Minimizing Lawyer Liability In Large Firm Real Estate Practice

(With Forms)

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For the real estate lawyer, liability risks seem to spring from the very ground. Luckily, these risks can be classified and contained.

IF "REAL ESTATE" PRACTICE is defined to include all representations related to real estate, large firm real estate practice, which often involves representation of developers and the creation of investment vehicles, including limited partnerships, is a practice area laden with significant lawyer liability risks. Those risks, although varied, tend to fall into a few recognizable categories, which are discussed below.

AIDING AND ABETTING • In many substantial claims, the law firm represented one of the parties in a business transaction who is later sued for wrongdoing such as fraud, misrepresentation, or breach of a fiduciary obligation. Real estate developments are often high-risk transactions undertaken by aggressive entrepreneurs. Such entrepreneurs often do not observe their disclosure obligations and ignore other legal niceties as well. Firms that represent such clients have been sued for "aiding and abetting" the client's alleged wrongful conduct because the firm prepared the papers for the deal and failed to disclose the client's alleged misconduct.

Big firm lawyers can't refrain from real estate work just because some participants in real estate deals are high-risk clients. Law firms can, however, recognize the kind of risks raised by representation of such clients, and subject them to closer than normal scrutiny in the new business intake process. They can also educate young lawyers

about the risks associated with this type of representation and encourage all firm lawyers to be sensitive to warning signs, possible indicators of improper disclosure, or similar client wrongdoing.

The best time to look for warning signs is before committing the firm to represent a high-risk client. Thus, the first line of defense against high-risk clients is a sound business intake system. This is especially important when considering representation of an entity or individual with which the firm has no prior experience. Too often, lawyers undertake to represent such clients without conducting *any* due diligence.

Client quality review procedures should normally include a second lawyer review of new business intake decisions, a creditworthiness review of potential new clients and existing clients opening new matters, early identification of high-risk engagements, and a due diligence protocol for potentially high-risk clients. Each step is important to an effective screening process.

Second-Lawyer Review

A lawyer eager to generate new business may not fully appreciate the risks presented by a marginal client or questionable transaction. Thus, many law firms now require new business intake decisions to be reviewed by a second partner (or committee) whose experience and seasoned judgment will be respected by their peers.

Creditworthiness Review

Many firms now routinely review the creditworthiness of all new clients. In addition to credit ratings, such reviews will often reveal other useful information such as prior bankruptcies, judgments, litigation, and regulatory action involving the potential new client. If a proposed new representation involves an existing or former firm client, the client's payment history with the firm should also be considered. Experience teaches that the people who fail to pay their lawyers often renege on their other business obligations.

High-Risk Engagements

Certain types of engagements tend to involve more risk than others. Several risk factors or warning signs are common in real estate practice. These include: clients who are raising money from third parties; potential clients who are changing lawyers or auditors in the middle of a transaction (this warning sign becomes a stop sign if the potential client will not permit you to talk to the prior counsel or auditor concerning the reasons for the change); entities or individuals who have sued other lawyers; entities or individuals who present transactions that have no apparent business purpose; and potential clients that have been found liable for financial malfeasance or have entered into consent decrees regarding such allegations. These kinds of matters deserve special attention by the firm's management.

Due Diligence Protocol

In the Internet age, there is little excuse for not discovering that your potential new client has an unsavory past. Various free or low-cost Internet sources can provide valuable information on potential clients. Law firm librarians or other appropriately trained support staff can usually collect and disseminate such information for the new business reviewers without unduly delaying the new business approval process.

Once the new real estate matter has cleared the new business intake process, the firm must continue to take care that it does not "assist" any misconduct by the client. For example, a common allegation in lawyer aiding and abetting cases is that the law firm assisted the client's scheme by issuing an opinion based upon facts that the firm knew were untrue. The situation in *Kline v. First Western Government Securities, Inc.,* 24 F.3d 480 (3d Cir.), *cert. denied,* 513 U.S. 1032 (1994), is instructive, although it did not involve a real estate transaction. The court held that a law firm could be found liable on an opinion based on assumed facts where the firm was aware that the assumed facts appeared inaccurate, even though the opinion letter was studded with warnings.

A lawyer who is asked to give such an opinion has two choices, according to the *Kline* court. The lawyer may investigate to determine whether the assumed facts are true; or the lawyer may withdraw. The lawyer may not, however, give the opinion without investigation. Thus, it is important to focus on the transaction as a whole rather than just the narrow legal issues that might be addressed in an opinion ostensibly based on an assumed set of facts.

Even if the representation does not involve giving an opinion, the firm may still be at risk for aiding and abetting the client's misconduct. For example, section 51(4) of the *Restatement (Third) of the Law Governing Lawyers* (ALI, Philadelphia 2000), provides that a lawyer may be liable to a nonclient when the lawyer's client has fiduciary duties to the nonclient and the lawyer knows that appropriate action by the lawyer is necessary to prevent or rectify the breach of fiduciary duty owed by the client to the nonclient where the breach is a crime or fraud or the lawyer has assisted in the breach. The court in *Granewich v. Harding*, 985 P.2d 788 (Or. 1999), applied this concept to hold that lawyers who had represented majority shareholders in a scheme to "squeeze out" a minority shareholder in breach of the majority shareholders' fiduciary duty could be jointly liable with the majority shareholders.

CONFLICTS OF INTEREST • The severity of many lawyer liability claims arising out of real estate practice has been exacerbated by conflicts of interest. Frequently, in a real estate transaction a big firm lawyer serves two functions.

First, the lawyer represents a party to the transaction. In that capacity, the lawyer attempts to gain an advantage for the firm's