that Congress intended to create an implied private right of action to enforce the individual provisions of the Act. Congress expressly authorized the SEC to enforce all provisions of the Act by granting the Commission broad authority to investigate suspected violations. This thorough delegation of authority to the SEC strongly suggests that Congress intended to preclude other methods of enforcement. Moreover, it is evident from the text of the Investment Company Act that Congress knew how to create a private right of action to enforce a particular section of the Act when it wished to do so. In Section 30(f) of the original Act, Congress expressly authorized private suits for damages against insiders of closed-end investment companies who make short-swing profits. Congress created a second express private right of action in 1970 when it added Section 36(b), which allows shareholders to sue an investment company’s advisor for breach of certain fiduciary duties relating to management fees. The District Court had found it significant that Section 13(c) referred to actions that a “person” could file and reasoned that Congress’ use of the word “person” in Section 13(c) must have meant that private persons, and not just the SEC, were authorized to bring an action for violation of Section 13(a). But the Ninth Circuit counters that this argument would only have validity if the Sudanese bar in Section 13(c) applied only to causes of action to enforce the other provisions of Section 13, including Section 13(c). But the bar is not so limited. The bar extends to any civil, criminal, or administrative action brought under any state or federal law. Thus, Congress intended the term “person” to include a wide range of potential plaintiffs. Congress meant to bar all such potential plaintiffs from remedies for divestment. It did not limit the Sudanese bar to plaintiffs under Section 13(a).

(P. Dubow) (SLC Ref. No. 2010-39-09) 


Court denying motion in limine seeking to preclude (i) use of plea agreement and
transcript of guilty plea proceeding of former CFO of Stanford Financial Group Company, and (ii) use of declarations and affidavits prepared by forensic accountant hired by Receiver for Stanford Financial Group, based on findings that such items met hearsay exceptions and that no unfair prejudice would result from the admission. Laura Pendergest-Holt and other former Stanford executives (“Respondents”) filed a motion in limine seeking to preclude certain evidence at a scheduled hearing on the issue of whether Underwriters at Lloyd’s of London and Arch Specialty Insurance Co. (the “Underwriters”) would be required to pay the Respondents’ defense costs. The Respondents sought to preclude Underwriters from using at the injunction hearing the plea agreement and transcript of the guilty plea proceeding of James Davis, a former Stanford CFO, or any of 22 declarations and affidavits prepared by a forensic accountant and fraud examiner hired by the Receiver of the Stanford assets. The Court acknowledges that Davis’s statements are hearsay, but admits the information that is against Davis’s penal and other interests under the hearsay exception in Federal Rules of Evidence (“F.R.E.”) 804(b)(3). However, statements made by Davis that inculpate others are not admitted under the 804(b) (3) exception. The Court also finds that Davis’s sworn factual statements about conduct in which he personally engaged satisfies the factors for admission under the residual hearsay exception, F.R.E. 807, because the plea-related factual statements had “circumstantial guarantees of trustworthiness,” the statements were more probative than any other evidence then currently available through reasonable efforts, and the admission of the statements would serve the interests of justice. The Court finds that the declarations, affidavits and exhibits prepared by the Receiver’s forensic accountant are admissible under F.R.E. 807 to the extent that they contain objective findings or other conclusions based on documents or other reliable information. However, the Court does not admit reports of the forensic accountant that include findings on ultimate facts potentially at issue in the litigation. Noting that the forensic accountant’s reports and analysis were prepared after months of extensive, complex and expensive work, and included information from “highly reliable sources,” the Court finds that the reports meet the factors required for admission under F.R.E. 807. Namely, the reports and analysis had “circumstantial guarantees of trustworthiness” and were more probative than other evidence that could be procured through reasonable efforts, plus their admission would serve the interests of justice. Finally, the Court finds that the Respondents failed to show that they would suffer unfair prejudice from admission of the Davis plea matters or the accountant’s reports, but reserves the right to entertain further argument and analysis as to admission of particular items during the hearing, or in post-hearing briefing. (J. Ballard) (SLC Ref. No. 2010-41-04)


Award Challenge * Confirmation of Award * Exceeding Powers * Standing/Privity Issues (Mootness) * Timeliness Issues.

That the directives of an arbitration Award have been complied with and performed does not constitute a defense to confirmation of that Award. This is a short Opinion, ending in confirmation of an AAA arbitration Award (AAA ID #13-148-01042-09) for the redemption of a hedge fund interest worth about $8 million. The Award was issued in January 2010 and Pine Street applied for confirmation in November 2010, pursuant to CPLR 7510 and 7514. Respondents objected that the Award had been performed and that the application for confirmation was untimely. The Court does not explain the basis for the untimeliness challenge, explaining only that New York’s CPLR 7510 allows one year from delivery of the Award to file for confirmation and this application was filed within ten months. With respect to the objection to confirmation based upon performance, the Court responds: “Respondents’ full compliance with the Award does not prevent the Court from confirming the Award.” In fact, CPLR 7511 provides only four grounds on which an application to confirm an Award may be denied (fraud; partiality; exceeding powers; and “a failure to follow the procedures of CPLR Article 75. Respondent does not allege any facts that fall with the four grounds...” meaning the application must be granted.


An arbitration Award, which is at least “barely colorable” based on the facts and the law, the result of confusion and uncertainty on the part of the arbitrators as to the applicable law, but not completely irrational, does not exceed powers and is not in manifest disregard of the law. cont’d on page 48
In response to petitioner’s request for confirmation of an arbitration panel’s Award (FINRA ID #09-03616) of over $579,000, respondent John Hancock Distributors, LLC (“JH Distributors”), moved to vacate on the ground that, in allowing the petitioner/claimant to proceed against JH Distributors, an affiliate of John Hancock Life Insurance Company (“JH Life”), the arbitrators either (1) exceeded their powers or (2) acted in manifest disregard of the law. JH Distributors claimed that, unlike JH Life, the non-FINRA entity which mishandled the petitioner trustee’s request to reallocate an annuity’s assets to the annuity’s money market account, or JH Life’s predecessor, John Hancock Mutual, which sold the annuity to petitioners, it had nothing to do with petitioners or the annuity. While JH Mutual, the predecessor to JH Life and the company that actually sold the annuity, had been a FINRA member, its successor JH Life was not. JH Distributors, which underwrote annuities as an affiliate of JH Life but not the annuity at issue, is a FINRA member. Petitioner apparently brought the claim against JH Distributors in order to invoke FINRA jurisdiction. Without deciding whether manifest disregard is a viable ground for vacatur under the FAA, the Court denies respondent’s request on both grounds and confirms the Award. As the Court notes, review of an arbitral Award is limited and deferential. As long as there is a “barely colorable” justification for the arbitrators’ decision, it must be upheld. Turning first to whether the arbitrators exceeded their powers, the Court concludes that, because respondent did not dispute that petitioner could have arbitrated with respondents’ affiliates, it was not “completely irrational” for the arbitrators to conclude that JH Distributors was a proper party. Moving on to manifest disregard, the Court finds that, because (1) respondent did not adequately present the law regarding the legal distinction between, or successor liability of, respondent and its affiliate, (2) the arbitrators did not independently recognize the law, (3) the law was otherwise not obvious, and (4) there were justifications in the record for the Award that are at least barely colorable, the Award will not be vacated. According to the Court, though respondent challenged petitioner’s right to proceed against it, in each instance the record indicates respondent’s emphasis of facts rather than law, confusion and uncertainty on the part of the arbitrators, and a governing legal standard that was not at all apparent. Furthermore, the party to the original contract (JH Mutual) had ceased to exist and the remaining potential respondents were corporate affiliates. Though the arbitrators may have made factual or legal errors, in the absence of clarity about the law, they could not have manifestly disregarded it. The arbitrators’ Award must therefore be confirmed.  

(D. Franceski: Perhaps as interesting as the lengths to which the Court goes to confirm the Award is the petitioner’s tactical decision to proceed against an affiliate with no apparent role in the matter, albeit the only JH affiliate over which FINRA had jurisdiction.) (SLC Ref. No. 2011-12-01)
the loan origination process, under the 1933 Act their actual knowledge is material. Nor are the 1933 Act claims unimmaterial. That similar Certificates were performing poorly or that publicly available documents had begun to report issues with loan underwriting guidelines in the subprime market, without a more direct link to the Certificates and loans at issue here, is not enough at this stage to conclude that Plaintiffs were on inquiry notice and obliged to investigate further. Finally the Court allows the Section 15 control person claims to proceed against the Goldman defendants as well.

(D. Franceski) (SLC Ref. No. 2011-07-06)


Class Actions, Effect of (Derivative Action) * Damages Calculations * Notice Requirement (Demand Futility).

An independent wrong and damages separate and apart from the damage done to the issuer corporation must be demonstrated to avoid having the class action dismissed as an improperly instituted derivative action.

This decision arises from the appeal of the Jefferson County, Alabama Circuit Court denying the motion of Regions Financial Corporation (“RFC”), Morgan Asset Management, Inc. (“MAM”), and employee James Kelsoe (“Kelsoe”) to dismiss an action brought by a number of individuals based upon the collapse of six Regions Morgan Keegan investment funds. The individuals had invested in these mutual funds and, due to the over concentration of the funds’ investments in sub-prime mortgage-based securities, the underlying investments in the funds became valueless and the funds collapsed. The plaintiffs lost almost their entire investments. They alleged that these damages were due to mismanagement of the funds, the improper valuation of the funds, and various other acts of misconduct of MAM, Kelsoe, and RFC. Initially, the defendants, on more than one occasion, attempted to remove the case to federal court and pursuant to the provisions of SLUSA to have the case dismissed. These tactics were unsuccessful and the federal court remanded the case to state court, because there was not a sufficient number of plaintiffs involved in the case. Thereafter, the defendants moved to have the case dismissed, arguing that the state court lacked jurisdiction since the claims that were made were essentially claims of a derivative nature and the plaintiffs had not complied with Rule 23.1 of the Alabama Rules of Civil Procedure. Those Rules require that a demand be made upon directors or comparable authority of the RMK funds prior to initiating a derivative action. The defendants in this case sought an order of mandamus from the Supreme Court of Alabama, directing that the action be dismissed for failing to comply with the demand requirement. The Alabama Supreme Court goes through an exhaustive analysis with respect to what kind of claims can be brought directly and what kinds of claims must be brought derivatively. In this regard, the Court finds that, where the damage alleged by the plaintiffs is dependent upon damage to the corporation and there is no independent harm to the plaintiffs, the claim must be brought derivatively. The Court notes that, in certain circumstances, where a breach of fiduciary duty by directors was alleged and there was a direct duty to the shareholders, that a direct action might proceed. However, in this case, the wrongful actions alleged were the mismanagement of the funds by MAM and the only possible method to bring an action against them was through a derivative action and not a direct action. Having made the determination that the action was one that had to be brought derivatively, the Court notes that Rule 23.1 states that, in order to maintain a derivative action, the plaintiff must allege and also, in the alternative, that demand is excused. The Court notes that in certain circumstances, where a breach of fiduciary duty by directors was alleged and there was a direct duty to the shareholders, that a direct action might proceed. However, in this case, the wrongful actions alleged were the mismanagement of the funds by MAM and the only possible method to bring an action against them was through a derivative action and not a direct action. Having made the determination that the action was one that had to be brought derivatively, the Court notes that Rule 23.1 states that, in order to maintain a derivative action, the plaintiff must allege and also, in the alternative, that demand is excused. The Court finds that, in certain circumstances, where a breach of fiduciary duty by directors was alleged and there was a direct duty to the shareholders, that a direct action might proceed. However, in this case, the wrongful actions alleged were the mismanagement of the funds by MAM and the only possible method to bring an action against them was through a derivative action and not a direct action.

Plaintiffs' having pled that they made a demand on the previous board of directors, but a new board of directors was appointed prior to the filing of the complaint. Defendants argued that it made a demand upon the new board of directors and also, in the alternative, that demand upon the new board of directors is futile. Defendants filed a motion to dismiss or, in the alternative, a motion to stay the action until the board of directors could investigate Plaintiffs’ claims. The Court denies Defendants’ motion to dismiss, but grants their motion to stay the action pending the response of the board of directors to Plaintiffs’ complaint. The pivotal issue in the case is the effect of Plaintiffs’ having pled that they made a demand on the new board of directors. The Court finds that under Maryland corporate law, a party is prohibited from simultaneously pleading that demand was made and also that it is excused. The Court states that demand is an either/or proposition, and a derivative plaintiff may not stand neutral by making a demand and continuing to argue that demand is futile.

cont’d on page 50
Plaintiffs admitted that the new board of directors is qualified to exercise its business judgment about whether the suit should go forward based upon Plaintiffs’ affirmative decision to argue that demand was made. Under Maryland corporate law, the new board of directors is required to affirmatively state its position on Plaintiffs’ suit, after an investigation, regardless of whether Plaintiffs made demand on it. Thus, Plaintiffs’ argument that demand is futile is moot if the Plaintiff also argues that it made a demand upon the board of directors. The Court orders a stay of the action until the board of directors responds to Plaintiffs’ complaint within the time period prescribed by the Court.

(P. Michaels) (SLC Ref. No. 2010-40-04)

**Riordan v. SEC,**


Enforcement Procedures/Practice

* Evidentiary Standards (Burden of Proof) * Sanctions (Regulatory)


The applicable statute of limitations for fines, penalties and forfeitures that may result from regulatory actions does not apply to the remedies of disgorgement or cease-and-desist orders.

This decision of the United States Court of Appeals for the District of Columbia reviews a decision of the Securities and Exchange Commission ("SEC" or "Commission"), upholding the ruling of an administrative law judge barring Guy P. Riordan ("Riordan") from being associated with a broker/dealer, entering a cease-and-desist order against him, and entering monetary sanctions, including disgorgement and civil penalties. Riordan’s appeal from the decision of the Commission was substantially based upon his claim that, in the administrative proceeding, the Commission had not presented sufficient evidence to support some of its claims and sanctions and that certain of the sanctions were applied to conduct that had occurred outside the statute of limitations. Riordan was alleged from 1996 through 2005 to have engaged in an ongoing scheme involving bribing the State Treasurer of New Mexico in order to secure brokerage business from the state. The evidence submitted during the administrative proceeding included lengthy testimony from the former New Mexico Treasurer, Michael Montoya, who in the interim had pled guilty to federal criminal violations. Montoya described regular and repeated kickbacks paid by Riordan in order to secure the brokerage business. The Court of Appeals had little problem in finding that the Commission’s evidence presented at trial was overwhelming. Riordan also claimed that he had been prohibited from presenting certain evidence relating to the fact that he had himself reported the misconduct of Montoya and that Montoya’s testimony against him should not be believed, because it was in retaliation for Riordan having blown the whistle. The Court of Appeals in reviewing the record finds that there is no evidence that Montoya had known that Riordan turned him in, and, thus, that evidence would not support any retaliatory action by Montoya. In addition, the Court of Appeals notes that in administrative proceedings, the “harmless error” rule applies and that, in light of the overwhelming evidence against Riordan, failing to allow this evidence was harmless error. Finally, Riordan complained that much of the conduct for which he was being sanctioned occurred outside the five-year statute of limitation that applies to SEC actions. The Court notes that the action was filed on September 25, 2007 and that the conduct of Riordan occurred both before and after that date. The statute of limitations that applies is 28 U.S.C. § 2462, which states that “an action, suit or proceeding for the enforcement of any civil fine, penalty or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued.” Riordan argued that much of the disgorgement that he was ordered to pay related to transactions that occurred prior to September 25, 2002 and that he was being fined for acts that occurred before that date. However, the Court of Appeals finds that, because his conduct continued after September 25, 2002, the civil fine that was ordered against him was appropriate. With respect to the disgorgement, that sanction was not a “fine, penalty, or forfeiture,” as described in the statute of limitations and thus was not barred by that statute. Similarly the cease-and-desist order and other sanctions ordered against Riordan were not fines, penalties, or forfeitures and no time limitation bars the imposition of those sanctions. The Court of Appeals affirms the Commission’s order.

(B. Wizand) (SLC Ref. No. 2011-09-07)

**RK Company v. See,**

No. 07-3894, 2010 U.S. Dist. LEXIS 19666 (7th Cir., 9/22/10).


A party that successfully prosecutes a claim under federal law is presumptively entitled to prejudgment interest. Defendant See was the founder of a pharmaceutical company that was developing products to treat sexual dysfunction. The company issued various press releases concerning the progress of developing these products, as well as filing forms with the SEC that mentioned the same. The press releases and SEC filings contained misstatements of facts. Nevertheless, See signed the SEC filings and approved the press releases. Plaintiff RK Company, described as the “investment vehicle” for an individual named Robert Krilich, purchased $500,000 worth of stock in See’s company. Krilich reviewed the false SEC filings and press releases before making the investment. The FDA eventually began investigating See and his company, leading to the company’s bankruptcy and demise. Plaintiff RK filed suit against See personally, alleging claims under federal and state securities laws, state deceptive practices law and common law fraud. After a bench trial, the district court entered judgment in favor of plaintiff, including prejudgment interest and attorneys’ fees. See challenges the judgment on appeal on a variety of...
Sacks v. SEC,
No. 07-74647 (9th Cir., 2/22/11).

Sacks v. SEC,
No. 07-74647 (9th Cir., 2/22/11).


A non-attorney representative is exempt from forum restrictions upon NAR appearances in FINRA arbitrations, where the restrictions were adopted after he was engaged in active representation.

Richard Sacks is subject to a bar from association with a broker-dealer. Mr. Sacks has also represented parties in FINRA and other SRO arbitration proceedings for many years. SAC’s Award Database reflects more than 100 Awards in which Mr. Sacks is named as a party representative; almost half of those Awards issued since 2000 and, in 2010. Mr. Sacks is listed in three Awards. Thus, he has maintained this NAR “practice” both before and after FINRA adopted restrictions that, if applied to Mr. Sacks, would have prevented him from operating in the FINRA arbitration forum. FINRA does not oppose non-attorney representation per se, unless state restrictions would prevent NARs from practicing, but, in April 2007, FINRA proposed a rule change that the SEC approved, which, as the Ninth Circuit put it in this decision, “prohibits non-attorneys who have been banned from the securities industry from representing parties in securities-related arbitration.” During the public comment period, Mr. Sacks wrote to the SEC, objecting that the FINRA rule change would be impermissibly applied retroactively, were he to be barred from practice in the forum. According to the Ninth Circuit, which is responding to Petitioner Sacks’ request for review, “the SEC’s Division of Market Regulation rejected Sacks’ protest” and approved the rule change. The SEC makes the jurisdictional objection that Petitioner has not exhausted his administrative remedies. The Administrative Procedures Act requires those challenging rules and procedures of governmental agencies to exhaust administrative remedies before moving in court for review. In this case, a special statutory review scheme has been adopted by Congress (15 USC §78y) that governs review of rules proposed by SROs and this makes the APA inapplicable to these circumstances. The exhaustion requirement in 75y(c)(1) allows circuit court review only after the objection has been “urged before the Commission or there was reasonable grounds for failure to do so.” The D.C. Circuit has held that an objection to the rule during the rulemaking process satisfies the “urged” predicate for judicial review to ensue. Here, Mr. Sacks objected during the comment process and the SEC responded to his objection in its approval order. Nothing more is jurisdictionally required to place the issue before this Court. Reaching the merits of Sacks’ petition, the Court agrees that retroactive application is impermissible. Statutes are applied retroactively only in circumstances where Congress has been express in that intention and retroactive application is disfavored. Here, Mr. Sacks was barred from the industry, yet his bar stated nothing regarding his capacity as a NAR in securities arbitrations. Thereafter, this new FINRA rule purported to bar him from a further activity that he had previously been permitted to pursue. Thus, retroactive application is apparent and, in these circumstances, it is also impermissible. “We hold that the rule here cannot be applied retroactively.”(SLC Ref. No. 2011-10-10)

SEC v. EARTHY MINERAL SOLUTIONS, INC.,


Guilty pleas in a criminal action suffice to support the application of collateral in a civil enforcement action; active participation in a related civil proceeding also suffices, even if the case ends in a default judgment, so long as the defendant actively participated in defense of the claims.

Three defendants, all accused of securities fraud in connection with a Ponzi scheme, are faced in this decision with the prospect of partial summary judgment, as a consequence of parallel proceedings. The charges against the trio are that they defrauded investors in Earthy Mineral Solutions and Natural Minerals Processing Company into investing approximately $20 million and that, in connection with those sales, engaged in securities registration and broker registration violations. The SEC seeks summary judgment only in connection with the Section 17 (1933 Act) and Section 10 (1934 Act) fraud charges and does so on the basis of criminal convictions of Defendants Schwartz and Higgs and a cont’d on page 52
civil judgment against Defendant Lawton. The issue before the Court is the reach of collateral estoppel in resolving the contested elements of the alleged fraud violations. To apply collateral estoppel based on the criminal convictions, the Court must find: (1) a substantial overlap in the evidence or issues; (2) the same applicable rule of law; (3) overlap in pretrial preparation and discovery; and (4) closeness in the relationship between the claims. The two actions stem from the same set of underlying facts and both charge federal securities act violations. While the criminal action was settled by guilty pleas, the admissions by Messrs. Schwartz and Higgs satisfy all elements of the civil fraud charges and, thus, there is no need to re-litigate those issues. The civil matter involving Defendant Lawton as a defendant did not involve the SEC, but under the doctrine of offensive non-mutual collateral estoppel, the SEC can assert the preclusive effect of the first action. Moreover, that may even be the case where the first action resulted in a default judgment, as long as the defaulted party actively participated in the litigation or had a reasonable opportunity to defend, but declined to do so. The earlier case ended with a default judgment based upon non-cooperation of defendants and failure to comply with discovery requirements. Despite Defendant Lawton’s claim that the charges against him were, therefore, not “actually litigated” in the prior suit, the record shows that Mr. Lawton filed over thirty pleadings and that the case proceeded for two years. The requested judgment is, therefore, granted. (SLC Ref. No. 2010-39-08)

SEC v. Loomis,
No. 2:10-cv-00458, 2010 U.S. Dist. LEXIS 87021 (E.D. Cal., 8/24/10).
Motion Practice (Default Judgment) * Remedies * Enforcement Practices/Procedures * FRCP (Rule 54).
In a multi-defendant case, where claims against all defendants overlap and where some of the defendants fail to answer the complaint, a motion for default judgment against the non-responding defendants will not be granted prior to trial of the matter, unless there is a just reason to grant the motion.
The SEC brought suit against four defendants—Loomis, Hagener, Loomis Wealth Services (“LWS”), and Lismar Financial Services LLC (“Lismar”). Loomis and Hagener answered the complaint. LWS and Lismar, which are corporations controlled, respectively, by Loomis and Hagener, did not. The SEC moves for default judgments against LWS and Lismar. The Court denies the motion without prejudice. With respect to multi-defendant cases, FRCP 54(b) provides that “the court may direct entry of a final judgment as to one or more, but fewer than all, claims or parties only if the court expressly determines that there is no just reason for delay.” Here, there is “no just reason for delay,” such that entry of judgment against LWS and Lismar prior to the adjudication of the claims against the remaining defendants would be appropriate. As to plaintiff’s first, second, third, and sixth claims for relief, which are asserted against all defendants, LWS and Lismar are similarly situated. The same is true for Hagener and Lismar with respect to plaintiff’s fourth and fifth claims. As to each of these claims, plaintiff has alleged liability as to a non-responding defendant that overlaps with the alleged liability of a defendant who has appeared and intends to defend himself. To the extent that claims are ultimately resolved in favor of Loomis or Hagener, there is a not insignificant risk of incongruous or inconsistent judgments were the Court to determine at this relatively early stage of the proceedings that LWS and Lismar are liable for the same violations of the securities laws that are alleged against Loomis and Hagener. Plaintiff may very well have valid claims against LWS and Lismar that are ultimately appropriate for entry of default judgment. However, given the overlapping nature of the claims as to different defendants and the current stage of the proceedings, there is just reason for delay in entering default judgment against the two non-responding defendants. Thus, the motion is denied without prejudice, subject to re-filing the motion at a more appropriate time.

SEC v. Payne,
No. 1:00 cv 1265, 2010 U.S. Dist. LEXIS 136105. (S.D. Ind., 12/23/10).
Collateral estoppel may be applied in civil cases to issues previously determined in a criminal conviction; a criminal conviction based on a guilty plea conclusively establishes for purposes of subsequent civil proceedings that the defendant engaged in the criminal act for which he was convicted.
The SEC filed this civil action against Payne one month before he was indicted for mail fraud and 20 counts of money laundering. Payne later pled guilty to five counts of mail fraud and to one count of money laundering. The SEC moved for summary judgment in the civil case, arguing that, because Payne pled guilty to the underlying allegations, he was collaterally estopped from re-litigating those issues. The Court agrees. Federal preclusion law determines the preclusive effect of a federal criminal proceeding. Collateral estoppel may be applied in civil cases to issues previously determined in a criminal conviction. A criminal conviction based on a guilty plea conclusively establishes for purposes of subsequent civil proceedings that the defendant engaged in the criminal act for which he was convicted. The SEC alleged that the facts underlying Payne’s criminal convictions conclusively established the elements of the counts in the civil action.
In responding to the SEC’s motion, Payne was required to identify potentially determinative facts and support them with admissible evidence or the SEC’s supported facts would be admitted to exist without controversy. Pro se litigants are subject to the same waiver rules as represented parties. Because Payne failed to identify any specific material fact in dispute, the factual basis underlying his guilty plea established the elements of the counts in the civil action.

(W. Nelson) (SLC Ref. No. 2011-08-06)
SEC v. PAYNE (DANKER),
No. 1:00 cv 1265, 2010 U.S. Dist. LEXIS 136108 (S.D. Ind., 12/23/10).
Collateral Estoppel/Res Judicata * Enforcement Practice/Procedure * Injunctive Relief.
Collateral estoppel may be applied in civil cases to issues previously determined in a criminal conviction; a criminal conviction based on a guilty plea conclusively establishes for purposes of subsequent civil proceedings that the defendant engaged in the criminal act for which he was convicted.

Danker was indicted for mail fraud and money laundering. Danker pled guilty to two counts of mail fraud and to one count of money laundering. In the civil enforcement action, the SEC moved for summary judgment arguing that, because Danker pled guilty to the underlying allegations in the criminal case, he was collaterally estopped from re-litigating those issues. The court agrees. Federal preclusion law determines the preclusive effect of a federal criminal proceeding. Collateral estoppel may be applied in civil cases to issues previously determined in a criminal conviction. A criminal conviction based on a guilty plea conclusively establishes for purposes of subsequent civil proceedings that the defendant engaged in the criminal act for which he was convicted. The SEC alleged that the facts underlying Danker’s criminal convictions conclusively established the elements of the counts in the civil action. In responding to the SEC’s motion, Danker was required to identify potentially determinative facts and support them with admissible evidence or the SEC’s supported facts would be admitted to exist without controversy. Pro se litigants are subject to the same waiver rules as represented parties. Because Danker failed to identify any specific material fact in dispute, the factual basis underlying his guilty plea established the elements of the counts in the civil action.
(W. Nelson) (SLC Ref. No. 2011-11-08)

SEC v. SALYER,
1933 Act (§17 & §20 (d)) * 1934 Act (§10 “Rule 10-b”) & (§21(d)(3)) * Remedies (Disgorgement) * Enforcement Practice/Procedure * Account Administration (Forgery) * Selling Away.
The purpose of disgorgement of profits acquired through securities fraud is to force a defendant to give up the amount by which he was unjustly enriched, rather than to compensate the victims of his fraud. The Securities and Exchange Commission (“SEC”) brought a civil complaint against defendant Mark Salyer, alleging violations of the anti-fraud provisions of the federal securities laws. The complaint sought declaratory relief, disgorgement of all profits or proceeds that he and his companies received as a result of the fraud, and civil penalties. The SEC alleged that Salyer forged customer signatures on wire transfer forms and convinced customers to invest in real estate ventures through a company that he controlled. Salyer entered into a consent judgment agreeing to a permanent injunction and providing that the amount of his disgorgement would be set by the Court. The agreed order provided that “the court shall order disgorgement of ill-gotten gains, prejudgment interest thereon, and a civil penalty,” pursuant to § 20(d) of the Securities Act and § 21(d) (3) of the Exchange Act. Salyer also agreed that he would be precluded from arguing that he did not violate the Federal Securities laws as alleged in the complaint. The Court notes that disgorgement constitutes the giving up or divestment of ill-gotten funds flowing from a defendant’s unlawful conduct. The purpose is to force a defendant to give up the amount by which he was unjustly enriched and to deter others from violating the securities laws, rather than to compensate the victims of fraud. The remedy is equitable and the amount need only be a reasonable approximation of profits causally connected to the violation. Salyer argued that the amount of disgorgement sought by the SEC, $5.7 million, was excessive, because some of the money taken was never under his control and still existed in the client’s accounts. The Court finds this argument irrelevant, given the fact that the purpose of disgorgement was not to compensate the victims, but to force the defendant to give up the proceeds of his fraud. It is also irrelevant whether Salyer or one of his companies actually took control of the funds, because Salyer had admitted that he controlled those entities. The Court assesses the full amount requested by the SEC and enters judgment accordingly.
(J. Ballard) (SLC Ref. No. 2010-40-06)

SEC v. SCOPPETOULO,
The materiality of non-public information is mostly a question of fact and difficult to assess at the pleading stage; generally, a decision on materiality must await discovery and the summary judgment stage.
This decision of United States District Court Judge Marcia G. Cooke denies a motion to dismiss by several defendants in an SEC enforcement action alleging insider trading. The Commission alleged that before the release of financial information by World Fuel Services Corporation (“World Fuel”) in May and August of 2007, certain of the defendants purchased shares of World Fuel options and stock and profited from the increase in price. Defendants Scoppetoulo and White were executives of World Fuel and were alleged to have tipped off other defendants in the case, including securities broker Sarang Ahuja, with respect to the contents of financial information that was to be released by the company, thereby allowing the other defendants to profit from their knowledge of material non-public information. The defendants moved to dismiss the complaint for failure to state a cause of action, arguing that the complaint did not allege materiality of the information disclosed, did not allege requisite scienter, and failed to satisfy the particularity requirements of Rule 9(b) of the Federal Rules of Civil Procedure. In reviewing the defendant’s motion, the Court examines the question of whether or not the information that was allegedly provided to the individuals who traded
cont’d on page 54
the stock was material and also whether the information was “non-public.” The Court finds that the information allegedly disclosed may have been such as to alter the total mix of information available to investors. Since the Court could not, at the pleading stage, determine that a reasonable person could not determine that the information was not significant, it was inappropriate to dismiss the case. With respect to whether or not the information was non-public, because it came from executives of the company, including the CFO of World Fuel, the Court believes that a reasonable person would have known that the information was inaccessible to an ordinary investor. Moreover, the timing of the phone calls and text messages that provided the information, vis-à-vis the trading by the other defendants, indicates that they clearly appreciated the significance of the information. The Court finds that the defendants’ argument that scienter had not been adequately pled is also insufficient. Proof of knowledge that information was non-public and material gives rise to a strong inference of scienter. The suspicious timing of communications and trading supports that inference. Thus, the Court concludes that the SEC has sufficiently pled scienter. Finally, with respect to whether or not the allegations of fraud have been alleged with particularity, as required by Rule 9(b) of the Federal Rules of Civil Procedure, the Court finds that the complaint alleged suspicious timing of phone calls and text messages; the proximity of the defendants obtaining the information and the subsequent trades; specific trades that were made in advance of the earnings announcements; and defendants’ prior trading history. All of these factors demonstrated sufficient particularity for the Commission’s allegations to survive the defendant’s Rule 9(b) challenge. Having made these findings, the Court denies the defendants’ motions to dismiss the Commission’s complaint.

(B. Wiand) (SLC Ref. No. 2011-07-07)

SEC v. TZOLOV AND BUTLER,

The SEC may use “offensive collateral estoppel” to obtain summary judgment in an enforcement action where defendant was previously found guilty by a jury of the same fraudulent conduct, even if the criminal conviction is on appeal.

Plaintiff SEC brought a civil enforcement action against defendants for violations of Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act for misrepresenting, in the sale of over $1 billion of auction rate securities (“ARS”), that they were backed by federally guaranteed student loans, when in fact they were collateralized by subprime mortgages, CDO’s, mobile home contracts and other non-guaranteed collateral. Following defendant Tzolov’s agreement to a Consent Order, the SEC moved for summary judgment against defendant Butler based on the collateral estoppel effects of a jury verdict finding Butler guilty of conspiracy to commit securities fraud, securities fraud, and conspiracy to commit wire fraud in a parallel criminal proceeding based on the same fraudulent ARS sales. “Offensive collateral estoppel” bars a defendant from re-litigating an issue when (1) the issues in both proceedings are identical, (2) the issue was actually litigated and decided, (3) there was a full and fair opportunity to litigate the issue, and (4) the issue was necessary to support a valid and final judgment on the merits. Defendant Butler opposed the SEC’s motion on the ground that the issues in the criminal action were not identical, not actually decided, and not necessary to support a valid and final judgment because the jury in the criminal proceeding rendered a general verdict on an indictment which covered misrepresentations to two corporate customers who were not included in the allegations of the SEC complaint. According to the Court, defendant “speculates” that the general verdict may, therefore, not have addressed the four other customers that were the subject of the SEC complaint. The Court considers the factual and legal bases of the SEC’s Section 17(a) and Section 10(b) claims, rejects defendant’s arguments and grants the motion.

First, the Court finds that the SEC complaint was not an exhaustive recitation of every victim of defendants’ fraudulent scheme and, therefore, must be read to encompass the same corporate customers named in the criminal action. It is the nature of the fraudulent conduct, and not the specific identities of the customer companies, which is relevant to the collateral estoppel analysis. Second, the existence of appellate issues, based on allegedly erroneous rulings in the criminal action, which Butler has appealed, does not defeat collateral estoppel. The appeal of a criminal conviction does not deprive a judgment of its preclusive effect. Finally, the Court concludes that injunctive relief is appropriate because there is a substantial likelihood that Butler will commit future violations based on (1) the egregiousness of the violations, (2) the “high degree” of scienter, (3) the repeated nature of the violations, and (4) Butler’s apparent lack of remorse—which, according to the Court, is evident by his conduct, including his “almost frivolous” opposition to the SEC’s motion.

(D. Franceski) (SLC Ref. No. 2011-09-08)

SIPC v. BERNARD L. MADOFF INVESTMENT SERVICES, INC., No. 08-01789 (Substantively Consolidated), 2010 U.S. Dist. LEXIS 81492 (S.D. N.Y., 8/6/10).

Bankruptcy Issues * Enforcement Practice/Procedure (SIPC Trustee) * Receivership/Trust/Estate (Trustee Fees) * Disclosure Issues (Conflicts of Interest) * Appellability (Interlocutory Order) * SIPA of 1970 (Constitutionality; Due Process).

The appeal of an interlocutory order will only be permitted in exceptional circumstances, if there is a question of controlling law and the determination will aid the resolution of the underlying action as a whole.

This decision relates to the repeated objections filed by certain Madoff claimants to fee requests submitted by Irving Picard (“Trustee”) and Baker &
Hostetler LLP (“B&H”), the law firm that represents him in connection with his task as SIPC Trustee, for services rendered in the resolution of the aftermath of the Madoff Ponzi scheme fraud. The investors who brought this objection initially challenged the method that the Trustee was utilizing to determine the amount of approved claims. Next, they began to challenge each of his fee applications by alleging that the Trustee had significant conflicts of interest because of his loyalty to SIPC, as opposed to the interests of the claimant creditor victims of the Madoff scheme. The Court has previously examined these claims and determined that there was no conflict, as the bankruptcy court had initially held a hearing and determined the disinterestedness of the Trustee and B&H. The third objection related to a fee petition and asserted that the Trustee had entered an action brought by the objectors in New Jersey and obtained an injunction regarding the claims of objections against SIPC. They claimed this action demonstrated a conflict of interest with the investor plaintiffs who had sued SIPC directly in the New Jersey action. This objection was also denied by the bankruptcy court. On appeal, the Court reviews the standards as to whether or not an interlocutory appeal under Section 129(b) was appropriate. The Court finds that, in order for an appeal to be appropriate, there must be a controlling question of law as to which there is substantial ground for difference of opinion and the Movant must show that an immediate appeal from the order may materially advance the ultimate termination of the litigation. Moreover, the Movant must demonstrate the existence of “exceptional circumstances” to overcome the general aversion to piecemeal litigation and to justify a departure from the basic policy of postponing appellate review until the entry of a final judgment. With respect to the issue of the conflicts of interest, the Court believes that the prior determination of disinterestedness had already been ruled upon in the case. In addition, the Second Circuit in Securities and Exchange Commission v. Oxford Securities, Ltd., has ruled that Securities Investor Protection Act provisions relating to these issues are constitutional. Thus, there is not any significant question as to controlling law. The Court must give due consideration to the nature, extent, and value of the services rendered and under SIPA must place considerable reliance on the recommendation of SIPC in determining fees. This had occurred in this case and there was little that was inappropriate about this determination. The Court does not accept the Movant’s argument that Congress had impermissibly created a statutory scheme that was permeated by a partiality and by conflicts of interest; it is beyond dispute that the Securities Investor Protection Act affords creditors due process. The Movants raised the question that, since the entry of the Trustee in the New Jersey action had occurred after the determination of disinterestedness, that that determination should not be binding. However, the Court notes that further matters with respect to this issue would require significant factual determinations; in light of the necessity of factual determinations, the matter was one that should not be determined on an interlocutory appeal. The Court denies all motions to allow an interlocutory appeal of the orders granting the fee petitions of Trustee Picard and B&H.


Account Administration (Stock Transfers) * 1933 Act (Securities Registration; Restrictive Legends) * Culpability Standards (Actual Knowledge) * Trading Issues (Transfer Restrictions).

A transfer agent is not responsible for a holder’s mistaken belief that a prior restriction on the transfer of a stock certificate had been removed.

In July 2002, the Southern District of New York issued a temporary restraining order (later converted into a preliminary injunction) prohibiting Guy Muller from transferring 500,000 shares of Save the World Air (“STWA”). Accordingly, STWA’s transfer agent, The Nevada Agency and Trust Company (“NATCO”), placed a restriction on the transfer of Muller’s stock certificates. Nevertheless, Muller deposited the shares with Ameritrade and attempted to sell them. Ameritrade checked with NATCO, was informed of the freeze, and returned the shares to Muller. Ameritrade made an entry in Muller’s account that a court order prevented the sale of the shares. In June 2004, Muller deposited shares of Save the World Technologies (“STWT”) into his Ameritrade account. NATCO was also the transfer agent for STWT and, since STWT was never the subject of any court order, NATCO cleared the transfer, and Muller sold the shares. However, Ameritrade’s stock broker apparently confused STWT with SWTA and made the following entry in Muller’s account: “There was a court order prohibiting the shares from being transferred into street name. We returned the shares to the client in November 2002. In June 2004, he deposited the shares again. They are clear now and I called the transfer agent to verify that the shares had been transferred.” In December 2006, Muller once again deposited the SWTA shares into his account. Without contacting NATCO and relying on the June 2004 account entry, Ameritrade allowed Muller to sell the shares and remove the sale proceeds from the account. But, when Ameritrade presented the shares to NATCO for transfer to street name, NATCO refused to transfer them, because the 2002 injunction was still in effect. Ameritrade was then forced to cover the resulting short in the account at a cost to it of $365,405. It then sued NATCO because of the latter’s failure to effect the transfer. NATCO filed a motion for summary judgment. The issue before the Court was whether Ameritrade had actual knowledge of the restriction on the SWTA shares. Ameritrade argued that it had no such knowledge, because it relied on the account entry made by its employee. The Court disagrees and rules that Ameritrade had actual knowledge of the restriction. Ameritrade was informed of the restriction in July 2002 and duly noted it. While the notes in Muller’s account also indicate that, in 2004, the SWTA shares had been cleared for transfer, it is undisputed that this information was incorrect. No

State Statutes Interpreted (NY CPLR 5225(b); UCC 8-510(a)) * Liability Issues (Imputed Knowledge; Corporate Subsidiary) * Account Administration * Collection Issues (Debtor-Creditor Law: Notice of Claims) * Remedies (Attachment).

Knowledge of adverse claims against the assets of an account holder at a securities firm is not imputed to an affiliated corporate banking entity seeking to attach those assets to satisfy a debt.

Petitioner Scher Law Firm brings a special proceeding, pursuant to NY CPLR 5225(b), on behalf of itself and the judgment creditors of Fred Deutsch, formerly a partner with Parklex Associates. The special proceeding, brought to preclude Respondents from attaching certain assets in Respondents’ possession and traced back to Deustch, has its roots in transactions undertaken in 2006. Specifically, in April 2006, Deustch opened the first of several securities accounts with Respondent RBC Dain. Deustch funded these accounts with many millions of dollars received through a sale of real estate. Subsequently, a number of Deuch’s partners commenced an action, alleging that Deutsch had committed fraud and theft, and responded to, a number of subpoenas issued by Petitioners, seeking information about Deutsch’s transfers, as well as court orders relating to the action begun by the Parklex defendants.

A short time later, and wholly separately from the Parklex proceeding involving RBC Dain, Royal Bank of Canada, the parent company of RBC Dain, extended a significant line of credit to Deutsch, utilizing the funds in the RBC Dain securities account as collateral; Deutsch now owes a large sum to Respondent RBC Bank as the result of his use of this credit line. Petitioners seek to preclude RBC’s attachment of these funds, alleging, in essence, that, at the time it extended its line of credit to Deutsch, RBC’s banking affiliate had either actual or implied knowledge of the Parklex partners’ claims to the funds in the RBC Dain accounts. In denying Petitioners’ motion, the Court rejects Petitioners’ claim that any knowledge possessed by the securities arm of RBC, RBC Dain, must be imputed to RBC’s bankers: information known to individuals within an organization who are not involved in a specific transaction, and which is not provided to those conducting the transaction, may not provide a basis to impute notice to the entire organization, unless the transmission of such information was deliberately impeded. The Court declines to find that the RBC Bank, at the time it extended the loan to Deutsch, had either actual or implied notice of the adverse claims against RBC Dain: the record shows that none of the information presented to RBC Dain by the Parklex plaintiffs was shared with RBC Bank; further, the due diligence performed by RBC Bank prior to approving the loan was wholly in keeping with RBC Bank’s standard procedures. Indeed, as the Court notes after a detailed analysis and summary of the record, the RBC Bank employees who were involved with the extension of the loan to Deutsch made reasonable efforts to be assured that no such adverse claims existed against Deutsch.

(N. Sorkin) (SLC Ref. No. 2011-08-02)


The applicability of the broker-dealer exception to the IAA hinges upon whether the advice in question relates to or is connected with the broker-dealer’s primary business, not upon the quantum or importance of the advice.

We have previously summarized two earlier decisions in this case (SLAs 2008-45 and 2009-38). This case of first impression among the federal appellate courts centers around the proper interpretation of the broker-dealer exception to the Investment Advisers Act (“IAA”). That exception exempts brokers and dealers who give investment advice so long as (1) the advice is solely incidental to their conduct as brokers or dealers, and (2) they receive no special compensation for that advice. Plaintiffs alleged that MetLife failed to disclose to them conflicts of interest created by MetLife’s commission structures and other incentives, which gave MetLife representatives -- in this instance, broker Laxton -- a financial interest in maximizing the sales of proprietary products. Plaintiffs alleged that these material omissions violated §§ 206 and 215 of the Investment Advisors Act of 1940. The district court held that Laxton fell within the IAA’s broker-dealer exception. On appeal, plaintiffs argued that Laxton did not meet the first prong of the broker-dealer exemption, because the investment advice formed a “central component” of all of Laxton’s transactions. The Court disagrees.

Under plaintiffs’ proposed reading, application of the exemption would hinge upon the quantum or importance of the advice. Besides creating a difficult problem of line-drawing, i.e., how much advice is too much and how to measure the importance of the advice, under plaintiffs’ interpretation “solely”would not meaningfully modify ‘incidental to’ and would become superfluous. The district court correctly concluded that the application of the broker-dealer exemption hinges on whether the advice in question relates to or is connected with the broker-dealer’s primary business, not upon the quantum or importance of the advice. The
Court also rejects plaintiffs’ argument that a broker-dealer receives “special compensation” whenever the broker-dealer receives an economic benefit from a transaction involving investment advice. Compensation received by a broker-dealer is “special” only when the compensation is received specifically in exchange for giving advice, as opposed to some other service, and the compensation takes a form other than a commission or analogous transaction-based compensation received for the sale of a product. Laxton’s advice was given only in connection with selling a variable universal life policy to plaintiffs. His advice was closely related to the sale of the policy and selling the policy was the primary object of the transaction. Accordingly, the advice was “solely incidental to” his conduct as a broker and he did not receive “special compensation.” (W. Nelson) (SLC Ref. No. 2011-09-06)

**TRADERIGHT SECURITIES, INC. v. RICHARD G. KIRSCHMAN IRA,** No. 10 C 2042 (N.D. Ill., 2/15/11).
**Arbitration Agreement (Uniform Submission Agreement) * Derivative/Vicarious Liability (Aiding & Abetting) * Stay of Arbitration * Waiver * Arbitrability * Agreement to Arbitrate.**

After signing a uniform submission agreement and filing an answer and a motion to dismiss in the arbitration, a party’s request for an injunction restraining the arbitration from going forward will be denied by the court. Defendants were clients of Enterprise Trust Company (“Enterprise”), an investment firm that was placed in receivership after being sued by the SEC for defrauding its clients. Enterprise maintained trading accounts with plaintiff Traderight Securities, Inc. (“Traderight”), a broker-dealer and FINRA member. Defendants filed a FINRA arbitration against Traderight and several alleged control persons at Traderight (the “Traderight parties”), claiming that Traderight acted negligently in supervising the trading in the Enterprise accounts and aided and abetted Enterprise’s fraud. The Traderight parties executed Uniform Submission Agreements and filed answers in the FINRA arbitration. Subsequently, the Traderight parties filed motions to dismiss in the arbitration. After the motions to dismiss were denied, the Traderight parties filed suit in federal court, seeking a declaration that they did not breach any legal duties to defendants and to enjoin the FINRA arbitration. Defendants countered by moving to compel arbitration. The Court rules in favor of defendants. By executing uniform submission agreements, the Traderight parties explicitly agreed to arbitrate the claims in question. The Traderight parties did not object to arbitrability at the outset or make any reservation of rights in their FINRA filings. To the contrary, they seemed content to participate in the arbitration until the panel denied their motions to dismiss, at which point they filed their lawsuit. If they wanted to challenge arbitrability, they needed to do so upfront, rather than signing submission agreements. Thus, defendants’ motion to compel arbitration is granted.

(J. Komie: Given that Traderight is a FINRA member firm and the other plaintiffs presumably associated persons – another basis for requiring arbitration – they seem fortunate not to have been sanctioned for filing this suit.) (SLC Ref. No. 2011-10-01)

**Computer Fraud and Abuse Act * Electronic Communications and Privacy Act * Jurisdictional Issues (Personal; Diversity; Supplemental) * Constitutional Issues (Due Process) * Raiding/Recruiting Issues.**

To impose jurisdiction on the basis of a tortious act committed outside the state causing injury to persons or property within the state, the court will apply a situs-of-injury test based on the original event that caused the injury. Here, the original event occurred in Chile. Lacking jurisdiction, the Court dismisses the claims against Mosqueira and Schultz. (W. Nelson) (SLC Ref. No. 2011-09-04)

**UBS FINANCIAL SERVICES, INC. v. WVU HOSPITALS, INC.,** 10 Civ. 4298 (S.D. N.Y., 1/4/11).

Because the FINRA Code constitutes the arbitration contract between UBS and cont’d on page 58
defendants, its provision on the hearing location is determinative.

Defendants commenced an arbitration before FINRA against UBS Financial Services and UBS moved to restrain defendants from proceeding with the FINRA arbitration or any form of action against UBS outside of New York County. In 2003, 2005 and 2006, UBS advised defendants to issue, through UBS, municipal bonds worth $329 million. Defendants contend that UBS failed to disclose that the fixed interest rates that UBS promised defendants were entirely dependent on UBS’s continued willingness to dominate and manipulate the market by placing support bids at low interest rates to effectively cap the ARS interest rate at a level desirable to defendants. The Court may issue a preliminary injunction only when the moving party demonstrates an irreparable harm and either the likelihood of success on the merits or sufficiently serious questions going to the merits to make them a fair ground for litigation; the balance of hardships must tip decidedly toward the party requesting the preliminary relief. The Second Circuit has held that it would be irreparable harm to be forced to expend time and resources arbitrating an issue that is not arbitrable. The Court finds that UBS has satisfied its burden of showing irreparable harm. The question of arbitrability is resolved by the courts, rather than the arbitrators, unless the parties have explicitly agreed otherwise. Pursuant to the FINRA Code, Rule 12200, a FINRA member must arbitrate a dispute if arbitration is required by a written agreement or requested by the customer, the dispute is between a FINRA member or associated person of a FINRA member and its customer, and the dispute arises in connection with the business activities of the member. The only question in the case at bar is whether defendants qualify as “customers” of UBS under the Code. Customer is not defined under the Code; in Rule 12100(i), it merely states that a customer shall not include a broker or dealer. Courts have interpreted the term customer broadly. In an early decision under the Code, the Third Circuit held that a securities issuer is a customer of a member firm where a dispute arises over a proposed underwriting. A recent Second Circuit case holds that any ambiguity in the meaning of customer should be construed in favor of arbitration. UBS has failed to present a strong prima facie case evidencing its likelihood of success on the question of whether defendants qualify as customers of UBS under the Code. Even if UBS could show that there are serious questions going to the merits, the Court is not persuaded that the balance of hardships tips decidedly in UBS’s favor. Any question of venue must be heard by the arbitrators. Because the FINRA Code constitutes the arbitration contract between UBS and defendants, its provision on the hearing location is determinative. (S. Anderson) (EIC: We presume UBS based its position regarding a New York County venue upon a forum selection clause in its financial advisory agreement, but the Opinion does not indicate.) (SLC Ref. No. 2011-07-01)

UFCWU v. Chesapeake Energy, No. CIV-09-1114-D, 2010 U.S. Dist. LEXIS 92208 (W.D. Okla., 9/2/10). Class Actions, Effects of * 1933 Act (§ 11, § 12(a)(2) & § 15 Control) * PSLRA (Pleading Requirements) * FRCP: Federal Rules of Civil Procedure * Materiality * Statutory Definitions (“Sellers”, “Solicitation”) * Negligence, Actionable. Solicitation for purposes of § 12(a)(2) potential liability includes both personal solicitation and substantial involvement in the offering process. Plaintiff United Food and Commercial Workers Union filed this purported class action, alleging that defendants violated §§ 11 and 12(a)(2) of the 1933 Act by misstating and omitting from the registration statement and prospectus certain material facts, thereby rendering the statement misleading to potential investors. The omitted facts related to margin accounts held by the CEO, hedging contracts with Lehman and certain “kickout” provisions in those hedging contracts. Defendants, including Underwriter Defendants UBS Investment Bank, ABN Amro, Banc of America Securities and Wells Fargo Securities, moved to dismiss, arguing that plaintiffs failed to show that the registration statement and prospectus omitted material facts necessary to insure that the contents of the documents were not misleading. The Court disagrees. Plaintiff did not allege that defendants intentionally misstated the facts nor made fraudulent representations; rather, plaintiff’s claims are based on the negligent failure to properly disclose facts and/or the failure to ascertain facts that could reasonably have been discovered through the exercise of due diligence. Although certain facts were generally disclosed, the disclosures should have been more detailed. Defendants had knowledge of the details, which were not otherwise available to potential investors. The lack of detail constitutes an omission of facts material to potential investors. Defendants also argued that, for purposes of the § 12(a)(2) claim, they were not statutory sellers. The Court rejects that argument, concluding that solicitation for purposes of § 12(a)(2) liability includes both personal solicitation and substantial involvement in the offering process. Here, plaintiff alleged sufficient facts to satisfy the applicable pleading requirements that defendants were involved in all stages of the offering. (W. Nelson) (SLC Ref. No. 2010-42-08)

USA v. Radley, No. 09-20699, 2011 U.S. App. LEXIS 1715, (5th Cir., 1/27/11). Criminal Issues * CEA (§§ 2 & 13) * Trading Issues (Natural Gas) * Market Manipulation * Statutory Definitions (“Transactions”) * Wire Fraud. The Fifth Circuit upholds a district court order dismissing indictments brought against natural gas commodities traders for violations of the Commodity Exchange Act (“CEA”), because the conduct alleged in the indictment consisted of transactions and thus fell within the exemption of §2(g) of the CEA. Defendants were commodities traders who traded futures in “TET propane” on an electronic interface known as Chalkboard. The government alleged that Defendants attempted to drive up the price of TET propane by placing stacked bids on Chalkboard. This forced sellers with naked short positions to purchase

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TET at the higher price, often directly from Defendants, in order to fulfill their obligations. The government also alleged that the Defendants withheld information about their purchases and falsely denied their attempts to control the TET propane market, in violation of the Commodities Exchange Act (CEA), 7 U.S.C. §13(a) (2). Defendants successfully moved to dismiss their indictments, arguing that their conduct fell within the statutory exemption of §2(g) of the CEA, which exempts off-exchange transactions in non-agricultural commodities. Advocating for a narrow interpretation of the statute, the government asserts on appeal that “transaction” should be defined as activities that create legally enforceable obligations. Because the complained of conduct (placing “stacked bids,” withholding supply from the market, falsely denying a scheme to corner the market, and falsely stating that the company intended to consume its propane) did not constitute contracts, the government argued they were not transactions protected by the CEA exemption. However, applying the ordinary meaning of transactions, as well as the CEA’s internal definition, which included conduct “commonly known to the trade as [a] bid [or] offer within the scope of a “transaction”,” the Court holds that the Defendants’ conduct falls within the exemption of §2(g). Because “transactions” can include more than the execution of a contract, negotiations could not be excluded from the exemption of §2(g). Defendants’ bids were placed on Chalkboard, some of which were accepted. Because market participants were free to accept or reject Defendants’ bids, the bids were part of Defendants’ business transactions and within the exemption of §2(g). Moreover, the other allegations against Defendants (withholding supply from the market, falsely denying a scheme to corner the market, and falsely stating that the company intended to consume its propane) concerned general business transactions and, therefore, fall within the exemption as well. Because the same conduct was used as the basis for the wire fraud charges and said conduct was legal within §2(g), the conduct could not be re-characterized as illegal activity under the wire fraud statute, 18 U.S.C. § 1343. The Fifth Circuit affirms the dismissal of the challenged indictments. (J. Ballard) (SLC Ref. No. 2011-10-09)


FLSA collective actions are not class actions within the meaning of FINRA Rule 13204.

At issue in this case is whether the exemption of class action claims from arbitration under FINRA Rule 13204 applies to FSLA collective actions claims. The Court concludes that it does not. Rule 13204 clearly states that class action claims may not be arbitrated under the FINRA Code of Arbitration Procedure. However, the Rule is silent as to collective action claims. Although collective and class actions have much in common, there is a critically important difference: collective actions are opt-in actions, i.e., each member of the class must take steps to opt in, in order to participate, whereas class actions are opt-out actions, i.e., class members automatically participate unless they take affirmative steps to opt out. A collective action binds only similarly-situated plaintiffs who have affirmatively consented to join the action. Here, the parties have agreed in writing to arbitrate certain disputes as required by FINRA. The FSLA collective action comes within the scope of the parties’ agreement to arbitrate.

(W. Nelson) (SLC Ref. No. 2011-11-02)

Vining v. Oppenheimer Holdings, Inc., No. 08-4435, 2010 U.S. Dist. LEXIS 103689 (S.D. N.Y., 9/27/10). Class Actions, Effects of * FRCP (Rules 9(b) & 12(b)(6)) * 1934 Act (§§ 10(b) & 20(a)) * SEC Rule 10b-5 * PSLRA (Pleading Requirements) * Culpability Standards (Scienter) * Sales Practice/Product Issues (Auction-Rate Securities “ARS”) * Misrepresentations/
claim for liability under Section 10(b), the Court holds that Plaintiffs’ Section 20(a) claim against Oppenheimer Holdings necessarily also fails. A plaintiff may plead scienter by alleging facts (1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness. Additionally, when the defendant is a corporate entity, the pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter. With respect to motive and opportunity, Oppenheimer’s profit motive in perpetuating the ARS market in order to maintain relationships with auction dealers and grow its underwriting business is a generalized motive, one which could be imputed to any publicly-owned, for-profit endeavor, and is not sufficiently concrete for purposes of inferring scienter. Plaintiffs’ allegations of insider sales are similarly insufficient to support a strong inference of scienter, because they fail to state the portion of stockholdings sold and the change in volume of insider sales. Moreover, these allegations do not specify what non-public information the Oppenheimer insiders were allegedly trading on during the relevant timeframe. In order to raise a strong inference of scienter by means of circumstantial allegations, Plaintiffs must allege that Oppenheimer engaged in conduct that was highly unreasonable and which represented an extreme departure from the standards of ordinary care. Plaintiffs do not satisfy this requirement by alleging that Oppenheimer had knowledge of certain facts that purportedly contradict the statements made to Plaintiffs about the ARS, because this knowledge does not give rise to the requisite level of scienter and because the allegations are not pled with sufficient specificity. With respect to the corporate scienter requirement, Plaintiffs assert that the intent or recklessness of Oppenheimer employee David White, who purportedly made training presentations to financial advisors, should be imputed to Oppenheimer. The Court holds that White’s role in the alleged fraud does not give rise to a strong inference that he acted with the requisite state of mind. Plaintiffs neither allege facts showing that White possessed a motive to defraud, nor that he engaged in behavior exhibiting conscious misbehavior or recklessness. The Court also takes into account plausible opposing inferences, as it is required to do under the PSLRA. Plaintiffs’ basic theory is that high-level Oppenheimer officials issued management directives and uniform sales materials to Oppenheimer financial advisors regarding ARS, and that these directives were issued recklessly or with the intention to defraud, because the prospect of ARS illiquidity was either known to Oppenheimer or so obvious that Oppenheimer must have been aware of it. While this inference is plausible, it is not at least as strong as the inference that Oppenheimer negligently or carelessly provided insufficient training to its financial advisors and was merely negligent in not detecting and disclosing the imminent market collapse. The Court grants Defendants’ Motion to Dismiss without prejudice.

(P. Michaels) (SLC Ref. No. 2010-41-09)


Disclaimers of liability in offering circulars are void under California law as a defense to certain claims, including negligent misrepresentation claims, which involve deceit.

This matter comes before the court on three motions to dismiss filed by defendants. In the Amended Complaint, plaintiffs, four closed-end management investment companies, allege various state and federal causes of action in connection with their purchase of WaMu securities through two offerings in 2006 and 2007. These securities were composed in part of the conveyances of home equity loans and adjustable rate mortgages originated by WaMu and were sold with offering circulars. The circulars described the securities and portions of WaMu’s business operations and incorporated certain filings with the SEC and press releases. Plaintiffs’ investment advisor and portfolio manager allegedly read and relied on the offering circulars. Three underwriters and broker-dealers sold the securities to plaintiffs, having purchased them directly from WaMu. These Initial Purchaser Defendants included disclaimers of liability in the offering circulars. The core allegations track those made in the WaMu Multi-District Litigation. In 2008, the FDIC took control of WaMu, causing its Trust Securities to transform into preferred stock that was worthless. The offering circulars contain misstatements about WaMu’s underwriting, appraisal practices and credit risk management, as well as incorporating several SEC filings and press releases that contain false or misleading information about WaMu’s financial condition. Rule 9(b) imposes a heightened standard for pleading fraud with particularity, even though it also permits pleading intent and knowledge generally. The claims against the Director Defendants must meet Rule 9(b), because they are grounded in the same course of conduct alleged to be fraudulent. Claims against the Initial Purchaser Defendants need only meet Rule 8(a) notice pleading. Officer Defendants move to dismiss the common law and statutory claims of fraud against them, because there is no showing that the plaintiffs themselves relied on any statements they allegedly made. The pleadings establish the agency relationship between plaintiffs and their investment advisor, so the fact that they did not personally read and rely on the statements is not fatal. However, plaintiffs’ allegation that their investment advisor read and relied on the offering circulars and the incorporated documents is too thin to satisfy Rule 9(b) or the requirement of pleading actual reliance under California law; thus, the common and statutory law claims will be dismissed. Indeed, the allegations of reliance against

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all defendants are too conclusory and vague to raise them from the possible to the plausible and will be dismissed as to all defendants. The disclaimers against liability in the offering circulars are void under California law, including negligent misrepresentation claims, which involve deceit. Under the group pleading doctrine, plaintiffs have adequately alleged Director Defendants’ negligent misrepresentations because they signed SEC filings and participated in certain day-to-day functions and had a special relationship with the company. Plaintiffs’ claims under Cal. Corp. Code § 25400(d) and § 25500 are viable under the broad view that persons who may be liable for misrepresentations must be involved in market activity at the time of the misrepresentations. Here, the Officer Defendants sold WaMu stock at the time that plaintiffs purchased WaMu securities. An offer or sale of a security is made in California when an offer to sell is made in the state or an offer to buy is accepted in the state or if both the seller and the purchaser are domiciled in the state and the security is delivered in the state. (S. Anderson) (SLC Ref. No. 2010-40-05)

WASHINGTON MUTUAL, INC. SECURITIES LITIGATION, IN RE, Lead Case No. 08-387 (W.D. Wash., 1/28/11). Class Actions, Effects of * Underwriting Issues * 1933 Act (§11) * Timeliness Issues (Statutes of Limitations) * Notice Requirements * FRCP (§15 “Leave to Amend”). For statute of limitations purposes, an amended pleading is deemed filed at the time the motion to amend is first made. This multi-district litigation began when Brockton Contributory Retirement System brought suit in May 2008 regarding WaMu’s public offerings in August 2006, September 2006, and October 2007. Due to a challenge to Brockton’s standing, which led to the Court granting a motion to dismiss in 2009, Plaintiffs filed a Second Amended Complaint in June 2009 that added two additional named Plaintiffs, Pompano and Detroit P&F. That gave the named Plaintiffs standing as to all three issues. It caused the Underwriter Defendants, however, to object that the new class representatives were too late in joining the suit. Their argument held that the one-year statute of limitations governing 1933 Act claims expired in May 2009, at the latest. The Court responds that, even accepting that date, it still finds that the new Plaintiffs joined on a timely basis. The Court makes the point that “an amended pleading is effectively filed when a motion to amend is filed... It is not, as Defendants suggest, the date the Amended Complaint is filed or when the Court grants leave to amend.” Back when the Court was considering the first motion to dismiss against Brockton, Plaintiffs indicated in their responsive brief that they had lined up additional complainants, in the event that the standing issue required amendment of the original complaint. They even named the additional Plaintiffs in their responsive briefs, so Defendants were on notice well before May 2009. As leave to amend is liberally granted and courts have routinely regarded requests in responsive briefs as formal motions to amend, the amended pleading may be deemed to have been filed at that time. Federal Rules even permit oral requests to be regarded as motions to amend. FRCP 7(b)(1)(A) explicitly permits “a party to satisfy the formal, written motion requirement by making oral requests of the Court for a ruling at a hearing or trial.” Defendants still object that the proper way to amend would have been to supply the Court with a formal pleading, along with a statement of intention. The Court thinks that suggestion ignores the Rules it cited, as well as the “realities of litigation.” Plaintiffs moved to amend and added the new class representatives on a timely basis. (SLC Ref. No. 2011-12-07)

WELLS FARGO MORTGAGE-BACKED SECURITIES LITIGATION, IN RE, No. 09-cv-01376-LHK, 2010 U.S. Dist. LEXIS 106687 (N.D. Cal., 10/5/10). Class Actions, Effects of * 1933 Act (§§ 11 & 12) * Pleading Requirements * FRCP (Rule 15) * Sales Practice/
false. The Court agrees. Misleading opinions can give rise to a claim under Section 11, only if the complaint alleges with particularity that the statements were both objectively and subjectively false or misleading. Plaintiffs did allege some facts tending to show that Wells Fargo intentionally manipulated the appraisal process, but they failed to allege that Wells Fargo knew that the appraisals, ratings, and LTV ratios were false or misleading. The Court rejects Wells Fargo's argument that plaintiffs must allege that the appraisers and the rating agencies, as well as Wells Fargo, knew that these opinions were incorrect. Plaintiffs need only adequately allege that Wells Fargo knew that these opinions were false or misleading to state a claim. Further, because Wells Fargo failed to raise this argument in its first motion to dismiss, plaintiffs are given leave to amend the claim, in order to show that Wells Fargo knew that the appraisals, ratings, and LTV ratios set forth in the offering documents were false or misleading.

(P. Dubow) (SLC Ref. No. 2010-41-06)

WELLS FARGO MORTGAGE-BACKED CERTIFICATES LITIGATION, IN RE, No. 09-cv-01376 LHK, 2010 U.S. Dist. LEXIS 106661 (N.D. Cal., 10/5/10).

Timeliness Issues (Statute of Limitations) * 1933 Act (§§ 11 & 15) * Class Actions, Effects of * Notice Requirements * Tolling Principles * Sales Practice/Product Issues (Subprime Mortgages “MBS”) * Standing/Privy Issues.

*The three-year statute of repose and one-year statute of limitations set forth in Sections 11 and 15 of the Securities Act of 1933 will not be tolled for a plaintiff who is added to a complaint to replace a plaintiff who had no standing. **The filing of a class action complaint is notice to any other putative plaintiffs who join the action later.

This consolidated class action complaint involved 54 separate offerings of mortgage-backed certificates issued by Wells Fargo. In response to a motion filed by Wells Fargo, the Court dismissed claims based on 37 of the offerings, because the named plaintiffs had not invested in them and, therefore, lacked standing to bring claims regarding these offerings. On May 28, 2010, plaintiffs filed an amended complaint, which identified five new plaintiffs who had invested in ten of the 37 offerings previously dismissed for lack of standing. Wells Fargo again moved to dismiss on the ground that the claims of the new plaintiffs were barred by the statute of limitations, which requires that any claim under these statutes be filed within one year of notice of the defendant’s acts and, in any event, not later than three years after the offering. In the case of seven of the offerings purchased by the new plaintiffs, the purchase occurred prior to May 28, 2007 and so the three-year statute of repose would normally be expected to apply. Wells Fargo also argued that the new plaintiffs had notice of their claims when the initial complaints were filed in March and April 2009. Since those filings occurred prior to May 28, 2009, the one-year statute of limitations applied. Plaintiffs countered that the filing of the initial complaints tolled both the three-year statute of repose and the one-year statute of limitations. They relied chiefly on American Pipe & Construction Co. v Utah, 414 US 538 (1974), where the Supreme Court held that, when a class action is dismissed for failure to certify the class, the statute of limitations is tolled for class members who then intervene to assert the same claims individually. The Court distinguishes American Pipe and grants the motion to dismiss. Unlike the putative class members in American Pipe, the new plaintiffs here had no reason to rely on the initial complaints to protect their claims. The original complaints did not allege that the named plaintiffs had any ownership interest in the 37 dismissed offerings. Thus, review of these complaints would have revealed that the plaintiffs in the original complaints lacked standing to bring claims as to these offerings. If named plaintiffs to a class action lack standing to bring a claim, no putative class members can step into the standing breach. As to the three remaining offerings, the original complaints stated many of the factual bases alleged in the amended complaint regarding these offerings. Specifically, the original complaints cited to the same registration statements and many of the same alleged misrepresentations and omissions within the registration statements. Although the amended complaint expanded on these allegations, the information in the original complaints was at least sufficient to put the new plaintiffs on notice of their claims. Thus, the new plaintiffs either knew of the basis for the revived claims or, through diligence, should have known of them more than one year before the amended complaint was filed.

(P. Dubow) (SLC Ref. No. 2010-41-07)


Class action defendants’ motion to dismiss granted where plaintiffs failed to allege fraud with requisite particularity. Class action plaintiff shareholders alleged that defendants Raymond James Financial, Inc. (“RJF”) and four of its principals engaged in a scheme to defraud shareholders by making material misrepresentations. The alleged misrepresentations concerned the adequacy of its loan loss reserves for its subsidiary, Raymond James Bank (“RJBank”), and the financial health of that loan portfolio between April 28, 2008 and April 14, 2009 (the “class period”). Specifically, plaintiffs alleged that RJF concealed the fact that RJBank was increasing risky commercial real estate lending at a time when the industry was contracting in that area, that if one large loan defaulted RJBank would take a substantial hit to its earnings, and that RJ Bank’s loan to value (“LTV”) ratios for its residential loans should have been adjusted in light of falling home prices. Plaintiffs also claimed that RJF misrepresented the health of...
its lending business by touting its risk management efforts and by claiming that it independently underwrote all loans on its books. Finally, Plaintiffs claimed that RJF’s management recklessly ignored economic information that should have made it increase its loan loss reserves. The Court notes that, in order to prevail on their securities fraud claims, the plaintiffs were required to show that the defendants, in connection with the purchase or sale of securities, made a materially false statement of a material fact which plaintiffs relied on, and to plead scienter with particularity. Additionally, this securities fraud case was subject to the heightened pleading standards specified in the Private Securities Litigation Reform Act of 1995 (“PSLRA”). The Court examines the alleged misrepresentations and finds that nearly all of them are not actionable fraud. The representations regarding the loan loss reserves are general statements of optimism and amount at most to mismanagement, not fraud. Similarly, statements regarding the health of the loan portfolio are classic puffery and not the type of statement that reasonable investors rely on. Additionally, the accounting related complaints regarding the LTV ratios, standing alone, are not sufficient to state a securities fraud claim. However, the alleged misrepresentation that RJF or RJBank independently underwrote all loans was actionable, because the plaintiffs had testimony from a confidential witness confirming that a large commercial loan that failed and caused the stock price to plummet was not independently underwritten.

The Court next examines the pleadings relating to scienter, and finds at most evidence of mismanagement, not of fraudulent intent. All corporate officers have a general motive to increase profits and present a strong balance sheet and the Court refuses to find an inference of scienter without more direct evidence of intent. Because the fraud claims fail, so do the control person claims. The motion to dismiss for failure to state a claim is granted.

(J. Ballard) (SLC Ref. No. 2010-39-05)


**Collection Issues (Forgivable Loan) * Class Actions, Effects of (Arbitration) * Parallel Proceeding * Employment Disputes * SRO Rules (FINRA Rule 13204).**

One may not block an existing arbitration before FINRA by filing a purported class action seeking declaratory relief with respect to the issues raised in the arbitration.

This action arises from a dispute that relates in part to an arbitration proceeding filed by RBC Capital Markets Corporation, RBC Dain Rauscher Inc., RBC Wealth Management, and RBC Capital Markets Corporation, (“RBC”) against a former broker, Carl Wright, (“Wright”) seeking to collect a forgivable loan that was made to Wright at the time he was hired by RBC. The initial loan was in the amount of $202,000. When Wright terminated his affiliation with RBC, $129,000 remained owing on the loan and after making demand, RBC instituted an arbitration proceeding. In response to the arbitration proceeding, Wright filed in state court in California a class action against RBC, alleging violations of the California Labor Code and related claims, essentially asserting that, at the time of hiring when he was required to sign the forgivable note with RBC, he was required to turn over his book of business and that contribution of property made the forgivable note void. RBC removed the case to federal court and moved to dismiss on a number of grounds, the most significant of which were “the first-to-file rule” and that Wright’s action should be stayed and compelled to arbitration as the FINRA arbitration rules that prohibit the arbitration of certain class action claims did not apply to the class action instituted by Wright. First the Court reviews the “first-to-file rule.” There had been pending for some time a class action in Minnesota that involved similar allegations and specific allegations relating to the California Labor Code. Because this action was pending between RBC and similarly situated plaintiffs, the Court determines that the Minnesota action was the first filed and that the California class action should not proceed. Given the advanced stage of the Minnesota litigation (summary judgment motions were then pending), it is appropriate to dismiss the California action, rather than staying or transferring it. With respect to the question of whether or not FINRA rules prohibit the arbitration of RBC’s claims against Wright, the Court spends significant time analyzing the application of FINRA Rule 13204 to arbitrations that involve similar class action claims. In this case, the Court determines that the rule does not prohibit the pursuit of this collection matter by RBC. Even though some claims might be similar, RBC’s action to collect its debt was instituted prior to Wright’s class action. Wright was essentially using his class action and his asserted interpretation of Rule 13204 as a sword and defensive tactic against RBC’s previously filed arbitration, rather than as a shield against brokerage firms seeking to defeat pre-existing class actions by compelling arbitration. The Court finds that Rule 13204(d) was never intended to preclude another party’s arbitration claim, but rather its purpose is to allow a Claimant to choose to pursue his own claim either in a class action in court or arbitration. Attempting to block an existing arbitration claim through the filing of a purported class action seeking declaratory relief with regard to the issues involved in the arbitration was deemed by the Court to be a misuse of Rule 13204; such tactics cannot be condoned. The Court dismisses a portion of the purported class action on “the first-to-file rule” and stays all remaining portions of the action pending resolution of the FINRA arbitration instituted by RBC.

(B. Wiand) (SLC Ref. No. 2011-08-01)
# TABLE OF CASES

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## FIRST CIRCUIT

**Braintree Laboratories v. Citigroup Global Markets, Inc.**, No. 09-2540 (1st Cir., 10/12/10). If a trial court had meant to provide relief other than what was requested in the motion at bar, the presumption on appeal is that the court would have said so; thus, a court granting arbitration intended to stay the litigation, not dismiss it (thus thwarting an immediate appeal).

**City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Waters Corp.**, No. 10-1514, 2011 U.S. App. LEXIS 1065 (1st Cir. (Mass.), 1/20/11). Motion to Dismiss class action against defendant for fraudulent omission granted due to lack of scienter.

**Huffington v. T.C. Group, LLC**, No. 10-1405 (1st Cir., 2/25/11). Court affirms district court order dismissing Plaintiff’s claims under Fed.R.Civ.P. (6), concluding that the forum selection clause in Plaintiff’s subscription agreement encompasses his claims and requires that they be brought in Delaware and not Massachusetts.


**Morales v. UBS Trust Co. of Puerto Rico**, No. 09-2205 (D. P.R.. 1/20/11). A party moving to compel arbitration must show that the other party is bound by the arbitration clause at issue.

**Dever v. Oppenheimer & Co., Inc.**, No. 09-5051 (Mass. Super. Ct., Suffolk Cty., 6/28/10). Enforcement of a confidentiality order contained in an arbitration Award invokes the Court’s enforcement powers and, therefore, represents “state action;” endorsing such an order when it broadly and without sufficient justification restricts conduct, and possibly speech, (III)eds public policy.

**Dever v. Oppenheimer & Co., Inc.**, No. 09-5051 (Mass. Super. Ct., Suffolk Cty., 12/22/10). Impounding of documents is the courts’ way of protecting documents produced in litigation from becoming publicly available, where the documents are proprietary in nature, are covered by a privilege, or, if made public, would invade the privacy of an individual.

## SECOND CIRCUIT

**Holmes v. Grubman & Citigroup Global Markets, Inc.**, No. 06-5246-cv, 2010 U.S. App. LEXIS 12863 (2nd Cir., 6/23/10). That the District Court dismissed claims on a basis that was incorrect in the final analysis does not preclude an affirmance, if the Appellate Court finds the claims invalid on other grounds.

**Iowa Public Employees’ Retirement System v. MF Global, Ltd.**, No. 09-3919-cv, 2010 U.S. App. LEXIS 19138 (2nd Cir., 9/14/10). A statement of confidence in a firm’s operations may be forward-looking – and thus insulated by the “bespeaks caution” doctrine – even while statements or omissions as to the operations in place (and present intentions as to future operations) are not.


**Amorosa v. AOL Time Warner Inc.**, No. 09-5270-cv (L), 2011 U.S. App. LEXIS 2149 (2nd Cir., 2/2/11). Although the absence of loss causation is an affirmative defense to a Section 11 claim under the 1933 Act, a complaint may be dismissed pursuant to Rule 12(b)(6), if the loss causation defect is apparent from the face of the pleading.

**Litwin v. Blackstone Group, LP**, No. 09-4426-cv, 2011 U.S. App. LEXIS 2641 (2nd Cir., 2/10/11). It is only when there is both materiality and a duty to disclose that a company may be held liable for omitting information from a registration statement or prospectus.

**Genworth Financial v. McMullan**, No. 09-CV-1521 (D. Conn., 6/10/10). *Misappropriation of trade secrets by a competitor is not necessarily irreparable harm, because the misappropriator is likely motivated to protect the secret to serve its own purposes. **Injunctive relief may be warranted in cases where there is a danger that, unless enjoined, a misappropriator of trade secrets will disseminate those secrets to a wider audience or otherwise irreparably impair the value of those secrets.*

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Chapple v. Fahnestock & Company, Inc., No. 03-4989 (E.D. N.Y., 8/5/10). While evidence of a hostile work environment can extend to incidents not necessarily involving the plaintiff, evidence of other lawsuits filed against the defendants making similar harassment allegations are likely to be more prejudicial and speculative than probative.

SIPC v. Bernard L. Madoff Investment Services, Inc., No. 08-01789 (Substantively Consolidated), 2010 U.S. Dist. LEXIS 81492 (S.D. N.Y., 8/6/10). The appeal of an interlocutory order will only be permitted in exceptional circumstances, if there is a question of controlling law and the determination will aid the resolution of the underlying action as a whole.

Woodward v. Raymond James Financial, Inc., No. 09-CV-5347 (RPP) (S.D. N.Y., 8/16/10). Class action defendants’ motion to dismiss granted where plaintiffs failed to allege fraud with requisite particularity.

Morgan Stanley Mortgage Pass-Through Certificates Litigation, In Re, No. 09 Civ. 2137 (LTS)(MHD), 2010 U.S. Dist. LEXIS 84146 (S.D. N.Y., 8/17/10). That a suit may be a class action adds nothing to the question of standing, for even named plaintiffs who represent a class must allege and show that they personally have been injured, not that injury has been suffered by other, unidentified members of the class to which they belong and whom they purport to represent.

Kearney v. ABN Amro, Inc., No. 04 CV 6885, 2010 U.S. Dist. Lexis 100419 (S.D. N.Y., 9/15/10). *While the duties and responsibilities of similarly situated employees need not be identical in order for a Title VII plaintiff to demonstrate discrimination or disparate treatment, they must be similar in all material respects. **Stray comments by the very individual who took steps to protect plaintiff’s job are not sufficient, in the context of the totality of the evidence, to demonstrate discriminatory animus.

Vining v. Oppenheimer Holdings, Inc., No. 08-4435, 2010 U.S. Dist. LEXIS 103689 (S.D. N.Y., 9/27/10). A plaintiff may plead scienter under the PSLRA by alleging facts (1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness.

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Morgan Stanley & Co., Inc. v. Seghers,
Broker-Dealer is successful on a motion for a preliminary
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Tradition Chile Agentes v. ICAP Securities,
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No. 09 Civ. 08862 (GBD), 2010 U.S. Dist. LEXIS 137150 (S.D.
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UBS Financial Services, Inc. v.
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New Jersey Carpenters Health Fund
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Carpenters Vacation Fund v. The Royal Bank
of Scotland Group, PLC,
Nos. 08 CV 8781, 08 CV 5093, 2011 Dist. Lexis 4343 (S.D.
N.Y., 1/18/11). Class Plaintiffs’ Section 11, 12(a)(2) and 15
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SEC v. Tzolov and Butler,
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Farber v. Goldman Sachs Group,
10 Civ. 873, 2011 U.S. Dist. LEXIS 16673 (S.D. N.Y.,
2/16/11). In a Rule 12(b)(6) motion to dismiss, plaintiff’s
obligation is to provide proof of his entitlement to relief, which
requires more than labels and conclusions and a formulaic
recitation of the elements of a cause of action.

Foragazzo v. Lehman Bros.,
No. 03 Civ. 5194 (S.D. N.Y., 2/23/11). In a class action,
young percentage award of attorneys’ fees will be assessed for
reasonableness using the Goldberger criteria, which include the
time and labor expended by counsel, the magnitude and
complexities of the litigation, the risk of the litigation, the
quality of representation, the requested fee in relation to the
settlement and public policy considerations.

Municipal Derivatives Antitrust Litgn., In Re:
Hinds County, MS v. Wachovia Bank, NA,
No. 08 Civ. 2516, 08 MDL 1950 (S.D. N.Y., 3/1/11).
Class actions seeking damages and regulatory settlements
seeking restitution may conflict, requiring judicial intervention
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to weigh the public interest in allowing one or both to go forward.

**Brady v. Williams Capital Group, LP & AAA**, No. 36 (N.Y., 3/25/10). When a petitioner’s statutory rights are imperiled by the costs of arbitration, a court must determine whether to enforce the arbitration agreement and sever any fee-sharing provision or, in the alternative, give the petitioner the right to remain in court or pay the contracted-for costs and stay in arbitration.

**Kirschner v. KPMG LLP**, Nos. 151 & 152, 2010 N.Y. LEXIS 2959 (N.Y., 10/21/10). The adverse interest exception, blocking imputation of knowledge of fraud from controlling corporate officers to the corporation (thus preventing application of the in pari delicto defense), applies narrowly to the circumstance where the corporation is actually a victim of the insiders’ wrongdoings.

**MBIA Insurance Corp. v. Merrill Lynch International**, No. 4163 (N.Y. App., 1Dept., 2/1/11). A contractual promise to provide AAA-rated securities to an investor is not a promise of credit quality; it is merely a promise to provide securities that have an AAA rating.

**The Scher Law Firm, as Nominee and Claimants’ Representative v. DB Partners I LLC, RBC Capital Markets Corporation, Royal Bank of Canada**, No. 24633/09, 2011 N.Y. Misc. LEXIS 142 (N.Y. Sup. Ct., 1/28/11). Knowledge of adverse claims against the assets of an account holder at a securities firm is not imputed to an affiliated corporate banking entity seeking to attach those assets to satisfy a debt.

**Pine Street Associates, LP v. Southridge Partners, LP**, No. 652109/2010 (N.Y. Sup. Ct., NY Cty., 3/3/11). That the directives of an arbitration Award have been complied with and performed does not constitute a defense to confirmation of that Award.

**THIRD CIRCUIT**

**CFTC v. Perkins**, No. 09-2507, 2010 U.S. App. LEXIS 13593 (3rd Cir., 7/1/10). The purpose of the CEA would be undermined if one entity could escape regulation merely by having another entity execute its trades.

**McGowan Investors, LP v. Frucher**, No. 07-3980, 2010 U.S. App. LEXIS 16908 (3rd Cir., 8/12/10). Objecting to a class action settlement does not prevent it from having a preclusive effect, once approved, upon the objector’s ability to re-litigate the issue in another forum.

**ING Life Insurance and Annuity Co. v. Gitterman**, No. 10-4076, 2010 WL 3283526 (D. N.J., 8/18/10). A financial advisor whose fiduciary duty requires consideration of the whole...
of a client’s assets does not violate a written non-solicitation agreement by contacting former clients about assets which include those still managed by the former employer.

Popkave v. John Hancock Distributors LLC,
No. 10-3680, 2011 WL 382713 (E.D. Pa., 2/7/11). An arbitration Award, which is at least “barely colorable” based on the facts and the law, the result of confusion and uncertainty on the part of the arbitrators as to the applicable law, but not completely irrational, does not exceed powers and is not in manifest disregard of the law.

Credit Suisse Securities (USA) LLC v.
West Coast Opportunity Fund, LLC,
No. 4380-VCN, 2010 Del. Ch. LEXIS 209 (Del. Chancery, 10/11/10). Under Delaware Chancery Court Rule 60(b), where exceptional circumstances have deprived the parties of appellate review, the court may vacate a prior ruling, even after the case is settled.

FOURTH CIRCUIT

Levin v. Alms & Assoc., Inc.,
No. 10-1896, 2011 U.S. App. LEXIS 2494 (4th Cir., 2/10/11). An appeal of arbitrability automatically divests the district court of jurisdiction over the underlying claims and requires a stay of the action unless the district court certifies the appeal as frivolous or forfeited.

Newman & Register v.
First Montauk Financial Corp.,
No. 7:08-CV-116-D, 2010 U.S. Dist. LEXIS 74695 (E.D. N.C., 7/23/10). Possible inefficiency may occur due to referral of a claim to arbitration, because the relevant federal law requires piecemeal resolution when necessary to give effect to an arbitration agreement.

FIFTH CIRCUIT

USA v. Radley,
No. 09-20699, 2011 U.S. App. LEXIS 1715, (5th Cir., 1/27/11). The Fifth Circuit upholds a district court order dismissing indictments brought against natural gas commodities traders for violations of the Commodities Exchange Act (“CEA”), because the conduct alleged in the indictment consisted of transactions and thus fell within the exemption of §2(g) of the CEA.

Davis v. Karl,
No. 10-875, 2010 U.S. Dist. LEXIS 85318 (E.D. La., 8/19/10). Civil conspiracy claims must plead all elements of the underlying tort in which defendants conspired; statutory rights of action under the Securities Act of 1933 do not permit a conspiracy claim.

Bilyeu v. Johanson Berenson LLP,
No. 1:08-cv-02006 (W.D. La., 9/27/10). The preferred method of petitioning for enforcement of an agreement to arbitrate is to move pursuant to the Federal Arbitration Act, rather than to seek dismissal of all claims under the Federal Rules; dismissal, as opposed to a stay of litigation under Section 3, is only appropriate in special circumstances.

Grant v. Houser,
No 10-1919 (E.D. La., 1/10/11). Court denying brokerage firm’s motion to compel arbitration of customer claims based on firm’s failure to supply sufficient evidence of assignment of arbitration agreement and upon a determination that equitable estoppels did not apply to compel arbitration.

Pendergest-Holt v. Certain Underwriters at Lloyd’s of London,
No. 09-3712, 2010 U.S. Dist. LEXIS 86393 (S.D. Tex., 8/23/10). Court denying motion in limine seeking to preclude (i) use of plea agreement and transcript of guilty plea proceeding of former CFO of Stanford Financial Group Company, and (ii) use of declarations and affidavits prepared by forensic accountant hired by Receiver for Stanford Financial Group, based on findings that such items met hearsay exceptions and that no unfair prejudice would result from the admission.

Billitteri v. Securities America, Inc.,
No. 3:09-01568 (N.D. Tex., 2/18/11). The All Writs Act permits a federal court to enjoin pending arbitration proceedings, at least for TRO purposes, that might threaten approval of a class action settlement.

Billitteri v. Securities America, Inc.,
No. 3:09-cv-01568-F (N.D. Tex., 3/7/11). Intervention who wish to object to a class action settlement must be unrepresented in the action and, yet, have an interest in the property or subject of the action that will be impeded or impaired by the Court’s approval of the settlement.

SIXTH CIRCUIT

Louisiana School Employees’ Retirement System, et al. v. Ernst & Young, LLP,
No. 08-6194, 2010 U.S. App. Lexis 19636 (6th Cir., 9/22/10). *In order for red flags to create a strong inference of scienter in securities fraud claims against outside auditors, they must be in the nature of an egregious refusal to see the obvious or to investigate the doubtful. **Accounting errors alone cannot support a plausible inference of scienter under Tellabs.

SEC v. Payne,
No. 1:00 cv 1265, 2010 U.S. Dist. LEXIS 136105. (S.D. Ind., 12/23/10). Collateral estoppel may be applied in civil cases to issues previously determined in a criminal conviction; cont’d on page 69
a criminal conviction based on a guilty plea conclusively establishes for purposes of subsequent civil proceedings that the defendant engaged in the criminal act for which he was convicted.

SEC v. Payne (Danker),
No. 1:00 cv 1265, 2010 U.S. Dist. LEXIS 136108 (S.D. Ind., 12/23/10). Collateral estoppel may be applied in civil cases to issues previously determined in a criminal conviction; a criminal conviction based on a guilty plea conclusively establishes for purposes of subsequent civil proceedings that the defendant engage in the criminal act for which he was convicted.

Clayton v. Heartland Resources, Inc.
No. 1:08CV-94, 2010 U.S. Dist. LEXIS 123654 (W.D. Ky, 11/16/10). Whether attendance at investor meetings and answering investors’ legal questions constituted an attempt to effect the sale of securities by an attorney, the content of the attorney’s answers and not simply the act of answering the questions is the key factor.

Haase v. GunnAllen Financial, Inc.,
No. 2:08-cv-10927, 2011 U.S. Dist. LEXIS 19454 (E.D. Mich., 2/28/11). Claims based on control person liability for an underlying primary violation of fraud must satisfy the pleading particularity requirements of Rule 9(b) and the PSLRA; conclusory allegations of participation as a “control person” or seller will not suffice to state claims for relief under the 1933 Act, 1934 Act or state statutory or common law.

SEC v. Salyer,
No. 2:08-cv-179, 2010 U.S. Dist. LEXIS 85545 (E.D. Tenn., 8/18/10). The purpose of disgorgement of profits acquired through securities fraud is to force a defendant to give up the amount by which he was unjustly enriched, rather than to compensate the victims of his fraud.

REGIONS MORGAN KEEGAN SECURITIES, Derivative, and ERISA Litigation, In Re,
No. MDL 2009 08-2260, 2010 U.S. Dist. LEXIS 101987 (W.D. Tenn., 9/24/10). Under Maryland law, when a plaintiff simultaneously argues that they have made a demand on the board of directors and that demand is excused, the plaintiff’s arguments that demand would be futile are mooted.

CFTC v. Bolze,
No. 3:09 Civ. 088 (E.D. Tenn., 3/2/11). Bankruptcy does not insulate fraudsters from responsibility to pay restitution and civil penalties that flow from their fraudulent activities.

Hantz Group, Inc. v. Haney, Mattes and Sterling Agency, Inc.,
No. 292954, 2010 Mich. App. LEXIS 2288 (Mich. App., 11/30/10). In the absence of a well-founded, legally sound or binding relationship, or expectancy of a relationship, tortious interference with a business relationship cannot be proved.

SEVENTH CIRCUIT

RK Company v. See,
No. 07-3894, 2010 U.S. Dist. LEXIS 19666 (7th Cir., 9/22/10). A party that successfully prosecutes a claim under federal law is presumptively entitled to prejudgment interest.

CFTC v. Lake Shore Asset Management, Ltd.,
No. 07 CV 3598, 2010 U.S. Dist. LEXIS 65370 (N.D. Ill., 6/30/10). A party that wishes to appeal an order approving a method of distribution from a common fund can ask the trial court to consider the request on appeal.

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court to stay the order pending appeal or to set aside a reserve to enable its claim to be paid if it prevails on appeal.

**Traderight Securities, Inc. v. Richard G. Kirschman IRA**, No. 10 C 2042 (N.D. Ill., 2/15/11). After signing a uniform submission agreement and filing an answer and a motion to dismiss in the arbitration, a party’s request for an injunction restraining the arbitration from going forward will be denied by the court.

**EIGHTH CIRCUIT**

**Detroit General Retirement System v. Medtronic, Inc.**, No. 09-2518, 2010 U.S. App. LEXIS 19379 (8th Cir., 9/16/10). Plaintiffs’ securities fraud class action lawsuit was dismissed for failure to state a claim, where plaintiffs’ pleadings did not satisfy the heightened pleading requirements for securities fraud and there was no indication that statements were false when made or that they were made with the requisite scienter.


**NINTH CIRCUIT**

**Betz v. Trainer Wortham & Co.**, No. 05-17054, 2010 U.S. App. LEXIS 13821 (9th Cir., 7/6/10). A remand to the district court is warranted in situations where the district court has procedures available to it relating to the scope of the record and the determination of the facts not available to the court of appeals.

**Northstar Financial Advisors, Inc. v. Schwab Investments**, No. 09-16347, 2010 U.S. App. LEXIS 16706 (9th Cir., 8/12/10). The fact that the Sudan Accountability and Divestment Act of 2007, which was codified in part as Section 13(c) of the Investment Company Act, gave investment companies a safe harbor from lawsuits arising from the divestiture of Sudanese related investments, does not mean that there is an implied private right of action under Section 13(a) of the Investment Company Act.

**Sacks v. SEC**, No. 07-74647 (9th Cir., 2/22/11). A non-attorney representative is exempt from forum restrictions upon NAR appearances in FINRA arbitrations, where the restrictions were adopted after he was engaged in active representation.

**Wright v. RBC Capital Markets Corporation**, No. CIV S-09-3601 FCD/GGH, 2010 U.S. Dist. LEXIS 80165 (E.D. Cal., 6/24/10). One may not block an existing arbitration before FINRA by filing a purported class action seeking declaratory relief with respect to the issues raised in the arbitration.

**SEC v. Loomis**, No. 2:10-cv-00458, 2010 U.S. Dist. LEXIS 87021 (E.D. Cal., 8/24/10). In a multi-defendant case, where claims against all defendants overlap and where some of the defendants fail to answer the complaint, a motion for default judgment against the non-responding defendants will not be granted prior to trial of the matter, unless there is a just reason to grant the motion.

**Charles Schwab Corp. Securities Litigation, In Re**, No. 08-cv-01510 (N.D. Cal., 9/13/10). Notice of the pendency of a class action, as well as the settlement terms proposed between the parties, must be provided to all class members, so that they have a reasonable opportunity to opt out of the class or object to the settlement before a release of claims is imposed upon them in exchange for settlement payments.

**Wells Fargo Mortgage-Backed Securities Litigation, In Re**, No. 09-cv-01376-LHK, 2010 U.S. Dist. LEXIS 106687 (N.D. Cal., 10/5/10). *A plaintiff asserting a violation of Section 12 of the Securities Act of 1933 must allege a purchase directly from the issuer at the offering, not subsequent to the offering.**

**SEC v. Loomis**, No. 2:10-cv-00458, 2010 U.S. Dist. LEXIS 87021 (E.D. Cal., 8/24/10). *A plaintiff asserting a violation of Section 12 of the Securities Act of 1933 must allege a purchase directly from the issuer at the offering, not subsequent to the offering.**

**Wells Fargo Mortgage-Backed Certificates Litigation, In Re**, No. 09-cv-01376 LHK, 2010 U.S. Dist. LEXIS 106661 (N.D. Cal., 10/5/10). **The three-year statute of repose and one-year statute of limitations set forth in Sections 11 and 15 of the Securities Act of 1933 will not be tolled for a plaintiff who is added to a complaint to replace a plaintiff who had no standing.**

**Bank of America Corp. ARS Marketing Litigation, In Re: Bondar v. BOA**, No. 09-md-02014 JSW, 2011 US Dist LEXIS 18208 (N.D. Cal., 2/24/11). A cause of action for market manipulation will fail if it is shown that the defendant disclosed the allegedly manipulative conduct prior to the purchase of the security.

*cont’d on page 71*
TD Ameritrade, Inc. v. The Nevada Agency and Trust Company,
No. 3:08-cv-00245-LRH-RAM, 2010 U.S. Dist. LEXIS 94781
(D. Nev., 9/9/10). A transfer agent is not responsible for a
holder’s mistaken belief that a prior restriction on the transfer
of a stock certificate had been removed.

SEC v. Earthly Mineral Solutions, Inc.,
9/24/10). Guilty pleas in a criminal action suffice to support the
application of collateral in a civil enforcement action; active
participation in a related civil proceeding also suffices, even if
the case ends in a default judgment, so long as the defendant
actively participated in defense of the claims.

Washington Mutual Securities Litigation,
In Re,
No. 2:08-md-1919 (W.D. Wash., 6/21/10). Disclaimers of
liability in offering circulars are void under California law as a
defense to certain claims, including negligent misrepresentation
claims, which involve deceit.

Washington Mutual, Inc. Securities Litigation,
In Re,
Lead Case No. 08-387 (W.D. Wash., 1/28/11). For statute of
limitations purposes, an amended pleading is deemed filed at
the time the motion to amend is first made.

Grand v. Nacchio,
One may simultaneously induce and participate in an illegal
securities sale; however, participation and inducement involve
separate factors and are not coterminous.

Lu Yu v. Global Merchant Center, Inc.,
2Dist., 12/14/10). A court case will be stayed under the doctrine
of forum non conveniens if there is a suitable alternate court
and the private interests of the parties and the public interests
in litigating the case are preserved. The fact that the law of
another forum is less favorable to a litigant is of no weight.

Choy v. Nopuente,
1Dist., 2/8/11). A motion to vacate an award on the ground
that the arbitrator(s) failed to admit material evidence will only
be granted upon a showing of substantial prejudice.

Hansalik v. Wells Fargo Advisors, LLC,
No. BS128947 (Cal. Super. Ct., LA Cty., 2/7/11). The law
disfavors default judgments and that principle requires strict
interpretation of notice requirements, even in arbitration
settings; inadequate notice leads to vacatur of this Award.

Hagman v. Citigroup Global Markets, Inc.,
No. BS128800 (Cal. Super. Ct., Los Angeles Cty., 2/9/11). An
arbitrator who fails to disclose his involvement in litigation involving
similar subject matter to the assigned dispute provides grounds
under California law for vacatur on evident partiality grounds.

Citigroup Smith Barney v. Henderson,
*A non-signatory to a contract with an arbitration clause will be
required to arbitrate a dispute arising from the contract, if
the non signatory enjoys the benefit of the contract. **A New
York court will determine whether a right to arbitrate has been
waived only if the underlying contract provides that it will be
enforced pursuant to New York law. ***Under the FAA, if an
agreement is silent on whether a court or an arbitrator will
decide the issue of waiver, then the default position is that the
issue will be decided by the arbitrator.

TENTH CIRCUIT

Dronsejko v. Grant Thornton,
Nos. 09-4222 & 10-4074, 2011 U.S. App. LEXIS 1052 (10th
Cir., 1/20/11). Claims of accounting irregularities or violations
of GAAP support a claim of scienter only when coupled with
evidence that the violations or irregularities are the result of the
defendant’s fraudulent intent to mislead investors.

Thomas v. Metropolitan Life.
The applicability of the broker-dealer exception to the IAA
hinges upon whether the advice in question relates to or is
connected with the broker-dealer’s primary business, not upon
the quantum or importance of the advice.

Aspen Insurance UK, Ltd. v. Fiserv, Inc.,
No. 09-CV-02770 (D. Colo., 12/9/10). Exclusionary clauses
designed to except particular conduct or situations from
insurance coverage provisions must be drafted in clear and
specific language; to benefit from an exclusionary clause, an
insurer must establish that the exclusion applies and is not
subject to any other reasonable interpretation.

UFCWU v. Chesapeake Energy,
No. CIV-09-1114-D, 2010 U.S. Dist. LEXIS 92208 (W.D.
Okl., 9/2/10). Solicitation for purposes of § 12(a)(2) potential
liability includes both personal solicitation and substantial
involvement in the offering process.

ELEVENTH CIRCUIT

Badger v. Southern Farm Bureau Life Ins. Co.,
No. 09-12999, 2010 U.S. App. LEXIS 15895 (11th Cir., 7/30/10).
In an arms-length securities transaction, the seller may have
disclosure duties to the purchasing corporation, but that duty
does not extend to the purchasing corporation’s shareholders.

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Board of Trustees of the City of Delray Beach Police and Firefighters Retirement System v. Citigroup Global Markets Inc., f.k.a. Salomon Smith Barney, No. 09-13451, 2010 U.S. App. LEXIS 20880 (11th Cir., 10/8/10). *A brokerage account agreement to arbitrate disputes under "other agreements between us" extends to other related roles that a broker may play, e.g., as pension consultant. **A governing board that authorizes its agent to complete an agreement for investment management services also, by implication, authorizes the agent to enter into agreements that will expedite that investment manager’s performance.


SEC v. Scoppetoulo, No. 10-20475-Civ-Cooke/Bandstra, 2011 U.S. Dist. LEXIS 7819 (S.D. Fla., 1/27/11). The materiality of non-public information is mostly a question of fact and difficult to assess at the pleading stage; generally, a decision on materiality must await discovery and the summary judgment stage.

Great Florida Bank, v. Countrywide Home Loans, Inc., Countrywide Securities Corp., and BAC Home Loans Servicing, LP (F/K/A Countrywide Home Loans Servicing, LP), No. 10-22124-CIV-Huck/O’Sullivan (S.D. Fla., 2/3/11). "Shotgun pleading,” or the practice of naming numerous defendants and then making allegations of misconduct that are attributable to all of them without distinction, is not an appropriate form of pleading, especially when the particularity requirements of FRCP Rule 9(b) are considered applicable to the claims.

GunnAllen Financial, Inc, In Re.: GunnAllen v. U.S. Specialty Ins. Co., No. 8-10-cv-2855, 2011 Bankr. Lexis 334 (M.D. Fla., 2/3/11). Settlement of the Liquidating Trustee’s claims against one of Debtor’s liability carriers for the balance of policy limits, on condition of a bar order which extends to claims against non-debtors as well, is not fair and equitable to claimants and will not be approved over their objections.

Regions Financial Corporation, Morgan Asset Management, Inc. and Kelsoe, Ex Parte: Rice v. RFC, In Re, No. 1090425, 2010 Ala. LEXIS 183 (Ala. Sup. Ct., 9/30/10). An independent wrong and damages separate and apart from the damage done to the issuer corporation must be demonstrated to avoid having the class action dismissed as an improperly instituted derivative action.

D.C. CIRCUIT

Riordan v. SEC, No. 10-1034, 2010 U.S. App. LEXIS 26277 (D.C. Cir., 12/28/10). The applicable statute of limitations for fines, penalties and forfeitures that may result from regulatory actions does not apply to the remedies of disgorgement or cease-and-desist orders.


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