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The Gray Zone: What All Lawyers Need To Know About Providing (Or Not Providing) Business Advice After *Peterson v. Katten Muchin*

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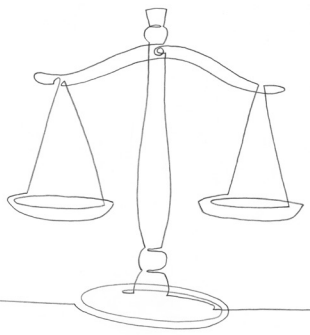
Consider the following scenario: a law firm is retained to advise a client, and specifically to structure certain transactions. The law firm has been retained to provide legal advice to sophisticated business people, but must the firm also affirmatively advise its savvy client about the business implications of the transactions? Must the firm question the risk analysis performed by the client and recommend alternative ways to structure its transactions? How far must the lawyers wade into the gray area that lies between purely legal and purely business advice?

Such were the issues put to the Katten Muchin lawyers who found themselves counseling an investment fund unwittingly embroiled in Tom Petters' massive Ponzi scheme. Following the scheme's collapse, the trustee of the fund's bankruptcy estate sued the law firm for malpractice, alleging that it failed to recognize flaws in the transactions—including the possibility of fraud inherent in an investment structure without direct contact or direct payment between the fund and the investment target (Costco)—and failed to advise the fund to obtain an adequate security interest in its investment.

Tackling this fact pattern, the Seventh Circuit recently had an opportunity to wade into the legal-business advice thicket, after the district court had granted Katten Muchin's motion to dismiss. The Seventh Circuit ruled that, at the pleading stage, the client fund had knowingly taken a risk and could not blame the law firm for failing to provide it business advice. *Peterson v. Katten Muchin*



At the 15th Annual Legal Malpractice and Risk Management Conference in February 2016, a panel of lawyers considered the implications of the Seventh Circuit's *Peterson v. Katten Muchin Rosenman LLP* decision (792 F. 3d 789 (7th Cir. 2015)) for transactional lawyers. Specifically, the panel considered how the following statement from the Court's opinion might impact the advice that lawyers are obliged to give to their clients:

> "Within the scope of the engagement a lawyer must tell the client which different legal forms are available to carry out the client's business, and how (if at all) the risks of that business differ with the different legal forms."

One of the panelists – and a frequent contributor to the Beazley Brief – was Kevin Rosen, a partner in the Los Angeles office of Gibson Dunn & Crutcher LLP and the chair of the firm's Legal Malpractice Defense Practice Group.

Kevin and two of his colleagues (Matthew S. Kahn (a partner in the firm's San Francisco office) and Nathaniel L. Bach (an associate in the firm's Los Angeles office)) agreed to prepare an article about the implications of the *Peterson* decision.

In their article, Kevin, Matthew and Nathaniel provide their perspectives on the decison and make suggestions about how lawyers can best protect themselves.

Beazley thanks Kevin, Matthew and Nathaniel for their efforts in putting together an article for this issue of the Beazley Brief. They have substantial experience successfully defending law firms and their lawyers in high-stakes litigation across the country. As a result, we value their opinions. We hope you find this article interesting and informative.

- Brant Weidner
Claims Manager
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Rosenman LLP, 792 F.3d 789 (2015). In a decision by Judge Easterbrook, the Court of Appeals reversed. The Court held that determining whether a lawyer's failure to provide certain business advice constitutes legal malpractice is ill-suited to the pleading stage. Summing up the court's rationale, Judge Easterbrook wrote that while "[a] lawyer is not a business consultant . . . [,] within the scope of the engagement a lawyer must tell the client which different legal forms are available to carry out the client's business, and how (if at all) the risks of that business differ with the different legal forms." *Id.* at 793. Properly advised, the client may then make a business decision. *Id*. at 791.

A simple hypothetical illustrates how this same issue might arise in a lawyer's everyday practice. Where a client retains a lawyer to provide advice about a real estate loan, is the lawyer's failure to advise the client to secure a deed of trust an actionable failure to provide legal advice? Or is that strictly a business decision? Under *Peterson*, such advice, while arguably business only, may nonetheless be considered legal, at least in the absence of other evidence, and thus a failure to provide the advice could state a claim for legal malpractice. See, *id.* at 792 ("Advising clients how best to maintain security for their loans using legal devices is a vital part of a transactions lawyer's job").

> Transactional lawyers should not overreact to *Peterson* and its recognition that there is no bright line between business advice and legal advice.

Peterson is not a watershed ruling—ultimately, and as discussed further below, it simply reaffirms long-standing principles regarding a lawyer's duty and the scope of engagement—but it is a high-profile and seemingly portentous decision from a respected judge of a leading Court of Appeals. This article explores the precedents underpinning *Peterson* and considers how lawyers can avoid the same claims asserted against Katten Muchin in that case.

A Lawyer's "Peripheral" Duty to Advise Clients

Peterson describes a duty akin to what a leading treatise has called a lawyer's "peripheral" duty to "advise the client regarding collateral matters," *i.e.*, "those legal needs that should be reasonably apparent to a lawyer, even if neither the lawyer nor the client intended the matter to be within the scope of the retention." 1 Ronald E. Mallen & Allison Martin Rhodes, Legal Malpractice § 8:8 (2016 ed.). Thus, "[t]he lawyer need not represent the client on such matters. The lawyer, however, should inform the client of the limitations of both the representation and the possible need for other counsel." *Id.*

A basic application of this peripheral duty is illustrated in a 1978 Kentucky case involving a lawyer who was initially hired to bring a wrongful death claim. See*, Daugherty v. Runner,* 581 S.W.2d 12 (Ky. App. 1978). The client later brought suit against the lawyer, arguing a failure to advise about a possible medical malpractice claim based on the same set of facts. Although the attorney was retained only for a wrongful death action, the court observed that, as between lawyer and client, the lawyer was best able to recognize the client's legal needs. See*, id*. at 17.

This peripheral duty principle does have limits, however, as many courts have recognized. For example, courts have found that a lawyer does not have an omnipresent responsibility to act as a "trustee" of the client's interests and ferret out all possible problems. See, e.g., *Birchfield v. Harrod,* 640 P.2d 1003, 1009 (Okla. Civ. App. 1982); *Fitzgerald v. Linnus*, 765 A.2d 251, 257 (N.J. Super. 2001) (noting that despite duty of care, lawyer is "not a guarantor against errors in judgment"). And notably, the peripheral duty is not one requiring proactive representation, but is rather a more limited duty to advise the client. See, *Nichols v. Keller,* 15 Cal. App. 4th 1672, 1687 (1993) (defendant-lawyer prosecuting claim "owe[d] the [workers compensation] claimant a duty of care to advise on available remedies, including third-party actions").

Does *Peterson* Expand a Lawyer's Peripheral Duty to Include Providing Business Advice?

Transactional lawyers should not overreact to *Peterson* and its recognition that there is no bright line between business advice and legal advice. As the Court of Appeals wrote, "[i]t is hard to see how any such bright line could exist, since one function of a transactions lawyer is to counsel the client how different legal structures carry different levels of risk, and then to draft and negotiate contracts that protect the client's interests." 792 F.3d at 791. But this otherwise ominous-sounding proclamation still turns on the inherently legal structure of the transaction, a characteristic that *Peterson* specifically highlights. *Id*. at 791 ("Knowing degrees of risk presented by different legal structures, a client *then* can make a business decision.") (italics in original, underlined emphasis added). Therefore, to the extent the advice upon which the client's business decision is based is not inherently "legal," neither *Peterson* nor the peripheral duty imposes upon a lawyer a duty to provide it in the first instance.

> Despite its foreboding tone, *Peterson* provides a roadmap for lawyers to help insulate themselves from claims regarding the provision of business advice (or lack thereof).

Notably, because the peripheral duty concept is not limited to transactional attorneys, litigators must be equally attuned to it. For example, in risk-managing a client's business relationship with a currently or potentially adverse party, litigators may be tempted (or directly asked) to provide advice on which course of conduct would be most advantageous as the client moves toward litigation. The litigator might then provide well-considered advice in order to position the client

favorably for anticipated litigation, but might not advise on other factors that might go into such a business decision, including tax or regulatory issues. As *Peterson* reminds us, the lawyer in this situation arguably is required to provide more holistic business advice—or at least to advise the client of the need for such advice (preferably in writing)—which may be outside of the lawyer's comfort zone, specialty or the agreed scope of representation.

Lessons Learned from *Peterson*: How Lawyers Can Protect Themselves

Despite its foreboding tone, *Peterson* also provides a roadmap for lawyers to help insulate themselves from claims regarding the provision of business advice (or lack thereof). The Court of Appeals couches its own practical advice to lawyers by highlighting what evidence it could not consider at the pleading stage. For instance: "The complaint does not tell us how sophisticated [the clients] were about commercial factoring and the legal devices available for lenders' protection." *Peterson*, 792 F.3d at 793-94. This statement suggests that if the clients were aware of the options to structure the transaction, then even in the absence of advice from their lawyers, they might be barred from pursuing such a claim. The Court of Appeals continued: "Nor does [the complaint] reveal what Katten was hired to do—what kind of advice the Funds wanted, what kind of advice Katten promised to provide." *Id*. A defendant may be able to convince a court to take judicial notice at the pleading stage of an engagement letter containing an agreed-upon scope of representation, but in most instances, defendant-lawyers will be hard-pressed to introduce such evidence on a motion to dismiss, as opposed to later in the proceedings.

The Court of Appeals' comments confirm the benefits to lawyers of defining the scope of the representation at the outset of an engagement, particularly in the retention agreement, and to document any modifications or limitations thereafter. A client may, for example, instruct the lawyer that it will conduct diligence itself, and such a decision and division of labor can and should be documented, even by means of a simple email. Indeed, an attorney's engagement agreement may not only affirmatively specify the contours of the representation to be undertaken (*e.g.*, tax advice regarding the sale of Wrigley Field), but also may list those services that fall outside the representation (*e.g.,* shall not include tax advice regarding the Cubs' salary cap). In other words, "an attorney's duty will turn on the parameters of the agreed representation." *In re JTS Corp*., 305 B.R. 529, 551-52 (Bankr. N.D. Cal. 2003).

That said, while defining the scope of the representation (especially negatively—*i.e.*, "shall not advise on…") should go a long way toward protecting lawyers against claims related to the provision of business advice, lawyers should still be mindful of their persistent peripheral duty. See, *Nichols,* 15 Cal. App. 4th at 1684 ("[E]ven when a retention is expressly limited, the attorney may still have a duty to alert the client to legal problems which are reasonably apparent, even though they fall outside the scope of the retention."). Thus, in addition to defining the engagement as best as possible, lawyers should also document the advice that is provided during the course of representation and the client's ultimate, informed decisions. At that point, the decisions have become the client's, and as *Peterson* makes clear, "[i]f a client rejects that advice, the lawyer does not need to badger the client." *Peterson*, 792 F.3d at 791.

Peterson is not a License to Litigate

Even beyond these affirmative steps that lawyers can take to try to insulate themselves, client-plaintiffs still face serious hurdles when attempting to bring claims on the basis that a lawyer failed to provide business advice.

The Court of Appeals' comments confirm the benefits to lawyers of defining the scope of the representation at the outset of an engagement, particularly in the retention agreement, and to document any modifications or limitations thereafter.

To begin, it is important to recognize that *Peterson* was an appeal of a denial of a motion to dismiss, and the Court of Appeals' opinion was quite critical of the lower court's failure to construe the allegations in the light most favorable to the plaintiff. At later stages of litigation, when plaintiffs do not receive the benefit of such presumptions, claims like those raised in *Peterson* can be harder to pursue. For example, unmeritorious claims may be more easily disposed of on summary judgment, where (unlike at the Rule 12(b)(6) stage) the defendant may present evidence. This does not mean, of course, that lawyer-defendants should not bring 12(b)(6) motions in the first place. Indeed, Katten Muchin prevailed in the district court, and a different appellate panel or circuit may have reached a decision consistent with the district court.

Moreover, client-plaintiffs face significant causation hurdles for these types of claims, *i.e.*, proving that the lack of advice was the proximate cause of the harm they suffered. See*, e.g., Viner v. Sweet*, 30 Cal.4th 1232, 1241 (Cal. 2003) ("Courts are properly cautious about making attorneys guarantors of their clients' faulty business judgment.") (citation omitted); *Garten v. Shearman & Sterling LLP,* 102 A.D.3d 436 (NY 2013) ("plaintiff's losses were caused by Pacific Jet's poor financial condition and plaintiff's misjudgment of risk based upon the false factual information provided to him"). As one court has put it: "The court has said it before and will say it again: *lawyers are not responsible for the business decisions of their clients." In re Greater Southeast Cmty. Hosp. Corp. I,* 353 B.R. 324, 358 (Bankr. D.C. 2006) (emphasis in original) (noting that while lawyers may have duty to inform corporate client of fiduciary breach by its officers or directors, "they are neither obligated nor expected to second-guess the

business judgments made by those fiduciaries").

If, for example, the evidence showed that the client in *Peterson* had undertaken its own analysis regarding the pros and cons of various forms of the transaction, the client would be harder pressed to argue convincingly that it would have actually been swayed by an attorney's advice. Indeed, where clients are sophisticated and may have their own internal counsel, it seems likely that they would undertake their own analyses and form their own independent judgments. Therefore, despite Judge Easterbrook's rejection of client sophistication as a factor that could be considered on a 12(b)(6) motion, the issue should remain highly relevant at the summary judgment and trial stages. See, *Rothman v. McLaughlin & Stern, LLP,* 127 A.D.3d 591 (NY 2015) (granting summary judgment for law firm upon "proof that plaintiff, an experienced investor, understood that the retainer agreement excluded due diligence from the scope of representation"); *Conklin v. Hannoch Weisman,* 678 A.2d 1060, 1069 (N.J. 1996) (lawyer's care "must be commensurate with the risks of the undertaking and tailored to the needs and sophistication of the client").

Conclusion

As cautionary as *Peterson* might seem on first blush—apparently signaling an ominous, mission-creep-like message for attorneys—it is best read merely as a reminder of the existence of the peripheral duty principle. It is also instructive, providing attorneys the tools not only to help guard against "failure to provide business advice" claims, but also to best serve their clients by clarifying the scope of what might otherwise be a loosely defined relationship.

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Inside the Box

Since Fall 2008, we've followed closely the evolving law on a critical risk management question for law firms and lawyers: does the attorney-client privilege protect internal communications between attorneys and their firm's general counsel regarding a current client representation? A developing trend in the law says that the answer is yes. But, even where the privilege has been endorsed, the court decisions are clear that certain steps must be taken to protect it.

The latest court to join the chorus in favor of the privilege is New York's Appellate Division (First Department). In *Stock v. Schnader Harrison Segal & Lewis,* 2016 NY Slip Op 05247, the court rejected the application of the fiduciary exception to the privilege. It reasoned that the in-house counsel's "real clients" were the lawyers and the firm itself, not the firm client from whose representation the issues arose. New York's Appellate Division joins high courts in Oregon (*Crimson Trace Corporation v. Davis Wright Tremaine LLP* (355 Or. 476 (2014)), Massachusetts (*RFF Family Partnership v. Burns & Levinson, LLP, 465 Mass. 702* (2013)) and Georgia (*St. Simons Waterfront, LLC v. Hunter, Maclean, Exley & Dunn, P.C.*, 293 Ga. 419 (2013)) in upholding an "intra-firm" privilege. The ABA has lent its support also. At its 2013 Annual Meeting, its House of Delegates adopted Resolution 103 which urged courts and other rule makers to support the premise that the attorney-client privilege does protect confidential communications between law firm personnel and the firms' designated in-house counsel. Notwithstanding this encouraging trend, many jurisdictions have not yet validated the privilege. Thus, lawyers and law firms must continue to be careful.

However, even where the courts have embraced the trend, the decisions make clear that the likelihood that the privilege will be recognized is enhanced if a firm follows certain steps, including:

- that the in-house counsel role within the firm has been formally established (general counsel or ethics counsel) and is clearly defined;
- that the in-house counsel is treated in form and in substance as counsel to the firm;
- that a separate billing file is established for in-house matters and the files are kept segregated from others relating to client work;
- that the in-house counsel has not worked on the matter involved in the communication; and
- that no consultation time with the in-house counsel is billed to the client but rather to billing codes expressly related to the in-house counsel's role.