Your Business:
More Lateral Movement, More Professional Liability Worries

February 7, 2014

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Consider this hypothetical.

Brenda Esquire, a partner at a large law firm, represented Businessman Blake. Blake and two business associates created a limited liability company, Wildwood, **FN:1** of which they were members, and that was governed by an operating agreement. The operating agreement provided conditions under which a member could withdraw, and prohibited the members from rendering services to anyone who owned or operated a competing business. For about a year, Esquire provided advice and assistance to the members in connection with Wildwood and its potential deals. She did not execute an engagement letter with Wildwood or disclose that she represented Blake individually.

Esquire then joined another large law firm as a lateral partner. She continued to advise Wildwood without an engagement letter. The relationship among the members soured after an important deal fell apart. Esquire gave advice to Blake in connection with a new company he had formed doing similar business, as well as advice about how to use the terms of the Wildwood operating agreement to his advantage. Esquire later asserted she was never counsel to Wildwood.

Eventually the other two members and Wildwood sued Esquire and her new firm, alleging that she had breached her fiduciary duties by representing Blake in deals that had breached his fiduciary duties and contractual obligations to his business partners, and by giving him legal advice that was adverse to the interests of Wildwood. The lawsuit sought tens of millions in damages.

Yes, this is a hypothetical. But it is largely based on the allegations of a real, recently filed lawsuit involving a lateral partner. And that lawsuit, it would seem, is part of a larger phenomenon: As law firms continue to acquire smaller firms or hire laterals as a growth strategy, there has been a noticeable uptick in associated professional liability claims.

Small-firm acquisitions and lateral hiring have been dominant growth strategies in the legal profession for the last several years. According to Altman Weil, law firm mergers and acquisitions have increased sharply since 2010, with 2013 representing a peak for the last seven years that it has been compiling data. The most recent surge has been driven by acquisitions of small firms with 20 or fewer lawyers. Similarly, according to recent client advisories published by Hildebrandt Consulting and Citi Private Bank, there has been a marked shift in favor of lateral hiring as a growth strategy since 2007.

However, Hildebrandt/Citi reports that firms also reveal disappointing success with this strategy, identifying 40 percent of such hires as failures or breakeven.
More important for purposes of this article, a leading provider of professional liability coverage for large law firms, Attorneys' Liability Assurance Society Inc., has noted an increase in professional liability claims connected with lateral hires. ALAS notes that those claims account for a significant portion of actual losses (i.e., payments through settlement or judgment). Of the losses or reserves ALAS has reported since 2005 for matters arising from the conduct of lateral lawyers, 70 percent have been posted just since 2010.

According to ALAS, lateral-hire claims have arisen from hiring missteps, such as incomplete due diligence on the attorney, the attorney bringing problematic clients and/or matters to the firm, and unidentified conflicts with existing clients. ALAS adds that more recent claims have also involved problems not connected with hiring *per se*, but with failure to integrate or provide sufficient oversight of lateral attorneys.

Experience does not provide immunity. To the contrary, attorneys with more than 10 years of experience account for the majority of claims, according to the leading treatise on professional liability, "Legal Malpractice," by Ronald Mallen and Jeffrey Smith, with Allison Rhodes. This treatise and others opine that the recent economic climate is one factor in professional liability claims, in that it has encouraged attorneys to take on clients or matters they might not otherwise take. If so, that temptation may be even greater for a lateral attorney who is trying to establish his or her worth at a new firm, and who may be facing near-term deadlines to achieve certain financial objectives.
This, then, is a cautionary tale for any firm hiring lateral partners, but particularly for firms using small-firm acquisition or lateral hiring as a growth strategy.

Professional liability claims are a fact of life, particularly in a profession where serious missteps can arise just as easily from a calendaring error as from an error in handling a trial. However, lateral hiring demonstrably carries special risks that are worthy of increased attention by law firms, both in their hiring and in their follow-through. There are many risk-prevention measures a firm can and should take: A comprehensive discussion is beyond the scope of this column, but the Mallen treatise is a useful resource, as is any insurer who focuses on prevention. (It is worth noting that consistently adhering to good policies and procedures once they are put in place is also very important, and is surprisingly often not accomplished.)

One of the risks that is elevated in lateral hiring is illustrated by our hypothetical: not adequately identifying conflicts that may either already exist in the representation, or that may exist in connection with clients of the new firm. Firms would do well to consider how effectively their hiring process and conflict checks screen for non-obvious potential conflicts.

Greater scrutiny of associated and interested persons in matters that come to the new firm may reveal otherwise hidden conflict issues. For example, in the hypothetical, there was an engagement letter identifying only Blake as the client. So relying on a superficial examination of paperwork may not have identified the representation of Wildwood, or the potential conflicts in that representation.

Similarly, conflicts in connection with associated parties can also arise when facts are disclosed that implicate an associated party, who before that time had not been considered adverse. Although this can happen in matters not involving lateral attorneys, it may be well worth the time and effort for someone to review files of matters coming to the firm or to make a more substantive inquiry about associated and interested parties.

In another fairly recent matter, some lateral attorneys who had been part of a small firm joined a new firm and continued representing a client for a period of time that was in litigation with a client of the new firm. They did not open a matter with the new firm or charge their time for this client to the new firm, but they were employees of the new firm and in some cases used its letterhead and identified it on caption and signature pages in court filings. Thus, the new firm found itself squarely in the sights of a lawsuit in connection with the handling of the underlying matter, although the alleged errors occurred prior to the attorneys' move to the new firm. Here, greater scrutiny of how matters that are *not* coming to the new firm are being handled and transitioned may help avoid problems.

Joint defense agreements that had been entered into while at a prior firm are also a non-obvious source of potential conflicts, particularly if there were inadequate waivers in the agreement. Case law is mixed in this area, so firms might do well to scrutinize any joint defense agreements and consider whether further action is warranted.

The reason for this column's focus on non-obvious conflicts in lateral hiring is that conflicts not only can create disruption and the loss of a client and hard-earned fees, but as ALAS has noted, what could have been a simple "mistake" can become much more difficult to defend and can create significantly more exposure when a conflict is added to the mix—including exposure to punitive damages for breach of an attorney's fiduciary duty. Jurors understandably view a conflict as a betrayal and tend to attribute bad motives to the attorneys' actions or failures to act, rather than accepting them as either mistake or inadvertence that resulted in little or no harm.

At best attorneys are not viewed as sympathetic by jurors. But the existence of a conflict can feed into negative preconceptions a jury may have about credibility, and can provide justification for a larger award of damages than if the conflict did not exist.

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FN:1 Wildwood is a name made up for purposes of the hypothetical; no association with any actual businesses that might have this name is intended.