the in-house bar association℠

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The Law of Inside Counsel

I. LIABILITY AND INSURANCE FOR IN-HOUSE LAWYERS

In-house corporate counsel are increasingly exposed to legal malpractice claims. As corporations bring more work in-house, the exposure to legal malpractice claims expands. These malpractice claims typically arise, not from in-house counsel's "client", but rather from third-parties or from statutory agents, like bankruptcy trustees or the FDIC, who take over after the client fails. Although in-house counsel sometimes are protected by director and officer liability insurance, many policies have an exclusion for legal advice. This exposes in-house counsel to personal liability and places them in the precarious position of having no coverage for many of their acts. Or it may place their corporate employer in the position of having an uninsured duty of indemnity to a corporate agent. While insurance companies traditionally did not offer in-house counsel policies for legal malpractice, a few companies have recently begun to offer such insurance coverage. This portion of the program will cover (1) areas in which in-house liability is arising; and (2) malpractice insurance coverage.

An extensive national bibliography can be found on the ACCA Website: www.acca.com/protected/bibs/malpractice/practice.html. These issues are also discussed in Carole Basri and Irving Kagan, Corporate Legal Departments (3d Ed. PLI 1997) ("Corp. Legal Depts.") at pp. 8-7 to 8-9 and 16-15 to 16-16. See also Ethics/Malpractice Issue: The Professional & Ethical Issues Facing the Attorney Employee, 937 PLI/Corp. 993 (1996).

A. In-House Liability to Third Parties.

An attorney's liability to a party other than his client originally arose under the third-party beneficiary theory. Although not dealing with an in-house attorney, Lucas v. Hamm, 56 Cal.2d 583, 15 Cal. Rptr. 821, 364 P.2d 685 (1961) establishes that an attorney may be liable to third parties. In Lucas the beneficiaries under a will sued the attorney who prepared it for losses they incurred when the will was contested. The court determined that the attorney could be held liable to the beneficiaries even though they were not the attorney's clients, i.e. were not in privity. Lucas departed from the previously recognized requirement for liability against an attorney - the claimant must have been represented by the attorney and, therefore, in privity with the attorney for liability to issue. See also Goerlich v. Courtney Indus., 84 Md. App. 660, 581 A.2d 825 (1990) where the court recognized the availability of the third party beneficiary theory, but held that an incidental benefit to a party to a shareholders agreement was not sufficient to create an intended beneficiary.

In Goodman v. Kennedy, 18 Cal.3d 335, 134 Cal. Rptr. 375, 556 P.2d 737 (1976), purchasers of stock sued the attorney who represented principal officers of the corporation issuing the stock. The appeal questioned whether and under what circumstances an attorney's duty of care in giving legal advice to a client extends to persons with whom the client, in acting upon the advice, deals wholly at arm's length. Although the court concluded that this defendant had no such duty, it acknowledged that such a duty could be extended where "the legal advice was foreseeably transmitted to or relied upon by plaintiffs or that plaintiffs were intended beneficiaries of a transaction to which the advice pertained." Id. at 740. The dissent would have imposed liability in this case.

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This third party beneficiary theory has been adopted in New Jersey. See In re Palmieri, 76 N.J. 51 (1978) (third party beneficiary liability may be established upon a showing of reliance) ; In re Hurd, 69 N.J. 316 (1976) (attorney's fiduciary obligation extends to all persons who he knows or should know are relying on his professional actions); Stewart v. Sbarro, 142 N.J. Super. 581 (App. Div. 1976). While New Jersey courts apply the third party beneficiary theory, by relaxing the privity requirement, the attorney must have some knowledge of third party reliance. See In re Hurd, supra; and Petrillo v. Bachenberg, 263 N.J. Super. 472 (App. Div. 1993) cert. granted, 134 N.J. 566. This procedure was fully explored in Rosenblum v. Adler, 93 N.J. 324 (1983) where the court extended liability of accountants/auditors to third persons known and intended to receive the audit and those who foreseeably might rely on the audit. However, in 1995, the New Jersey Legislature adopted a privity statute limiting accountants' liability to third parties. N.J. Stat. Ann. § 2A:53A-25, but not protecting lawyers or other professionals.

In New York, there is an obvious absence of authority regarding liability of attorney's to third parties. This is due, in part, to New York's strict adherence to privity. This was established in the seminal case of Ultramares Corp. v. Touch, 174 N.E. 441, 255 N.Y. 170 (1931) (professional defendants cannot be liable for negligence absent a relationship approaching privity).

In Ultramares, an accounting firm prepared a balance sheet for a company. The balance was to be used to obtain financing from banks and other lenders. The plaintiff relied upon the balance sheets in providing financing to the corporation. When the plaintiff was not repaid, because the business of the borrowing company failed, the plaintiff sued to accountants for negligently preparing the balance sheets. The court held that although the accountants could be held liable to their "employer", liability would not be extended to third parties with whom the accounting firm had no relationship, i.e. no privity.

In Summit Solomon & Feldesman v. Matalon, 216 A.D. 2d 91 (1st Dept. 1995) the court held that the two shareholders of a corporate defendant individually liable to the lawyer that had defended the corporation where there was privity because the individual shareholders had signed the retainer agreement. Such an agreement might even cause a New York court to find liability to shareholders in malpractice.

Maryland courts refused to follow the "balancing of factors approach" adopted by the Lucas court. Rather, in Noble v. Bruce, 349 Md. 730, 709 A.2d 1264 (Md. 1998) the court rejected claims by beneficiaries of a will. The court reinforced the strict privity requirement for a legal malpractice law suit in Maryland. There is a narrow third-party beneficiary exception to the strict privity requirement. To establish a duty by an attorney, a non-client

> must allege and prove that the intent of the client to benefit the non-client was a direct purpose of the transaction or relationship. In this regard, the test for third party recovery is whether the intent to benefit actually existed, not whether there could have been an intent to benefit the third party. Noble, 349 Md. at 746-47 citing Flaherty v. Weinberg, 303 Md. 116, 130-31 (Md. 1985).

See also Goerlich, p.4 above, accepting the theory but finding the proof lacking.

In Seaboard Supply v. Congoleum Corp., 770 F.2d 367 (3d Cir. 1985) in-house counsel who had drafted an agreement that alleged violated the antitrust laws for his corporate employer was named as a defendant co-conspirator. The court found no antitrust violation in the agreement. See generally, 61 A.L.R. 4th 464 & 615 on a lawyer's liability to third parties.

B. Suits by Client against General Counsel.

Although less frequent than third party claims against in-house counsel, corporations have sued former general counsel. See e.g. Marks Polarized Corp. v. Solinger & Gordon, 124 Misc.2d 266, 476 N.Y.S.2d 743 (Queens Cty. 1984). In Marks, the corporate plaintiff alleged that its former general counsel should be held liable for legal malpractice for aiding and abetting two individuals who controlled the corporation and perpetrated a series of frauds against it. The complaint was dismissed for failure to state a cause of action because the plaintiff could not meet the elements necessary to establish legal malpractice. See also Bricklin v. Stengol Corp., 1 Conn. App. 656, 476 A.2d 584 (App. Ct. 1984) (derivative claim

Bricklin v. Stengol Corp., 1 Conn. App. 656, 476 A.2d 584 (App. Ct. 1984) (derivative claim against general counsel for legal malpractice could not be sustained).

In order to support a claim for legal malpractice, in general, a claimant must prove (1) negligence, (2) which is the proximate cause of (3) damages. In New York, the claim must also have arisen within the context of an attorney-client relationship.

In Peterson v. Kennedy, 771 F.2d 1244 (9th Cir. 1985), the district court declined to find legal malpractice against the representative of a union in collective bargaining. The court maintained that the legal malpractice claim was precluded by a breach of duty claim against the union. While the court based its decision on immunity under Section 301 of the Labor Management Relations Act, it generally discussed in-house counsel liability. Citing Peterson, the Court of Appeals of California in Aragon v. Pappy, Kaplon, Vogel & Phillips, 214 Cal. App.3d 451, 262 Cal. Rptr. 646 (2d App. Dist. 1989) refused to distinguish between in-house and retained counsel. Like Peterson, Aragon involved the collective bargaining process and applied the immunity under Section 301 of the Labor Management Relations Act, but its reasoning is generally applicable. For instance, the court in Peterson held that because the services performed by the attorney were part of the collective bargaining process, they were not held liable in legal malpractice. Peterson reasoned that such representation does not constitute an "attorney-client" relationship.

The reliance on the establishment of an attorney-client relationship and specific legal representation is the underpinning for finding legal malpractice against in-house counsel who also render business decisions. Thus, employees have tried to argue, so far unsuccessfully, that they, not the company that employed them, were clients of in-house counsel. See November 4, 1991 National Law Journal article about a former broker instituting a suit against three of Prudential Securities Inc.'s in-house counsel. Similarly, in Klenx v. Bustamonte, 1999 WL 107097 the Texas Court of Appeals affirmed a finding of no long arm jurisdiction over three in-house Smith Barney lawyers accused of malpractice by a Texas broker employed by Smith Barney.

In Ferranti International v. Clark, 767 F. Supp. 670 (E.D. Pa. 1991) the former General Counsel of Lancaster, Pa.'s Ferranti International was sued by his former employer alleging various improprieties that were the subject of a grand jury subpoena. The former General Counsel sought to disqualify the outside counsel he had chosen to represent the company in the matter, claiming they also represented him. The claim was rejected and counsel not disqualified. The case was later settled without disclosure of its terms. See also Edelman v. Schecter, 91 Civ. 6889 (S.D.N.Y.)

C. Attorney/Director Liability.

An attorney's liability is sometimes obscured by the dual roles many in-house attorneys have. In ruling on an attorney's liability, several courts have distinguished between an attorney's acts as a lawyer versus acts as an officer/director of a corporation. While the attorney is not always held liable for legal malpractice, the courts may impose liability where the attorney exercised business judgment. See e.g. Brennan v. Reed, Smith, Shaw & McClay, 304 Pa. Super. 339, 450 A.2d 740 (Pa. 1982); and Tillamook Cheese & Dairy Assoc. v. Tillamook County Creamery Assoc., 358 F.2d 115 (9th Cir. 1966).

In Brennan, the defendant represented the plaintiff in the formation of a partnership to drill for oil and gas. The partnership went bankrupt and was sued by several purchasers of interests in the oil and gas wells. The partnership was eventually held liable for various securities violations and then sued Reed, Smith, Shaw & McClay for malpractice. On appeal, the court reversed the lower court's dismissal of the action and held that a *prima facie* case of legal malpractice had been shown. The court remanded the matter for a new trial. In ruling on the viability of their legal malpractice claim, the Court stated: "In a professional capacity, the attorney had a duty to provide sound and accurate legal advice or suffer liability for his negligent failure to do so." Id. at 748.

In reaching its decision, the Court relied upon Collins v. Fitzwater, 277 Or. 401, 560 P.2d 1074 (1977) where a corporate attorney-director was sued by the director of a corporation. The director was seeking relief from damages he sustained after he was held liable to purchasers of securities issued by the corporation. He alleged that the attorney should be held liable for failing to advise the corporation to register its securities. The Collins court, in holding the attorney liable, stated "when a corporate attorney errs in the performance of his legal duties, we can think of no reason why the layman rather than the attorney should bear

legal duties, we can think of no reason why the layman rather than the attorney should bear the ultimate burden of the error." Id. at 408. The court affirmed the finding of liability against counsel.

However, in Tillamook, supra, the District Court determined that it would not hold corporate counsel liable "if the role of the counsel was only that of a legal adviser." In Tillamook, the plaintiff alleged various violations of antitrust laws against a corporation, its directors and general counsel. The general counsel successfully moved for summary judgment. On appeal, the court held that the district court erred in granting summary judgment in favor of the general counsel, explaining "if he goes beyond [the legal] role and . . . makes policy decisions for the corporation, then he subjects himself to liability . . . ." Id. at 118. Cf. Seaboard Supply, above at 6.

In-house counsel should be particularly wary of being included as an insider under the Securities Exchange Act of 1934. Some courts have held that counsel to an issuer, who is also an officer or director, may have a duty of disclosure under this Act as an insider. In Reingold v. Deloitte, Haskins & Sells, 599 F. Supp. 1241 (S.D.N.Y. 1984) the plaintiff filed a class action and counsel was held liable because they prepared and filed disclosure documents containing false statements. See also In re National Smelting of New Jersey, Inc., 722 F. Supp. 152 (D.N.J. 1989) (potential liability against in-house counsel, who was also officer, for 10(b) violations) and Marin v. Trupin, 778 F. Supp. 711 (S.D.N.Y. 1991) (Rule 12(b) claim against several defendants, including in-house attorney).

In National Smelting, the plaintiffs alleged that a statement issued to prospective bondholders contained misrepresentations and omissions upon which they relied to their detriment. They alleged that a director/in-house attorney of the company which approved the offering statement should be held liable for the misrepresentations. The court denied the defendant's motion for summary judgment and noted the potential liability to in-house counsel. "Someone in . . . [the] position of [director and in-house counsel] . . . may, by totally abdicating any responsibility to ensure that the Official Statement was materially complete, potentially be liable under § 10(b) and Rule 10(b)(5)." Id. at 163.

See Corp. Legal Depts., pp. 16-9 to 16-17.

D. Specific Areas.

Regardless of the parties, there are emerging areas in which liability against in-house counsel is increasingly visible. For example, there are increasing suits against counsel involved in commercial sales and securities for failure to disclose information to purchasers. In addition, real estate counsel may be vulnerable to claims for failure to obtain an environmental audit. Regulators have turned to general counsel, in addition to officers, for wrongful conduct contributing to the failures of savings & loan institutions.

1. Commercial Transactions and Securities.

In Escott v. Barchris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) the corporation issuing the debentures, the underwriters and counsel for each were sued by buyers of those debentures. The counsel were not sued by the employers, but by third parties seeking to establish liability as a result of in-house counsel's representations of the employer in the security transaction. The court held in-house counsel liable for his failure to make a reasonable investigation of the truth of statements in a portion of the prospectus he signed. See also Oregon Shiitake Tech. Inc. v. Kennedy, 118 Ore. App. 575, 848 P.2d 635 (1993) (sole shareholder and director of corporation sued counsel for lost contracts and profits resulting from counsel's advice on the sale and registration of securities.)

2. Banking.

Generally, in-house counsel of failed institutions were swept up as an officer or board member, and not simply as an attorney. This is partially because most in-house counsel did not have legal malpractice policies and, therefore, did not present a source of recovery. However, in some cases it would have been easier to prove that the lawyer, rather than the business person, was liable for a failure. The most controversial case against lawyers in the S & L arena is In re Kaye Scholer, OTS AP-02-19 (March 1, 1992). In that matter, the Office of Thrift Supervision instituted an action against the law firm in connection with the failure of Lincoln Savings & Loan Association. No official decision is rendered in this matter because Kaye Scholer settled with the OTS for $41 million. See also FDIC v. Monahat, 907 F.2d 546

(5th Cir. 1990) cert. denied, 499 U.S. 936, 111 S. Ct. 1387 (1991) (malpractice action by FDIC against general counsel for a federally chartered savings and loan that went into receivership); FDIC v. Stahl, 840 F. Supp 124 (S.D. Fla. 1993) (suit against general counsel for Broward Federal for legal malpractice); and In re John Thomas Pappas, 106 B.R. 268 (D. Wy. 1989) (although discussing unrelated issues in bankruptcy, the opinion notes a suit by the FDIC against Pappas for legal malpractice in connection with legal advice he provided to Yellowstone State Bank as general counsel.)

With the rise of mergers and additional regulations, in-house lawyers have more responsibility for the decisions made in banks, with mixed results. On the one hand, in-house counsel can help to control legal costs and streamline decision-making. However, in-house counsel in many banks will now be caught in the midst of activities, traditionally farmed out to outside counsel - like mergers and acquisitions of failed institutions - which lead to liability.

E. Negligence and Outside Counsel.

Because many in-house counsel act as "supervisor" to outside counsel, litigants have attempted to include in-house counsel in liability for acts of its outside counsel. The law is limited in this area. However, courts have not been easily persuaded that liability should extend to in-house attorneys. In Raytheon Co. v. Tully, Lawyers Weekly No. 12-372-94, the court would not hold the in-house attorney liable for outside counsel's failure to answer interrogatories. However, the American Bar Association's Model Rules of Professional Conduct provide that lawyers, including general counsels, with supervisory responsibilities, may be held liable for the conduct of other lawyers within a corporation. See Rules of Professional Conduct 1.13 and 5.1.

F. Malpractice Insurance for In-House Counsel.

As a result of the increasing liability, as illustrated above, in-house counsel have sought to protect themselves through insurance coverage. Until recently, the availability of professional liability insurance for in-house counsel was limited, if available at all. When we last did this program in 1995, only two policies were available. Even where in-house counsel were covered by directors and officers insurance, many policies exclude coverage for "legal" advice.

There are currently five companies we know of that offer malpractice insurance to in-house counsel in New Jersey.

ACCA sponsors the Employed Lawyers Professional liability program offered by Executive Risk. This policy provides coverage up to $50 million for each claim and $100 million in aggregate. For additional information on this policy, see Appendix B.

CNA also offers a policy to in-house counsel. This policy is limited to $25 million per claim and in aggregate. See Appendix C for information regarding this policy.

A smaller policy is offered by Evanston Insurance Company. This policy is limited to $10 million for each claim and in aggregate. Note that this policy is not available in New Hampshire. See Appendix D for information regarding this policy.

American National Lawyers Insurance Reciprocal ("ANLIR") offers a policy for in-house counsel which is limited to $10 million per claim and $20 million in aggregate. The policy is currently offered in only 13 states including Maryland and New Jersey. In New Jersey, the policy is only available to members of the Bergen County and Passaic County Bar Associations. However, ANLIR plans to expand coverage of the policy in New Jersey in the near future. See Appendix E for information regarding this policy.

Finally, United National Insurance Company (Concord) offers a policy for in-house counsel which is limited to $10 million per claim and in aggregate. This policy is currently being revised.

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