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Discussion Paper: Limiting Law Firms' Professional Liability Exposure

How law firms can maintain client relationships while protecting themselves against malpractice claims

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The relationship between law firms and their corporate clients is changing.

Corporate attorneys are increasingly bringing more work in-house and spreading the remaining work among a number of law firms. In the process, they are demanding more concessions from outside legal counsel in exchange for the opportunity to remain on the company's approved counsel list. These concessions can range broadly from data protection provisions to limits on working with the client's competitors, requests for statute of limitation waivers, broad indemnity agreements and more.

Many law firms feel pressure to yield to these requests in the interest of maintaining the client relationship. Further complicating matters is increased competition from both traditional rivals and new market entrants, such as accounting and consulting firms and technology-enabled providers offering legal services at reduced rates. Since these new competitors are not law firms, they are not bound by the same ethical rules that law firms operate under and can, therefore, require extensive contractual limitation of liabilities from clients. Meanwhile, where law firms utilize outside specialists and consultants to cut costs while maintaining service levels, they take on supervisory responsibility for the actions of these third-parties and increase their own liability exposure.

Against this backdrop, law firms are increasingly presented with engagement letters that open the door to greater professional and cyber liability exposure, often beyond the scope of their insurance coverage. Further, as the severity of professional liability claims continues to rise, law firms are increasingly viewed as deep pocket defendants. As a result, proactive risk management, beginning at the point of client engagement, has become an increasingly important part of the overall practice management strategies that law firms employ to protect their future viability.

This discussion paper takes a closer look at the importance for law firms to utilize engagement letters that are designed to limit their professional liability exposure. Proper attention to three components in the letter can assist in accomplishing this objective. In fact, many professional liability claims can be avoided by the judicious use of a well-thought-out engagement letter. Taking prudent steps to limit or guard against potential liabilities can reduce the likelihood that clients will later file claims, as well as reducing the costs associated with these claims, which include loss of fees, self-insured retentions, the cost of insurance and damage to the firm's reputation.

Why Many Law Firms Do Not Attempt To Limit Their Liability In Engagement Letters…

Unlike accounting firms and other professional organizations, law firms typically do not attempt to limit their liability in their engagement letters. In fact, many firms do not secure formal letters of engagement from clients at all. Some law firms are concerned that clauses seeking to limit their liability are not enforceable due to ethical restrictions. Others fear that asking clients to agree to certain concessions could negatively impact the relationship, putting them at a disadvantage compared to more agreeable competitors. In addition, many law firms do not believe that putting these kinds of restrictions in place will significantly reduce liability to an extent that justifies the expense and resources necessary to implement them.

…And 5 Reasons Why They Should

While it is understandable why law firms may be reluctant to take steps to limit their liability in the engagement letter, there are a number of reasons why they should reassess this position:

1. **Clients are now requiring their own engagement letters** and the clients' contract language typically seeks to impose and expand liability on law firms, often through boilerplate language that seems to run counter to the retained counsel's position as a trusted counselor and advisor.
2. **Law firms are held to very high professional standards**, and even with the best quality controls in place, the professional liability exposure they face can result in claims in excess of their insurance policy limits, often from engagements in which the firm received very little compensation.
3. **Law firms may be at a competitive disadvantage** as their subcontractors and other providers who take steps to limit their own liability can offer services at cheaper rates.
4. **The American Bar Association ("ABA") recommends that lawyers communicate key terms of representation to clients**, preferably in writing, either before or within a reasonable time after the representation has begun (see ABA, Model Rules of Professional Conduct (hereinafter "MRPC"), "Client-Lawyer Relationship, Rule 1.5, Fees").
5. **All experienced malpractice insurers recommend that law firms secure signed engagement letters** that clearly state the responsibilities of the firm and include provisions that limit the firm's liability, where permitted.

Structuring Engagement Letters That Limit Law Firm Liability

While the vast majority of states permit agreements limiting a lawyer's liability, a few notable outliers unequivocally forbid a lawyer from entering into such an agreement.[1] Where permitted, the client must be independently represented by counsel, which can include in-house counsel (see MRPC, "Client-Lawyer Relationship, Rule 1.8 (h) (1), Current Clients: Specific Rules").

Despite differences in enforceability from state to state, there seems to be little dispute regarding three components of a well-structured engagement letter that can help law firms in their client relationships and provide possible protection against malpractice claims. The three key components to the letter are: (1) identifying the client, (2) defining the scope of engagement, and (3) handling conflicts of interest.

Identify the Client

Defining who *is* and who *is not* the client is one of the most critical components of an engagement agreement. Without a tightly drawn definition of clients and non-clients in their contracts, law firms may be more susceptible to claims of conflict of interest that can be difficult and costly to defend. For an example of an ambiguous engagement letter with a client that exposed the law firm to malpractice and fiduciary breach of claims by a non-client, see the case of *Exeter Law Group LLP v. Wong*, 2016 NY Slip Op 32425(U) (Sup Ct, NY County 2016).

- **Corporate Clients.** When representing a corporation, law firms should define precisely who the corporate client is, and seek to specifically exclude those persons or entities the firm does not represent. For example, if Company A is a client, the firm should designate Company A's officers, directors, employees, subsidiaries and assigns as non-clients.
- **Founders of a Company or Partnership.** If the firm's client is a partnership or company with partners, the founders or partners should be designated as non-clients. Conflict of interest claims have been alleged based on a believed attorney-client relationship between a law firm and one of the founders and minority partner of the client. Including language that clarifies what parties are included from those excluded in the attorney-client relationship can help law firms minimize these kinds of risks. A case that illustrates the importance of clearly designating clients and non-clients alike in an engagement letter is *Home Care Industries, Inc. v. Murray*, 154 F. Supp.2d 861 (D.N.J. 2001).
- **Spouses and Domestic Partners or Parents and Children.** Including language that clearly identifies the client and also designates non-clients is especially important when the law firm has a pre-existing relationship with one or more of the parties or their family members. *Silberberg v. Meyers*, 885 N.Y.S. 2d. 713 (Sup. Ct 2009) is an example of the effective use of clear engagement letter language to define which family members are included in the definition of client, and which ones are not.

Scope of the engagement

It's equally important to **define the scope of the engagement in the contract as clearly and specifically as possible**. MRPC Rule 1.2 (c), "Scope Of Representation And Allocation Of Authority Between Client And Lawyer," states that a lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.

Law firms have traditionally shied away from narrowly defining the scope of engagement, believing that it is impractical to obtain frequent written amendments changing the scope of the engagement letter. Although a broadly worded scope of engagement section allows a firm to represent a client on a range of matters without the need for a new engagement letter, this could come with a price. In the event of a claim, a law firm's belief about what it was retained to do may differ greatly from its client. From a risk management standpoint, the more restrictive the description, outlining solely what that firm intends to do, the better. Further, more precision and certainty around what the firm has or has not agreed to do encourages more frequent client contact, and could have other benefits as well, especially with respect to activities falling under an alternative fee arrangement rather than traditional hourly billing.

The case *AmBase Corp. v. Davis Polk &Wardwell*, 866 N.E. 2d 1033 (N.Y. 2007) is an example where the law firm prevailed in a malpractice case, in part, because the engagement contract wording was limited in scope and, therefore, viewed by the court as precise and clear. In contrast, the law firm in *Barack v. Seward & Kissell, LLP*, 16-cv-09664 (S.D.N.Y Sept.12, 2017) lost its motion to dismiss because the court found the language in the retainer agreement to be too broad.

In drafting contract wording regarding the scope of the client engagement, attorneys should consider limitations on both the subject matter and the duration of their representation. The following are sample disclaimers law firms should consider including when drafting this section of their client contracts:

- Where the firm represents the client in general litigation, and where insurance coverage is available to the client, the firm should consider stating that it *"is neither opining on the scope of any available insurance nor representing the client in notifying insurers of claims, or in any negotiating or settlement of claims."*
- With litigation matters, it is particularly important to state that *"the firm does not provide any guarantee or promise as to the outcome of any client matters undertaken by the firm."*

- Where relevant, the contact should explain *"that the firm does not act as an investment advisor, or accountant, appraiser, insurance consultant, or architect or engineer, and does not accept any liability or responsibility for their appointment, supervision or performance of such entities that have been retained to perform those services."*
- Although clients may want their terms to control, the law firm's contract should state, *"In the event of any conflict between the provisions of the firm's engagement letter and any outside counsel guidelines, the provisions of the firm's engagement letter shall control."*
- Where the client has also retained another firm to handle an aspect of the engagement, it should be clearly specified what assignments the other firm will be handling, as claims have been brought by clients alleging that the firm had a broader role than the firm assumed. For example, specify if the firm will not make UCC filings in order to avoid any confusion (e.g., *"The firm will not be responsible for any UCC filings, or patent annuity work."*)
- In a merger and acquisition scenario, a firm may wish to specify that it has not been retained to give tax advice relating to the transaction. Even if another firm has given a tax opinion relating to the transaction, the firm may still want to consider including a provision that they have not been retained to review other counsel's work.
- In the sale of a company, a firm may also want to specify whether their representation of the company will survive the transaction. If it does, new management will then have full access to the firm's client files. In a case where a hostile takeover has occurred, new management could use this opportunity to comb through the firm's files for communications relating to the defense of the takeover.

Conflicts of interest

Conflicts of interest cause a significant number of malpractice claims that are very difficult to defend. As such, many firms look to secure a blanket advanced conflict of waiver in the engagement letter.

An example of this kind of language is: *"The Firm represents a large number of other clients and it is possible that during the course of such representation of the client by the firm, other clients may seek to assert or protect interests adverse to the client. These may constitute conflicts of interest that could prevent or otherwise inhibit the firm's ability to represent such client. As a condition to the undertaking of this representation by the firm, the client agrees that the firm may continue to represent or undertake to represent existing or new clients even if those interests are directly adverse to or different from the clients, so long as such representation is not substantially related to work for the client."*

While these kinds of waivers can be effective, they can also be challenged (see *Sheppard, Mullin, Richter & Hampton, LLP v. J-M Manufacturing Co., Inc.,* Case no S232946, a case currently under review by the California Supreme Court in which Sompo International and other malpractice insurance carriers have filed an amicus brief).[2]

Challenges are normally based on the premise that in order for any conflict to be waived, the specific nature of the conflict and the identity of the other client should be disclosed, factors that may be impossible to identify at the time the engagement letter is signed.

Additional Disclosures to Consider

Depending on the situation, there are a number of additional disclosures and items law firms should consider when preparing engagement letters that can help limit professional liability exposure. These include:

- **Indemnification agreements that limit liability to specific amounts of damages.** While there are significant restrictions on a law firm's ability to limit liability, they may be able to do so when retained to provide non-legal services, such as when retained to provide supervisory responsibility for outside

providers. Services that can be handled by non-lawyers include certain trust and estate or other fiduciary work, tax advice, electronic discovery and patent annuity tasks.

- **Restrictions on the statute of limitations.** This protection can be achieved directly in states where it is allowed, or indirectly through a clause in the engagement letter stating that any dispute is to be handled by arbitration or litigation in a specific state and in accordance with the laws of that state that has the shortest statute of limitations.[1] Firms can also include language stating the engagement is terminated when the service is complete in order to ensure that the firm's liability does not remain open-ended.
- **"Waiver of jury trial" provisions.** While this kind of provision does not directly impact a firm's ability to limit professional liability, it will allow the attorney to control the forum in which any disputes are to be resolved, thus potentially leading to a more predictable outcome. The firm should also consider including language stating that at the option of the firm, mediation or arbitration may be required in place of litigation for any client disputes, especially when the dispute involves fees.
- **Protections against third-party suits and liability.** Law firms should consider including the following types of statements in both their own engagement letters as well as on any documents a third party could potentially read:
  - *"Any opinion provided to the client cannot be relied on by any third party without the specific agreement of the firm."*
  - *"Clients are prohibited from assigning claims to third parties."*
- **Limiting the liability associated with supervising subcontractors.** In situations where a subcontractor is supervised by the law firm, retained counsel should take steps to guard against becoming fully responsible for any negligence of the subcontractor. For example, attorneys may request that subcontractors maintain certain minimum coverage in their insurance policies or request that a subcontractor indemnify the law firm for any claims brought by a client in response to actions taken by that subcontractor.
- **Disclosure regarding electronic communications.** For example: *"We may communicate with you and others via email. Such emails can be intercepted read, disclosed or otherwise used or communicated by an unintended third party. We cannot guarantee or warrant that emails from us will be properly delivered and read only by the addressee and may result in attorney client privilege being waived. We specifically disclaim any liability or responsibility whatsoever for such interception or unintentional disclosure, and you agree we shall have no liability for any loss or damage to any person or entity resulting from the use of email transmissions."*

How to Respond if a Client Asks for an Indemnity Agreement

Before finalizing or amending the terms of any engagement letter or indemnity agreement, a law firm should have its own general counsel review the contract. In fact, a firm should avoid entering into an indemnity agreement if possible, although many firms feel pressure to do so in the interest in maintaining a client relationship. If faced with this type of request, the following strategies can help law firms respond.

- **Attempt to persuade the client that an indemnity agreement is not appropriate for a professional service firm.** Law firms act in a professional role and are subject to ethical restrictions. As such, they are unlike other vendors who may serve simply as suppliers of products.
- **Explain that indemnity agreements were originally intended for bodily injury and property damage claims** brought by third parties, and therefore, should exclude professional services. Most law firms are protected for bodily injury and property damage claims in a commercial general liability insurance policy and against data breaches through the purchase of a cyber liability policy.

- **Remind the client that it is not in their best interest.** Entering an indemnity agreement can change the fundamental relationship between the client and its retained counsel. Doing so can potentially invalidate the law firm's professional liability insurance policy, thus reducing a source of recovery for any malpractice claims made against them. In addition, requiring these agreements could reduce the number of law firms available to the client, and firms who sign them may seek higher rates to counteract increased exposure under their professional liability insurance policy.
- **Request that the client waive any indemnity provisions to the extent they impair or conflict with the firm's malpractice insurance policy.** Signing an indemnity agreement could trigger a contractual liability exclusion in the firm's insurance policy and leave it unprotected, reducing a source of recovery to pay a client's malpractice claim against the firm.
- **If indemnification is agreed to, obtain reciprocal indemnification from the client.** If the firm indemnifies the client against claims based on negligence of the firm, require that the client, in turn, indemnify the firm for claims caused by client negligence.
- **If all else fails, assert the firm's right to proportionate liability.** Include a clause similar to the following into the agreement: *"Without limiting the generality of the forgoing, the obligations undertaken by outside counsel do not impair outside counsel's ability to assert defenses of contributory or comparative negligence, or defenses otherwise applicable in professional negligence or negligent supervision claims."*

Conclusion

Changing client relationships, increased competition and a rise in claims severity underscore the imperative for law firms to take steps to limit their professional liability exposure. While the laws governing client agreements vary from state to state, the inclusion of provisions for identifying the client, defining the scope of engagement and handling conflicts of interest can play an important role in a firm's risk mitigation process.

Understandably, firms do not want to place demands on clients that could potentially jeopardize the relationship. However, as clients increasingly look to limit their own liability exposure, it is reasonable for them to expect that their retained counsel should do the same. In this context, a carefully crafted and thoughtfully presented engagement letter can be an important tool to help firms strike a successful balance between protecting the firm and preserving their client relationships.

If you have additional questions about related issues beyond those outlined above, please feel free to contact us directly.

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[1] Hinshaw & Culbertson LLP has prepared a listing that shows how each state views this issue and provides details about the statute of limitations for commencing a legal malpractice action based on claims of negligence for each state.

[2] Since we originally wrote this paper, the California Supreme Court has issued a decision in Sheppard, Mullin, Richter & Hampton, LLP v. J-M Manufacturing Company, Inc. In that case, the Court held (in part) that without full disclosure of existing conflicts known to the attorney, the client's consent was not informed for purposes of California's ethics rules. The court did not reach the issue of whether a blanket advance waiver would be permissible (p 28). As California still follows the Model Code, a different outcome may result under the Model Rules.

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