TADC PROFESSIONAL LIABILITY NEWSLETTER

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This newsletter is intended to summarize the most significant recent cases impacting non-medical professional malpractice litigation. It is not a comprehensive digest of every case involving professional liability issues during the period or of every holding in the cases discussed. This newsletter was not compiled for the purpose of offering legal advice. Any opinions expressed herein are those of the author and do not necessarily reflect the views of Thompson Coe Cousins & Irons, LLP.

Legal Malpractice – Statute of Limitations

Estate of Whitsett v. Junell, No. 01-04-00078-CV (Tex. App.—Houston [1st Dist.] Feb. 1, 2007, no pet.)

In *Whitsett*, the First District Court of Appeals applied the *Hughes* tolling rule to a legal malpractice claim until plaintiff's appeal in the underlying litigation was dismissed. The *Hughes* rule tolled the statute of limitations even though the defendant attorney withdrew from the representation before the litigation concluded and the alleged malpractice stemmed from claims that were never asserted in the underlying suit.

Whitsett hired Junell in December 1981 to sue Whitsett's former attorney (Dardas). In December 1982, Junell filed Whitsett's suit against Dardas, alleging *inter alia*, breach of fiduciary duty, legal malpractice, and violations of the DTPA. Whitsett alleged that she asked Junell to assert additional claims against Dardas in the lawsuit, but that he advised against it because pursuit of those claims would be futile.

Junell withdrew from representing Whitsett in February 1991. Whitsett ultimately lost the underlying action against Dardas. The Fifth Circuit dismissed her appeal of the underlying suit on March 30, 1993.

Whitsett filed suit against Junell on March 30, 1995. One of her allegations was that Junell negligently failed to assert several claims in the Dardas suit. Junell moved for partial summary judgment, asserting that the statute of limitations had expired on the negligence claims arising from causes of action unasserted or not included in the underlying Darden suit. The trial court granted Junell's motion.

The First District Court of Appeals reversed. The court began by restating the *Hughes* tolling rule: "[W]hen an attorney commits malpractice in the prosecution or defense of a claim that results in litigation, the statute of limitations on the malpractice claim against the attorney is tolled until all appeals on the underlying claim are exhausted." The *Hughes* rule applies even if the client terminates the attorney after the act of negligence but before the conclusion of the litigation.

Junell argued that the *Hughes* rule did not apply because Whitsett's claims against him arose only from his alleged failure to file tort claims against Dardas. The claims were never filed and therefore never litigated. Thus, Junell argued that his alleged malpractice could not have occurred "during the prosecution …of a claim that result[ed] in litigation," as required by *Hughes*.

The *Whitsett* Court disagreed with this reasoning. It noted that *Hughes* and its progeny have held that the phrase "in the prosecution or defense of a claim" includes underlying claims that should have been brought but were not. The Court further held that this phrase includes all claims for an indivisible injury that an attorney pursues on behalf of a client.

Personal Jurisdiction

Bergenholtz v. Cannata, 200 S.W.3d 287 (Tex. App.—Dallas Aug. 17, 2006, no pet.)

In *Bergenholtz*, the Dallas Court of Appeals affirmed a special appearance granted in favor of a California law firm that had formerly represented Texas companies in California litigation.

Bergenholtz was a Texas resident who owned or controlled several Texas and Canadian corporations. Bergenholtz and his companies hired the appellee law firms to defend them in a California lawsuit brought by a California company. Bergenholtz eventually

sued his former attorneys for legal malpractice, breach of fiduciary duty and fraud. All three of the appellee law firms entered special appearances asserting that the trial court lacked personal jurisdiction over them. The trial court granted the special appearance and the Court of Appeals affirmed.

On appeal, Bergenholtz claimed that the appellee firms purposefully availed themselves of the jurisdiction of Texas courts when they entered into contracts to represent Bergenholtz, billed Bergenholtz in Texas and accepted payment from Bergenholtz mailed from Texas. Bergenholtz further alleged that one of the lawyers, Theresa Cannata, entered an appearance for Bergenholtz in a related Texas bankruptcy matter and communicated repeatedly with Bergenholtz's Texas bankruptcy counsel.

The Court discussed the well-established test for personal jurisdiction: a court may exercise personal jurisdiction if the defendant has minimum contacts with the state and exercise of jurisdiction will not offend traditional notions of fair play and substantial justice. The "touchstone" of personal jurisdiction is the nonresidents' "purposeful availment" of the benefits of Texas law.

The Court first considered appellee Spellberg who was not licensed to practice law in Texas, had never been a resident or citizen of Texas, had never appeared pro hac vice in Texas or owned property in the State. His representation of Bergenholtz was limited to the California lawsuit. Perhaps most significantly, he did not solicit Bergenholtz's business and his representation was not the result of Spellberg's seeking clients in Texas. While Spellberg sent Bergenholtz legal advice, correspondence and billings from California to Texas, the Court noted that it considered only the defendant's actions to determine purposeful availment, not Bergenholtz's. The Court concluded that Spellberg did not satisfy the purposeful availment test and thus personal jurisdiction was improper.

Turning to appellee Cannata, the Court acknowledged that she similarly had no material prior contacts with Texas. The Court then considered the additional fact that she appeared in the Texas bankruptcy proceeding (in addition to the California suit). However, upon closer scrutiny the Court found that the purpose of Cannata's appearance in that action was little more than to receive future notice from the bankruptcy court. She was not lead counsel in the Texas bankruptcy, did not file the bankruptcy, and did not choose the forum. Indeed, Cannata made no other filings in the bankruptcy action beyond her appearance. The court concluded that this fell short of the "purposeful availment" necessary to establish personal jurisdiction.

Legal Malpractice -- Privity

Belt v. Oppenheimer, Blend, Harrison & Tate, Inc., 192 S.W.3d 780 (Tex. May 5, 2006)

In *Belt*, the Texas Supreme Court held that there is no legal bar preventing an estate's personal representative from maintaining a legal malpractice claim on behalf of the estate against the decedent's estate planning attorneys.

Oppenheimer, Blend provided estate planning advice and prepared a will for decedent David Terk. Following Mr. Terk's death, the co-executors of Terk's estate sued Oppenheimer, Blend for legal malpractice. The co-executors claimed that Oppenheimer, Blend's malpractice resulted in over $1.5 million in avoidable tax liability. The trial court granted Oppenheimer, Blend's motion for summary judgment on the grounds that estate planning attorneys owe no duty to the personal representatives of a deceased clients' estate. The court of appeals affirmed the trial court.

The Texas Supreme Court reversed the court of appeals. The Court began by reaffirming the *Barcelo* privity rule: in Texas only the estate planner's client may maintain a legal malpractice claim in the estate planning context. This is the minority rule – in most states a will beneficiary may bring a legal malpractice claim against the lawyer who drafted a will even though the beneficiary was not the client and thus not in privity with the lawyer.

However, the Court concluded that the *Barcelo* rule does not bar a suit brought by the estate's personal representatives on behalf of the decedent client's estate. In Texas, the estate's personal representatives generally have the capacity to bring a survival action on behalf of the decedent's estate. The Court held, on a matter of first impression, that a legal malpractice claim in the estate planning context survives the decedent client. The Court reasoned that such legal malpractice claims seeking recovery for purely economic loss are essentially limited to property damages.

Thus, survival of the legal malpractice claim comports with the common law rule that actions for damages to property survive the decedent. The Court added that a legal malpractice claim in the estate planning context accrues before the client's death. Therefore, some (if not all) injury arises during the decedent's lifetime and the claim survives the decedent.

The Court noted that the estate's personal representatives are generally the only individuals who have the capacity to bring a claim on behalf of the decedent's estate.

Finally, the Court concluded that its holding did not conflict with the policy concerns underlying *Barcelo*. The interests of the decedent and will beneficiary may conflict with each other. However, the interests of the estate's representative should generally mirror those of the decedent. Indeed, if both beneficiaries and personal representatives lacked standing to bring suit in the estate planning context, the estate planning lawyer would be essentially immune from liability for his malpractice.

Summary Judgment /Safekeeping of Client Funds

Cluck v. Commission for Lawyer Discipline, 214 S.W.3d 736 (Tex. App.—Austin Jan. 19, 2007, no pet.).

In *Cluck*, the Austin Court of Appeals considered the distinction between an advanced fee and a true retainer as well as the proper handling of an advanced fee by an attorney. The Court also addressed the standard of review for summary judgment orders in attorney discipline actions brought in district court.

Complainant Smith signed a contract for legal services with attorney Cluck in 2001. The contract called for a $15,000 "non-refundable retainer." It further provided that Cluck's fees would be billed at an hourly rate "first against non-refundable fees and then monthly thereafter." The contract stated that "no part of the legal fee is to be refunded."

Smith paid Cluck $15,000, but soon thereafter asked Cluck to cease his efforts because she had reconciled with her husband. Approximately one year later, Smith asked Cluck to resume work on her divorce. Cluck requested that Smith sign an amendment to their contract, by which she would pay an additional $5,000 "non-refundable fee" and Cluck's hourly rate would increase from $150 per hour to $200 per hour. Smith agreed and paid the $5,000.

Smith terminated Cluck as her attorney approximately one month later due to dissatisfaction with the progress of her case. She asked for a refund of the $20,000 less reasonable fees and expenses. Cluck refused to refund any of the monies paid by Smith. Neither side disputed that Cluck deposited the $20,000 paid by Smith into his operating account.

Smith filed a grievance with the State Bar. The Commission for Lawyer Discipline alleged that Cluck violated several of the Rules of Professional Conduct, including charging and collecting an unconscionable fee, failing to hold client funds in a trust account and failing to promptly deliver client funds. The trial court granted the Commission's motion for summary judgment and denied Cluck's. Cluck appealed and the Third District Court of Appeals affirmed.

The Court noted that appeals from summary judgment orders in attorney discipline actions are "governed by traditional summary judgment standards." In this matter, the trial court granted summary judgment for the Commission on all of the asserted grounds. Each ground was independently sufficient to support the findings of professional misconduct. Thus, the Court of Appeals noted that it must affirm the summary judgment if it found for the Commission on at least one violation of the Rules.

Moving to the merits, the Court agreed with the Commission that the fee paid to Cluck was neither non-refundable nor a retainer. A true retainer is not a payment of services but rather a fee to secure the lawyer's services and compensate him for the loss of opportunity to secure other employment. If the fee is not paid to compensate for lost opportunities, then it is a prepayment for services and not earned until the services are actually rendered. A true retainer is earned when it is received. Additionally, designation of fees as non-refundable is not dispositive of the question of whether they are earned immediately upon payment.

The Court held that the payments to Cluck were not retainers but advanced payments of fees. Cluck provided no evidence that the payments were made for his availability or lost opportunities. Rather, their contract stated that Cluck's hourly fee would be billed against the deposit.

The Court concluded that Cluck violated the Disciplinary Rules of Disciplinary Conduct when he deposited the funds in his operating account instead of his trust account because the payments were

unearned fees rather than a true retainer. Additionally, Cluck committed professional misconduct when he refused to refund the unearned portion of the fees to Smith upon request.

Breach of Fiduciary Duty – Proof of Damages

Baker Botts, L.L.P. and Wells Fargo Bank, N.A. v. Cailloux, No. 04-05-00446-CV (Tex. App.—San Antonio Feb. 14, 2007, pet. filed).

In this case, the San Antonio Court of Appeals considered the necessary proof to establish that a law firm's alleged failure to advise its client caused the client's damages.

Baker Botts, L.L.P. was hired by Floyd and Kathleen Cailloux to craft an estate plan for their multimillion dollar estate. Mr. Cailloux died before the estate planning was complete. Baker Botts was also retained by Wells Fargo, the independent executor, to represent it for administration of Mr. Cailloux's estate. Finally, Baker Botts was retained by a foundation (the "Old Foundation") created during Mr. Cailloux's lifetime that was intended to serve as a method for charitable contributions upon his death. Following Mr. Cailloux's death, through its respective engagement letters Baker Botts informed each of its three clients of the potential conflicts of interests inherent in representing all three parties simultaneously.

Wells Fargo organized a meeting within three weeks after Mr. Cailloux's death to discuss estate planning issues in light of his passing. Representatives of Wells Fargo, the Old Foundation, and Baker Botts were present. The Cailloux children were also present on behalf of the family, although Mrs. Cailloux was not present. Shortly after this meeting, Baker Botts devised two potential estate planning options for Mrs. Cailloux. Option One required Mrs. Cailloux and Mr. Cailloux's estate to withdraw their interests in a previously created family limited partnership that was intended to allow transfer of significant wealth to their children while avoiding income and taxes. Option One also envisioned Mrs. Cailloux's use of her power of appointment to eliminate a testamentary gift to the children as well as a new will leaving the balance of the estate to charity. This would have saved Mrs. Cailloux's estate $32 million in taxes. Option Two would have passed Mr. Cailloux's entire estate to charity immediately rather than upon Mrs. Cailloux's death. Significantly, it would have required Mrs. Cailloux to disclaim all of her rights under her deceased husband's estate, relying on her own sizeable wealth for income. Finally, it would have allowed Mrs. Cailloux the benefit of making the charitable contributions during her lifetime and would have resulted in substantial estate tax savings similar to Option One.

Baker Botts discussed these two options with a representation of the Old Foundation before speaking with Mrs. Cailloux. During this conversation, Baker Botts indicated that it would advise that Mrs. Cailloux select Option Two. Following this conversation, Baker Botts drafted a memorandum discussing both options. The Memo mentioned that if the charitable gifts were given during Mrs. Cailloux's lifetime as contemplated by Option Two, she could enjoy the charities' gratitude and could perhaps become directly involved with the Old Foundation. The Memo was forwarded to Wells Fargo and the Old Foundation for their review and comment but was not initially provided to Mrs. Cailloux. Following conversations with representatives of both Wells Fargo and the Old Foundation, the Memo was revised to delete reference to Mrs. Cailloux's potential direct involvement with the Old Foundation.

Two days later, Baker Botts provided the Memo to Mrs. Cailloux and her son Ken Cailloux. During this meeting, where a Wells Fargo representative was also present, Mrs. Cailloux told Baker Botts that it need not withdraw from representing her due to the potential conflict of interest. She then stated that her primary estate planning goals were to take care of her children, make gifts to charity, and avoid taxes (in that order). Following this meeting, Baker Botts sent Mrs. Cailloux a letter confirming that Option Two was the plan that she and Wells Fargo had elected to pursue. After exchanges of several drafts of the necessary documents, Mrs. Cailloux eventually signed a new will and a disclaimer of her husband's estate effecting Option Two.

Approximately one year after Mrs. Cailloux signed the estate planning documents, Ken Cailloux obtained a power of attorney from his mother, who had been diagnosed with early stage Alzheimer's disease. In the course of litigation with the Old Foundation, Ken Cailloux determined that Baker Botts and Wells Fargo had conspired to increase funding to the Old Foundation to the detriment of Mrs. Cailloux and her family. His claims focused upon their recommendation of Option Two, through which Mrs. Cailloux disclaimed her rights to her late husband's estate and the Old Foundation was funded immediately rather than upon her death.

At trial, a jury concluded that both Wells Fargo and Baker Botts had breached their fiduciary duties to Mrs. Cailloux through several failures to fully disclose all important information to her. Due to her illness, Mrs. Cailloux had not testified at trial. The jury found actual damages of $65.5 million—the amount that Mrs. Cailloux would have received in trust if she had not disclaimed her rights to her husband's estate. While the jury apportioned fault equally among Mrs. Cailloux, Baker Botts, Wells Fargo and the Old Foundation, the trial court's judgment required Baker Botts and Wells Fargo to pay the full amount of the judgment.

On appeal, Wells Fargo and Baker Botts contended that Ken Cailloux (as next friend of Mrs. Cailloux) had failed to establish the damages element of his breach of fiduciary duty claim. Specifically, they argued that there was no evidence that any of the alleged breaches of fiduciary duty caused Mrs. Cailloux to disclaim her right to her husband's estate. Ken countered that but for Appellants' failure to fully explain (1) the conflicts of interest inherent in their joint representation and (2) Mrs. Cailloux's rights under her husband's will, she would have refused to disclaim her rights to her husband's estate.

The Court noted that Mrs. Cailloux did not testify at trial and no other testifying witness had knowledge of Mrs. Cailloux's true intentions. Thus, the only evidence regarding Mrs. Cailloux's intentions was highly speculative. Ken Cailloux did testify to a conversation in which his mother stated generally the she wanted to leave her money to her children. However, the Court held that this was not probative of the specific question of whether Mrs. Cailloux would have signed the disclaimer of her husband's estate but for the alleged failures to advise. In the absence of evidence of Mrs. Cailloux's specific intentions, the Court would have to make numerous inferences based upon speculation in order to find the necessary causative link between the Appellants' acts and Cailloux's claimed damages.

The Court analogized this scenario to prior cases in which courts rejected assumptions as to a decedent's motives or intent. Without either the claimant present to testify or competent evidence regarding the claimant's intent, causation could only be proven by speculation and inference. The Court refused to engage in such "impermissible inference stacking" and reversed the trial court's judgment.

Professional Misconduct – Reasonableness of Fees

McCleery v. Commission for Lawyer Discipline, No. 0104-01036-CV (Tex. App.—Houston [1st Dist.] October 5, 2006, pet. denied).

In *McCleery*, the Court upheld a disciplinary sanction against an attorney who, on the eve of trial, amended his fee contract with a pro bono client to include a contingency fee.

The trial court's findings of fact included the following: Attorney McCleery agreed to represent Alonzo Williams through a referral from the Houston Volunteer Lawyers Program ("HVLP"). HVLP is an organization that connects low income persons with lawyers who have volunteered their time on a pro bono basis. HVLP's policy was that any attorneys' fees awarded to an indigent client at trial would be donated back to HVLP. Mr. Williams was elderly, infirm, indigent and had only a grade school education.

Following their initial meeting, Williams signed a Professional Services Agreement with McCleery providing that McCleery's representation would be pro bono. Williams sought representation for a dispute concerning defective home repairs and financing of those repairs. McCleery sent a demand letter to the defendant in the underlying matter, filed suit on Williams' behalf and participated in an unsuccessful mediation. Williams' suit alleged violation of the DTPA, breach of contract, fraud and conspiracy. He sought trebled and exemplary damages.

On the evening before trial, Williams and McCleery met for dinner. During the course of this dinner, McCleery presented Williams with a Legal Representation and Fee Agreement. The new Fee Agreement provided that McCleery would receive 40% of "all sums collected." Williams, who had traveled to Houston from Louisiana for trial, had not been presented with the Fee Agreement prior to this meeting. McCleery did not disclose this new proposed arrangement to HVLP, did not withdraw from representation or close the matter prior to proposing the new Fee Agreement, and did not tell Williams that he could have the new Fee Agreement reviewed by separate counsel.

Williams prevailed at trial. Eventually the parties settled for a $36,210 cash payment and $13,790 in debt forgiveness. McCleery characterized the recovery as a $50,000 award and took $20,000 as

attorney's fees and $1,427 in expenses. Williams realized a cash recovery of $14,783.

The trial court concluded that McCleery had collected an unconscionable fee and failed to communicate the basis of the fee within a reasonable time in violation of Rules 1.04(a) and (c) of the Texas Disciplinary Rules of Professional Conduct. The trial court issued a public reprimand and ordered restitution of $20,000.

On appeal, the Court quoted the portion of TDRPC Rule 1.04(a) which states that "[a] fee is unconscionable if a competent lawyer could not form a reasonable belief that the fee is reasonable." While reasonableness is an uncertain term, in most cases the circumstances at the time an arrangement is made should determine the question of unconsionability. Two factors discussed in the comments to TDRPC Rule 1.04 controlled in this instance: overreaching by the lawyer and the lawyer's failure to accurately explain how a fee is calculated. This latter factor is informed by whether the client is a sophisticated business client negotiating at arm's length or an uneducated or unsophisticated individual having no prior experience in such matters. If the client is not sophisticated the arrangement should be more carefully scrutinized for overreaching.

Given Mr. Williams' situation and the circumstances surrounding the presentation of the new fee arrangement, the Court applied the more searching level of scrutiny. It noted that McCleery failed to clearly explain that the 40% contingency fee would include forgiveness of a note to the defendant as well as a release of lien.

McCleery had testified that he suggested to Williams after mediation that McCleery's new partner should receive some fee. Williams denied that this conversation took place. The trial court commented that even if it assumed that McCleery's explanation was true, the new Fee Agreement remained unconscionable particularly given the 11th Hour presentation to Williams. The Court of Appeals agreed and affirmed the trial court.

Hoover Slovacek LLP v. Walton, No. 04-1004 (Tex. Nov. 3, 2006).

In this case, the Texas Supreme Court disapproved of a provision in an attorney fee agreement requiring the client, upon discharge of counsel, to immediately pay a contingency fee equal to the present value of the attorney's interest in the client's claim.

Walton hired Hoover Slovacek LLP ("Hoover") to recover unpaid royalties from several oil and gas companies operating on his ranch. Their contract provided for a 30% contingency fee for all claims collected through trial. The parties' engagement letter also included a provision which bound Walton to immediately pay Hoover, upon termination, the present value of the contingency fee plus costs. The letter did not describe the manner in which the present value of the claim would be calculated.

Walton and Hoover agreed to hire local counsel, and reduced their contingency fee arrangement to 28.66%. The parties settled with some of the oil companies and Walton paid Hoover's contingent fee. Hoover then turned to the claim against the remaining oil company (Bass). Walton authorized Hoover to settle the remaining claim for $8.5 million. Hoover made an initial demand of $58.5 million to Bass. Walton become upset with this demand because Hoover did not discuss it with him beforehand and he found it so excessive that it damaged his credibility. In the meantime, Bass responded with a $6 million counteroffer that included Walton's sale of several surface estates, easements, and his royalty interests. Walton refused this counteroffer but authorized Hoover to settle only the unpaid royalty claims for $6 million. Eventually, Walton discharged Hoover because of both perceived inactivity and the $58.5 million demand.

Walton, through new counsel settled the claim against Bass for $900,000. Hoover sent Walton a bill for $1.7 million (28.66% of $6 million) contending that Bass' prior authorization to settle the case for $6 million established the present value of the claim at the time of discharge. Walton, who had paid Hoover's successor firm $283,000 in hourly fees, refused to pay Hoover.

At trial, the jury failed to find that Hoover was terminated for good cause or that Hoover's fee was unconscionable, awarding Hoover $900,000. The court of appeals reversed, held that Hoover's fee agreement was unconscionable as a matter of law and rendered a take-nothing verdict for Walton. The Texas Supreme Court affirmed in part and reversed in part.

The Court began its analysis by emphasizing the ethical and fiduciary considerations accompanying an attorney's fee agreement. The primary purpose of contingent fee agreements is to allow clients to obtain legal counsel if they cannot afford an attorney on an hourly basis. On the other hand, if a contingency fee

attorney is discharged without cause before the conclusion of the representation, the attorney may seek compensation in quantum meruit or through enforcement of the contract after the client recovers damages. In either case, the fee must not violate the ethical prohibition against charging or collecting an unconscionable fee.

The Court determined that Hoover's termination fee was improper for at least three reasons. First, it made no distinction between terminations with or without cause. Second, it calculated the attorney's fee as a percentage of the value at the time of discharge, circumventing quantum meruit or contingency fee measurement following recovery of damages. Third, it required payment immediately upon discharge.

Hoover's provision that payment be made immediately upon discharge prejudiced Walton's freedom to employ counsel of his choosing. Requiring immediate payment of fees to Hoover, before recovery of any damages, essentially operated as a penalty for terminating the firm. It constituted an "undue burden" on Walton's ability to change counsel and was therefore violative of public policy.

The immediate payment provision also led to an improper contingency fee that exceeded the client's actual recovery. Precedent requiring that contingency fees be paid out of the client's actual net recovery protect the client from the attorney's potential overreaching and superior information regarding the risks of litigation. Hoover's termination fee, on the other hand, impermissibly shifted the risks in its favor and against Walton, particularly given the incomplete information known to the parties at the time of termination.

Finally, the absence of criteria in the fee agreement establishing how the present value of Walton's claim would be calculated troubled the Court. An attorney is required, at the outset of the representation, to inform a client of the basis for the attorney's fees. The fee agreement between Walton and Hoover wholly failed to do so with respect to the termination fee.

While the Court concluded that the termination fee provision was unconscionable, it did not declare the entire fee agreement unenforceable. Instead, reversing in part the court of appeals' decision, it severed the offending provision but allowed Hoover to proceed on claims based upon quantum meruit or other proper post-recovery measures of fees.

Accounting Malpractice – Privity/Third Party Beneficiary/Negligent Misrepresentation

Prospect High Income Fund v. Grant Thornton, LLP, 203 S.W.3d 602 (Tex. App.—Dallas Oct. 18, 2006).

In this opinion, the Dallas Court of Appeals examined whether bond holders could assert claims against the bond issuer's outside auditor.

Several bond and hedge funds (the "Bondholders") acquired bonds during a five year period from Epic Resorts, LLC with a par value of $105,000,000. As a part of Epic's indenture agreement, it was required to file audited financial statements with the Securities and Exchange Commission. The agreement further required Epic's auditors to send the bond trustee (U.S. Trust) a written "statement of negative assurance": that in the course of making its examination necessary to certify Epic's financial statements, nothing came to the auditor's attention which would lead it to believe that Epic had violated certain articles of the indenture agreement.

Epic agreed to open an escrow account with U.S. Trist using the proceeds of the Epic bonds. Thereafter, Epic was required to maintain a minimum account balance of $8,450,000 to serve as security for the bondholders.

Epic hired Grant Thornton ("GT") to audit its 1999 and 2000 financial statements. In both statements, Epic declared that it maintained "$8,450,000 at all times in escrow to cover the next required interest payment" on the bonds. However, during the course of GT's audit, it discovered that Epic had opened a cash management account rather than an escrow account and that the account did not contain the required minimum balance. The GT partner who oversaw the audit testified that he believed U.S. Trust was allowing Epic to dip below the minimum balance as long as Epic had enough case in all of its accounts to meet the minimum balance requirement. He was not concerned because each time he checked, Epic had over $12 million in total funds available with U.S. Trust. He determined that the declarations in the two financial statements required Epic to maintain a minimum balance generally but not necessarily keep $8.45 million in a specific escrow account. GT issued audit reports for both 1999 and 2000 providing that both fairly represented Epic's financial position. GT also issued the "statement of negative assurance" to U.S. Trust for 1999.

Epic eventually defaulted on its interest payments and was forced into involuntary bankruptcy by two of the Bondholders. Thereafter, the Bondholders sued GT for, *inter alia*, negligence, negligent misrepresentation, fraud and third-party-beneficiary breach of contract. GT successfully moved for summary judgment on all claims.

On appeal, the Court affirmed summary judgment on the professional negligence claims on two grounds. First, the Court noted that the economic loss rule barred the Bondholders' claims because they did not allege either personal injury or property damage. Second, the Court held that a professional negligence claim requires privity of contract. It rejected the holdings of two pre-*McCamish* cases to the extent they suggested that third-party negligence claims against accountants are permitted. The Court further noted that those decisions involved negligent misrepresentation claims rather than professional malpractice.

The Court then applied Texas law in holding that the Bondholders could not maintain a breach of contract claim as third party beneficiaries. The Bondholders suggested that more favorable Pennsylvania law should apply because the relationship between Epic and GT was centered in Pennsylvania. However, the Court, applying the "most significant relationship" test determined that the trial court did not err in applying Texas law. At least one of the principal Bondholders received and relied upon the representations in Texas. The Court held, applying Texas law, that the contract between Epic and GT did not specifically vest the Bondholders with the right to sue to enforce the contract.

The Court reversed summary judgment on the Bondholder's fraud claim. The Court examined the reliance element of the fraud claim in the context of an accounting firm's alleged fraudulent misrepresentations. The Texas Supreme Court has held that an auditor would be liable for misrepresentation only to those persons the auditor actually intended or had reason to expect would rely upon the misrepresentation. The Supreme Court rejected a standard of "mere foreseeability" in favor of reliance that is "especially likely" and justifiable. However, in the present case the Court held that a genuine issue existed regarding whether the Bondholder's reliance was especially likely. The indenture agreement provided that Epic "shall furnish" its annual reports to each "securityholder" within 15 days of filing. The Bondholders each came within the definition of securityholder. Thus, the Court concluded that summary judgment was inappropriate on the Bondholders' supposed failure to show GT's intent to induce reliance. Additionally, even though the bonds were purchased before GT's alleged misrepresentations, the Court held that the Bondholders could have decided to stop holding the bonds but for GT's alleged fraudulent misrepresentations.

Finally, the Court reversed summary judgment on the negligent misrepresentation claims. GT argued that the Bondholders were not among the limited class of persons entitled to sue a professional for negligent misrepresentation. A third party may sue a professional for negligent misrepresentations delivered to a known party for a known purpose. Thus GT's potential liability would be limited to (1) specifically identified recipients of the representations and (2) recipients, although not specifically named, belonging to the group or class it knew would receive the information. GT argued that although auditors are aware that bond investors are likely to review audited financial statements, auditors do not know which specific investors will receive and be influenced by the representations. However, the Court concluded that the Bondholders were not merely members of a large universe of potential investors. There was some evidence that Epic ordered the audit solely to satisfy the bond indenture and that GT's "statement of negative assurance" was generated solely to protect the current bondholders. Moreover Texas law suggests that existing investors may be included within the limited class of potential claimants for negligent misrepresentation claims. Thus, the Court reversed the summary judgment as to the Bondholders' negligent misrepresentation claim.

Legal Ethics – Recording Telephone Conversations Without Advance Disclosure

Opinion No. 575, Professional Ethics Committee for the State Bar of Texas (November 2006).

In this Opinion, the Committee overruled its prior opinions and stated that, under certain circumstances, the Texas Disciplinary Rules of Professional Conduct do not forbid a lawyer from making an undisclosed recording of the lawyer's telephone conversations with a client or other third party.

As recently as 1996, the Committee had concluded that a lawyer may not ethically record a telephonic conversation without advance consent. The Rules do not specifically address the propriety of such an electronic recording. Moreover, applicable federal and Texas law does not generally prohibit such

recordings by a participant in the conversation whether or not that participant is a lawyer.

The Committee thus concluded that the Disciplinary Rules do not generally prohibit an attorney from making an undisclosed recording of a telephone conversation in which the lawyer is a party as long as the lawyer complies with four requirements. Because applicable law does not prohibit such conduct, it cannot qualify as "dishonesty, fraud, deceit or misrepresentation," within the meaning of Rule 8.04(a)(3).

First, because of the potential conflict between recording such conversations and the client's expectation of confidentiality, the lawyer should record a conversation with a client only if it furthers the legitimate interests of the client or lawyer. Second, if the recorded conversation is with a client, the lawyer must take the appropriate steps to safeguard confidential information contained in the recording. Third, the lawyer should not record a phone conversation if the undisclosed recording is in violation of other applicable laws (of another jurisdiction, for example). Finally, the lawyer may not make an undisclosed recording if the recording would be contrary to a representation made by the lawyer to any third party.

Legal Ethics – Surrender of Client Property Disclosure of Attorney Notes to Former Client

Opinion No. 570, Professional Ethics Committee for the State Bar of Texas (May 2006).

In this Opinion, the Committee determined that, with limited exceptions, upon request a lawyer must provide a former client with the lawyer's notes from the lawyer's files for that former client.

Rules 1.14(b) and 1.15(a) of the Texas Disciplinary Rules of Professional Conduct, taken together, generally provide that documents within a lawyer's file for a particular client are the client's property and must be surrendered to the client upon request. Nevertheless, courts have struggled with the client's rights to obtain attorney notes and other internal work product generated during the course of the representation. Texas courts have tended to require a lawyer to surrender his entire file to the former client upon request. On the other hand, the Restatement (Third) of the Law Governing Lawyers (2000) recognizes that some jurisdiction allow attorneys to withhold portions of the client file. Among the types of such documents discussed by the Restatement are law firm documents intended only for internal review, like memoranda discussing which lawyers are assigned to a particular case, whether a lawyer must withdraw because of the client's misconduct or the firm's possible malpractice liability to the client.

The Committee rejected the limitations contained in the Restatement in favor of a blanket requirement that attorneys produce the client's file in its entirety, including notes. The Committee recognized that the lawyer might be motivated to withhold certain notes from the client in order to protect the lawyer's interests. Allowing a lawyer to make this unilateral decision potentially undermines the lawyers' duty to his client.

The Committee recognized some limited circumstances that would justify withholding a lawyer's notes from the client. Each of these implicate the lawyer's duties to third parties other than the client (e.g., information in attorneys' notes are subject to a protective order, notes where the disclosure would violate the lawyer's duty to another person, or notes containing information that could reasonable be expected to cause harm to a mentally ill person). The Committee further stated that a client file may be withheld when the lawyer has asserted a lawyer's lien.

Absent the foregoing circumstances, however, the Committee concluded that the lawyer must provide to a former client, upon request, the lawyer's notes from the lawyer's file for that former client.