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Law Surrounding Third-Party Liability of Law Firms in Spotlight

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When a company collapses and creditors or a trustee are looking to recoup losses, banks and accounting firms have often been targeted under the theory that it was their advice or their ignorance that allowed the collapse to occur.

In the past few years, law firms have been added to that list of third-party defendants targeted for their alleged roles in allowing fraudulent, or simply bad, business practices to continue by their clients.

Timothy Hoeffner of DLA Piper in Philadelphia has handled internal investigations and represented a number of third-party defendants in securities and fraud cases. While he couldn't comment on specific cases given his or his firm's role in many, Hoeffner said there is "clearly an increasing trend in pursuing law firms as a deep pocket in a case brought by a liquidator or a trustee involving a failed company."

While he was hesitant to call such suits against law firms a trend given the fact-specific nature of these cases, John G. Harkins Jr. of litigation boutique Harkins Cunningham said suits against firms saw a particular upswing beginning when the financial markets crumbled in 2008 and more companies collapsed and in turn had trustees looking to recover assets.

The potential third-party liability of law firms could soon see its day before both the U.S. and Pennsylvania Supreme courts, albeit on very different sets of facts.

On October 1, the U.S. Supreme Court asked the U.S. solicitor general to weigh in on a case involving the Ponzi scheme by convicted financier R. Allen Stanford in Texas. Four securities class action suits were filed in Louisiana state court and Texas federal court by investors in Stanford's companies and were ultimately consolidated for appeal before the U.S. Court of Appeals for the Fifth Circuit. Among the defendants, which included insurance brokers and Stanford's companies, were law firms Proskauer Rose and Chadbourne & Parke.

The defendants sought to dismiss the actions under the Securities Litigation Uniform Standards Act (SLUSA). The Fifth Circuit said SLUSA was Congress' response to plaintiffs attorneys looking to move their securities class actions to state courts after the 1995 passage of the Private Securities Litigation Reform Act limited recoveries in federal courts for claims related to forward-looking statements and created penalties for frivolous filings.

SLUSA mandates that no class action based on state law can be maintained by a private party that alleges a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security, the court noted.

"Because we find that the purchase or sale of securities (or representations about the purchase or sale of securities) is only tangentially related to the fraudulent schemes alleged by the [investors], we hold that SLUSA does not preclude the [investors] from using state class actions to pursue their recovery," the Fifth Circuit ruled March 19.

Both Proskauer Rose and Chadbourne & Parke filed petitions for certiorari with the U.S. Supreme Court.

In Pennsylvania, K&L Gates is waiting for the state Supreme Court to rule on its allocatur petition in a legal malpractice action brought by the trustee of bankrupt beverage manufacturer Le-Nature's.

K&L Gates was hired by a special committee of the board in 2003 to investigate whether there was fraudulent activity by the company. K&L Gates found no evidence of fraud, but three years later the company went into bankruptcy and its president was later convicted of fraudulent financial practices and sentenced to more than 20 years in prison.

K&L Gates and accounting firm Pascarella & Wiker had argued the firms only had a duty to the special committee of Le-Nature's that hired them in 2003, and not to a trustee of the now-bankrupt company. Allegheny County Court of Common Pleas Senior Judge R. Stanton Wettick Jr. agreed, finding they had no obligation beyond the special committee and that the trustee could not claim damages for deepening insolvency of the company between the 2003 internal investigation and the 2006 collapse of the company.

But Superior Court Judge John L. Musmanno said in his opinion that the special committee had a duty to the company and K&L Gates was providing legal services to Le-Nature's through the special committee.

"K&L Gates was retained to investigate the exact type of injury being inflicted upon Le-Nature's," Musmanno said. "By negligently conducting its investigation, K&L Gates affirmatively caused harm to Le-Nature's by concealing the looting of the company and wrongdoing by [former CEO Gregory J.] Podlucky, and affirmatively representing that no evidence of fraud or misconduct existed."

K&L Gates appealed that decision to the Pennsylvania Supreme Court and a number of the state's largest law firms have filed an amicus brief in support of K&L Gates' position. The appeal is still pending.

While DLA's Hoeffner said there was a growing trend of plaintiffs including law firms among defendants in their suits, he did note that there are "significant hurdles" the plaintiffs will face — including the duty of care, privity, causation and in pari delicto, or the concept that someone who has unclean hands can't sue another party for the same actions.

When asked whether we may see more suits involving law firms based on prosecutors' focus on bringing claims or charges related to securities fraud, Hoeffner said, "Fortunately, the government has demonstrated some restraint in dragging law firms into the mix of targets in significant fraud cases."

One case in which the government did go after outside counsel was in the prosecution of former Mayer Brown partner Joseph P. Collins, who was convicted and sentenced to seven years in prison for his alleged role in helping Refco Inc. executives defraud investors of more than $2 billion. That conviction, however, was overturned in January based on the trial judge's ex parte communication with a juror.

What law firms do once brought in as a third-party defendant varies. Law firms aren't faced with as many of these suits as accounting firms are just given the smaller number of accounting firms. Some may look to vehemently defend their reputation, while others may find it more prudent to settle given it is the only such case they are facing at the time.

While K&L Gates is fighting the case against it, in 2009 Blank Rome settled for $20 million with the trustee of former client American Business Financial Services. The firm admitted no wrongdoing by settling.

Among several claims, the trustee alleged Blank Rome knowingly assisted ABFS officers in perpetrating a Ponzi scheme and misled the U.S. Securities and Exchange Commission about the financial health of ABFS, according to the complaint. The trustee of ABFS was seeking in excess of $750 million against Blank Rome in compensatory damages along with punitive damages and attorney fees and costs.

These cases show the high price trustees put on their claims against the firms — $750 million in Blank Rome's case and $500 million in the suit against K&L Gates.

Harkins represented Blank Rome in the ABFS case. He said that when claims are that large and the insurance companies come onto the scene, the insurers start to play a role.

"It's a very hard-nosed business decision," Harkins said.

It seems that for K&L Gates, Proskauer Rose and Chadbourne & Parke, the business decision has been to fight these claims. Whether the Pennsylvania and U.S. Supreme courts will allow those battles to continue remains to be seen.

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