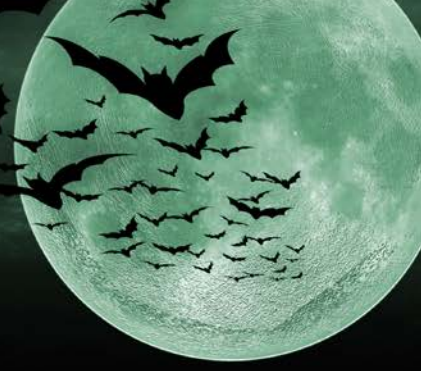
Halloween Issue
October 2016

The Lawyers' Lawyer Newsletter

Recent Developments in Risk Management



TRICK OR TREAT!

The editors of the Halloween edition of the *Lawyers' Lawyer Newsletter* invite you to enjoy frightening tales of shocking assaults by non-clients on an unsuspecting law firm; a lawyer's nail-biting escape from a disqualification motion thanks only to a less-than-diligent client; the slow motion nightmare of a lawyer's desperate and sometimes failed struggle for freedom when a client can't be contacted; and the gruesome results of an overly broad scope of engagement description. We hope these horror stories will frighten and delight just in time for All Hallows' Eve.

Trick or Treat Editors' Note: This case is a trick for lawyers who make representations to a third-party investors (and potentially other non-clients) who rely on the lawyers' representations.

Statements by Lawyer Relating to Investments — Liability to Third Parties for Negligent Misrepresentation

***Chanin, et al. v. Machcinski, et al.*, 139 A.D.3d 490 (2016)**

Risk Management Issue: Is a lawyer liable for representations made by the lawyer to a third-party investor who relies on the representations, thereby losing his investment?

The Case: Plaintiffs were investors in a hedge fund owned and controlled by Dr. Walter Gerasimowicz and two of his companies. The hedge fund, the two companies and Dr. Gerasimowicz were all represented by Defendant Victor Machcinski. In 2011, Plaintiffs made a series of investments in the Fund. Plaintiffs complained that unbeknownst to them, by the time they were induced to invest in the Fund, Gerasimowicz had already wrongfully diverted $2.65 million from the Fund in purported loans to another of his companies.

In late 2011, Plaintiffs were contacted by the SEC inquiring about their investment in the Fund. Concerned, Plaintiffs considered withdrawing their investment and seeking counsel to compel its return. Before doing so, they sought an explanation from Gerasimowicz for the SEC inquiry. On Gerasimowicz's behalf, his lawyer Machcinski assured the Plaintiffs that the SEC inquiry was routine, stating:

> The SEC has vigorously implemented its new oversight responsibilities under Dodd-Frank, and its communications with you regarding the Fund resulted from this new and very expansive authority. Please be assured that there has been no suggestion or insinuation by the SEC that there is or has been any impropriety regarding Meditron's services to the Fund.

Plaintiffs claim they relied on this representation and took no action to seek the return of their investment. In fact, a year later, the SEC found Gerasimowicz and his companies in violation of numerous securities laws including misappropriation and misuse of the Fund's assets, ordered them to disgorge $3.1 million and pay civil penalties of over $1.9 million. As a result, Plaintiffs lost their entire investment in the Fund.

Plaintiffs instituted suit against Machcinski and his firm, asserting a lone cause of action for negligent misrepresentation. They sought recovery of the investment they allegedly lost because of their reliance on Machcinski's false and misleading statements.

The trial court dismissed the complaint on Machcinski's motion, finding that the "pleadings fail[ed] to allege the existence of privity, or a privity-like relationship between Plaintiffs [and Defendants]" supportive of a negligent misrepresentation claim. The court noted that

Statements by Lawyer Relating to Investments, continued on page 2

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the complaint contained no allegation that "Plaintiffs solicited the explanation from Machcinski" or that Machcinski knew that Plaintiffs were going to rely on the letter to "determine whether to withdraw their invested funds." On these facts, the court concluded that "Plaintiffs fail[ed] to assert facts giving rise to a special relationship of confidence and trust between them and Defendants."

The Appellate Division, First Department reversed. The court opined that the requisite "privity-like" relationship existed where Plaintiffs alleged that they requested a letter from Machcinski regarding the implications of the SEC inquiries and that Machcinski responded with a letter directly addressed to Plaintiffs and specifically answering their concerns. On the other hand, Defendants failed to establish as a matter of law that there were no false statements in the letter, that Plaintiffs' reliance was unreasonable, or that the alleged false statements did not proximately cause Plaintiffs' alleged losses.

Comment: This case should be considered in light of *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). In that case, the United States Supreme Court addressed the scope of attorneys' liability in investment matters through its holding that private actions for aiding and abetting claims against secondary actors like attorneys and accountants involved in securities transactions are prohibited under Rule 10(b) of the Securities Exchange Act of 1934.

However, in the course of that opinion, the Court stressed that assuming all of the requirements for primary liability under Rule 10(b)-5 are met, secondary actors like attorneys remain liable under the Securities Acts as primary violators if they employ any manipulative device or make a material misstatement or omission which is relied upon by a purchaser or seller of securities.

This case portends an expansion of the scope of an attorneys' potential liability to third-party investors when the attorneys themselves make representations on behalf of but independently of their clients in connection with securities matters.

The decision provides a third-party investor with an alternative theory for relief against lawyers and other secondary actors to the claim under Rule 10(b). Under *Chanin*, a lawyer can be liable to a third party for negligent misrepresentation even in the absence of privity so long as "privity-like circumstances" exist.

This is significant because, unlike a federal securities fraud claim under Rule 10(b)-5, which requires the misrepresentation to have been made in connection with the purchase or sale of securities, the *Chanin* opinion allows a negligent misrepresentation claim to proceed where the investor has not bought or sold securities but has merely maintained his or her investment in reliance on a lawyer's representations.

Risk Management Solution: This case highlights the risks confronted by lawyers in independently communicating with third parties who are doing business with their clients other than to pass on information clearly provided by the client. Even when limiting their statements in that way, lawyers should state that they are not acting as attorneys for the third parties, and that the third parties should seek independent legal advice if necessary. Given that the case may be viewed as enlarging firms' liability to third parties, firms may wish to do some training on these topics to alert their lawyers to this exposure.

Trick or Treat Editors' Note: This case is an unexpected treat for a lawyer facing a disqualification motion, if a former client fails to promptly seek disqualification after the conflicted attorney undertakes representation of a party adverse to the former client.

Disqualification — Substantially Related Matters — Waiver of Conflict by Lack of Diligence in Seeking Disqualification

***State of Minnesota, et al v. 3M Company*, Hennepin County (Minn.), Court File No. 27-CV-10-28862 (Feb. 5, 2016)**

Risk Management Issue: Does a client waive its former attorney's conflict of interest by failing to promptly seek disqualification after the conflicted attorney undertakes representation of a party adverse to the former client?

The Case: Beginning in 1992 the 3M Company utilized the services of the law firm of Covington & Burling LLP to represent it in connection with various matters, including a regulatory matter before the U.S. Food and Drug Administration involving 3M's production of fluorochemicals and perfluorochemicals (collectively "the FCs"). By 1998 concern had arisen regarding the use of FCs and, in an effort to deal with the litigation risks, 3M assembled a litigation defense team, which included a Covington attorney as well as lawyers from several other law firms.

Although Covington continued to perform legal services for 3M, Covington attorneys ceased working on FC-related matters by 2006. By October 2010 Covington ceased representing 3M in any matters whatsoever.

Approximately two months later, on December 30, 2010, the State of Minnesota sued 3M, alleging, among other things, that the FCs produced by 3M presented a risk of serious harm to human health and the environment. Covington represented the state in the FC lawsuit.

On January 4, 2011, almost immediately after the FC lawsuit was filed, 3M's in-house litigation staff engaged in discussions regarding Covington's representation of the state in the lawsuit and the potential conflict resulting from that representation.

Despite immediate recognition of the potential conflict posed by Covington's representation of the state in the FC lawsuit, 3M took no action to address the issue for over a year, until March 2012, when it informed the court of the conflict issue. Covington refused to voluntarily withdraw from representing the state.

Finally, on April 30, 2012, one month before the discovery cutoff in the FC lawsuit, 3M moved to disqualify Covington based on the alleged conflict of interest.

Following review by the Minnesota Supreme Court, the case was remanded to the trial court for an evidentiary determination as to whether 3M had waived the right to seek Covington's disqualification.

On remand, the trial court first noted that the issues involved in the FC lawsuit were "substantially related" to the issues involved in Covington's prior representation of 3M in the FC regulatory matter and, therefore, Covington's representation of the state in the FC lawsuit constituted a conflict under Rule 1.9 of the Minnesota Rules of Professional Conduct. However, the court held that 3M had waived the right to seek disqualification by delaying in filing the motion for disqualification for approximately 16 months, from January 2011 when it first knew of the potential conflict, until April 2012. Accordingly, the motion for disqualification was denied on the basis that 3M had waived the right to seek disqualification.

Risk Management Solution: If there is an actual conflict on the part of an attorney who is representing a party adverse to the former client, it is imperative that the former client immediately — or at least very promptly — seek to disqualify the conflicted attorney as soon as the adverse representation becomes known. Without prompt action, the former client risks waiving the conflict and foregoing the right to seek disqualification of its former attorney — even though the attorney has knowledge of privileged information and attorney work product from a prior matter which is (or may be) substantially related to the current case. However, the law firm would nevertheless continue to be found to preserve the former client's secrets and to not to use them to the detriment of the former client.

Trick or Treat Editors' Note: This case could be either a trick or a treat. For lawyers who don't specify the scope of their engagement, this case is a trick; but for lawyers who spend the time to carefully outline the scope of the engagement, it's a treat. If you've read our newsletter faithfully, we expect it will be the latter.

Disqualification — Overly Broad Scope of Engagement Creates Concurrent Representation Conflicts

***M'Guinness v. Johnson et al.*, 243 Cal. App. 4th 602 (2015)**

Risk Management Issue: What can counsel for a closely held corporation do to avoid disqualification in the event of shareholder disputes?

The Case: The law firm was corporate counsel for a small construction company, Think It, Love It, Construct It, Inc. (TLC), which had three shareholders: James M'Guinness, Steven Johnson, and Scott Stuart. TLC was incorporated in 2002. In May 2006, it retained the law firm. The client agreement provided that the nature of the legal representation was "[a]dvice and representation concerning [TLC] and other general legal work directed by you from time to time." The agreement also advised TLC that it may "terminate" the relationship "at any time," and "at the conclusion of [the] engagement, at your request and at your cost for any file review, copy and delivery charges, we will review and deliver your files to you, along with any of your funds or property in our possession, charged at our hourly rate." A retainer of $2,500 was deposited into the firm's client trust account. Over the next six years, the law firm performed approximately 25 hours of legal work for TLC. In October 2012, the firm's accounting records showed a balance of $1,417 in the client trust account. The firm sent monthly invoices, which sometimes contained a carry-forward balance, but no charges for new legal services during the invoicing period.

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On January 23, 2013, M'Guinness sued Johnson and TLC alleging that Johnson mismanaged the company and misappropriated control of it. M'Guinness sought involuntary dissolution of TLC. The law firm appeared and answered on behalf of Johnson, and filed a cross-complaint against M'Guinness, Stuart and TLC. M'Guinness, Stuart and TLC moved to disqualify the law firm, arguing that it had impermissible conflicts of interest based on its concurrent and prior representation of TLC. Johnson and the firm argued that the representation ended in early March 2012 and that the prior representation did not create a conflict of interest because it was unrelated to the issues involved in the litigation.

The trial court denied the motion, holding that "the evidence was insufficient to warrant automatic disqualification based upon concurrent representation because 'disqualification is a drastic measure, it is generally disfavored and should only be imposed when absolutely necessary.'"

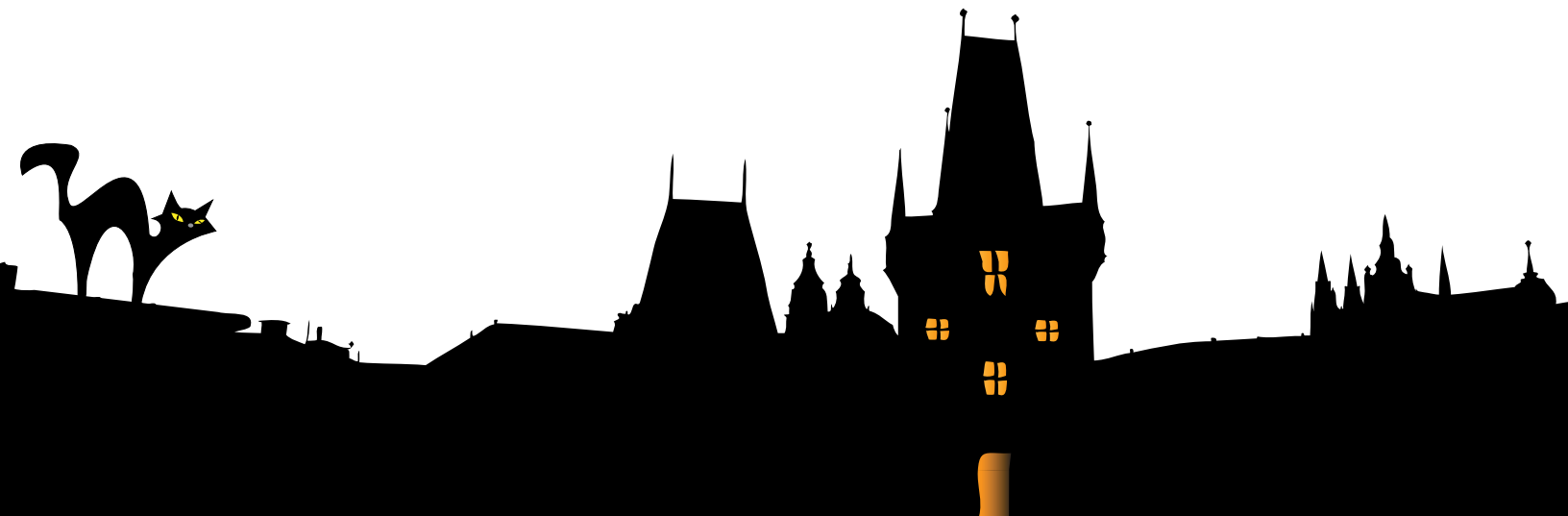
The appellate court reversed, holding that the trial court abused its discretion:

> "The undisputed facts demonstrate that the Law Firm continued to represent TLC through the time the lawsuit was instituted. If a party moving to disqualify an attorney establishes concurrent representation, the court is required, 'in all but a few instances,' to automatically disqualify the attorney without regard to whether the subject matter of the representation of one client relates to the representation of a second client in the lawsuit."

The finding of concurrent representation was based on: (1) the "open-ended nature" of the client agreement; (2) the firm's retention of the funds in the trust account, which indicated that the relationship was not "terminated" in accordance with the client agreement; (3) the actions of a firm partner (an "old football buddy" of Johnson's) up through April 2013 in which the partner exerted control over corporate property and sent emails to M'Guinness' counsel shortly after the lawsuit was filed, which created the implication that he still represented TLC; (4) the law firm's billing practices; and (5) "as a matter of corporate law, the Firm's ongoing duty to TLC precluded its representation of Johnson in a lawsuit involving allegations in which the interests of the corporation diverged from those of shareholder litigants."

Comment: The court found that it was critical that the firm had agreed to act as all-purpose corporate counsel for TLC, and that the termination of that relationship could only be effected "by specific methods described in the agreement and under conditions that included the Firm's return of all property and funds to the client," which did not happen. It is also noteworthy that the court's holding rested in part on the law firm partner's guarded email response to M'Guinness' counsel's question "when, if ever, [did] your firm stop [] representing TLC[?]" The partner said, "I have not yet looked at the possibility of representing TLC Builders in this case. I will do so today." The court reasoned that the response "could be viewed as having implied that his Firm still represented TLC" because he did not say when the representation ended, but did indicate he might be representing TLC "*in this case*" (emphasis in opinion).

Risk Management Solution: This case highlights the importance of crafting engagement agreements in order to define in detail the structure and scope of the representation. A lawyer's eagerness to be a "jack of all trades" for a single client may appear to be good for business, but it could also expand the scope of duties owed to the client and thus the lawyer's malpractice exposure. Or, as in this case, it could lead to subsequent conflicts of interest and disqualification. Engagement letters need to be crystal clear about the scope of the representation, including the identity of the client and the method of termination, and abide by those terms. *See also*, Cal. Bus. & Prof. Code § 6147 (governing contingency fee agreements) and § 6148 (governing noncontingency fee agreements).



Trick or Treat Editors' Note: This case is a trick for lawyers who don't diligently attempt to locate their client before seeking to withdraw.

Motion to Withdraw — Meaning of Requirement to "Diligently Attempt" to Locate the Client

***Caveman Foods, LLC v. Ann Payne's Caveman Foods, LLC,* Civ. No. 2:12-1112 WBS DAD**

Risk Management Issue: When a lawyer or law firm wants to withdraw from an engagement in a matter involving litigation, what constitutes a "diligent attempt" to locate a client?

The Case: Caveman Foods, LLC (Caveman) filed a trademark infringement and unfair competition suit against defendant Ann Payne's Caveman Foods, LLC (defendant). Defense counsel renewed a motion to withdraw as counsel for defendant that it had previously made.

Counsel initially filed its motion for withdrawal in February 2014, reporting that defendant had notified the firm that it had ceased all business operations and had no assets available for distribution to creditors. Counsel stated that defendant also terminated counsel's services and consented to counsel's motion for withdrawal. During the hearing on that motion, defendant's corporate representative, George Sampson, and his personal attorney appeared by telephone. Sampson's attorney, however, instructed him not to answer any questions or speak to the court. As such, the court could not verify whether the individual on the phone was a proper representative of defendant, whether defendant had ceased its business operations and terminated counsel, and whether defendant understood and agreed to the consequences of being unrepresented by counsel. As a result, counsel's motion was denied.

A year later, counsel renewed its motion to withdraw. Counsel stated that it had not undertaken any work in this action on behalf of the defendant after its first motion for withdrawal was denied. Counsel further stated in its motion that the defendant was no longer an active company and that it had no office, telephone, email, employees, or forwarding contact information in the United States. Counsel had sent notice of the motion to defendant's registered office in Pennsylvania and to the last-known email address of one of defendant's former representatives.

The court denied counsel's renewed motion to withdraw. The court noted that although Rule 3-700(C)(5) of the California Rules of Professional Conduct permits an attorney to withdraw if the "client knowingly and freely assents to termination of the employment," a client's assent alone does not require the court to grant a motion for withdrawal. The court was unable to verify counsel's representations or assure that defendant fully understood and agreed to the full consequences of counsel's withdrawal.

Counsel also argued that withdrawal was appropriate under Rule 3-700(C)(1)(d), which permits withdrawal if the client "renders it unreasonably difficult for the [attorney] to carry out the employment effectively." Counsel argued that defendant has ceased all business operations, was no longer an active company, had no assets that can be distributed to creditors, and had no office, telephone, email, employees, or forwarding contact information in the United States. The court, however, did not find this a compelling argument either. The court noted that a simple internet search for "Ann Payne's Caveman Foods" revealed that the defendant was actually an active company that was headquartered in Toronto, Ontario, Canada. The defendant also had an actively maintained website and recent press releases. Additionally, the website listed its current mailing address, phone numbers, email addresses, the names and contact information of its representatives, the addresses of eight retailers that sold the defendant's product, and upcoming events that defendant's agents were going to attend in the near future. Based on the foregoing, the court found that counsel's contentions that defendant was unresponsive and "unwilling or unable to communicate" were unfounded.

Furthermore, the court noted that granting counsel's motion to withdraw would effectively place defendant in immediate violation of the Local Rules since it would no longer have counsel to represent it. E.D. Cal. L.R. 180(a) ("A corporation or other entity may appear only by an attorney.").

The motion was denied, and the court noted that counsel could withdraw only if it located replacement counsel for defendant.

Risk Management Solution: When filing a motion to withdraw on these grounds, it is first necessary to undertake a diligent attempt to locate the client. If it proves impossible to contact him or her through a telephone call or email or by fax, it is still necessary to make enquiries, including internet research and possibly even by engaging an investigator in order to demonstrate that the client has actually disappeared.