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Duty to Advise of the Legal Risks from Business Transactions

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Introduction

Lawyers owe specific duties to their clients, mainly with respect to reasonable legal advice. If reasonable care is not exercised by an attorney when providing legal advice and services, there is a potential for a malpractice claim against that attorney. For attorneys that represent businesses, however, legal advice can sometimes be blurred with business advice. It is important to note that lawyers are not business consultants and do not specifically owe a duty to their clients to protect them from poor business decisions.[1] The problem occurs when it is hard to distinguish between the legal and business advice. These issues come to light in various types of cases. One example is where a client entered into a business deal that later turned out to be a Ponzi scheme, causing the client to file for bankruptcy.

In *Peterson v. Katten Muchin Rosenman LLP*, the Seventh Circuit recognized the overlap that can occur between legal and business advice.[2] Because of this overlap attorneys must provide advice regarding the different legal forms and risks associated with possible poor business decisions, especially if one of the risks could result in bankruptcy.[3] Attorneys should

[1] *See* Abrams v. DLP Piper (US) LLP, 2013 WL 2634767 *6 (N.D.Ind. June 12, 2013).
[2] Peterson v. Katten Muchin Rosenman LLP., 792 F.3d 789, 791–93 (7th Cir. 2015).
[3] *See id.*

now, as a precautionary measure, advise their clients of the risks that could result from their business decisions.

This precautionary measure has not typically been a routine legal service. If the duty was not a routine legal service, then it could create an aiding and abetting problem. However, certain routine legal services do not amount to substantially assisting in a claim for aiding and abetting in a breach of fiduciary duty and this duty can still be considered routine legal services because if attorneys do not advise of these risks they could potentially be subject to a legal malpractice claim. In *Abrams v. McGuireWoods, LLP*, the court had to determine if the defendant law firm substantially assisted in a breach of fiduciary duty which ultimately led to bankruptcy.[4] The court determined that the law firm did not aid and abet the managers because the lawyers did not do "something more than the provision of routine professional services."[5] However, if the services the law firm provided were more than routine legal services, there could be a possible cause of action for aiding and abetting.[6]

Part I of this article discusses the legal duty lawyers have to their clients to advise them of the legal risks and alternatives in connection with business transactions. Part II explains potential risks faced by lawyers in advising clients and describes what typically would not constitute substantially assisting in a breach of fiduciary duty under a claim for aiding and abetting. This article concludes that law firms should take precautionary measures to advise their clients of the risks that may result from a business transaction, and make sure their clients

[4] 518 B.R. 491 (N.D. Ind. 2014).
[5] *Id.* at 503 (citing Meridian Horizon Fund, LP v. KPMG (Cayman), 487 Fed. Appx. 636, 643 (2d Cir. 2012))
[6] *Id.*; Abrams v. DLA Piper (US) LLP, 2014 WL 3361802, *7 (N.D. Ind. July 9, 2014) (holding that "the plaintiff crafted claims that are plausibly supported with specific allegations regarding the relationships and transactions between various entities involved. . . does not warrant dismissal at this stage of the proceedings").

understand the law in order to avoid disciplinary measures, such as legal malpractice, against them.

Discussion

I. Lawyer's Duty to Advise

Universally, courts have recognized that lawyers are not business consultants and thus do not owe a duty to protect their clients from making poor business choices.[7] "Lawyers have an obligation to exercise reasonable care only with respect to their legal advice."[8] One of the reasons courts have generally not held attorneys liable for failing to provide business advice is because they lack the knowledge required to give business advice.[9] If a business wants advice on whether to go forward with a business transaction, they should consult a business-consulting firm. A business firm has the requisite knowledge to be able to provide reasonable and professional business advice, unlike a law firm.

A. Lawyers' Duty to Advise Pre- Peterson v. Katten

Prior to the decision in *Peterson v. Katten,*[10] courts made the distinction between legal and business advice, demonstrating that although the line can sometimes be grey, both do not overlap. In *Abrams v. DLA Piper (US) LLP,*[11] the United States District Court for the Northern District of Indiana stated, "attorney client relationships do not include business advice given to the Debtors. Rather the lawyers had obligations to exercise reasonable care only with respect to their legal advice."[12] The court concluded that legal advice and business advice were not the

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[7] Abrams v. DLA Piper (US) LLP., 2013 WL 2634767, *6 (N.D. Ind. June 12, 2013) (holding that a law firm is not liable based on failure to provide business advice).
[8] *Id.* at *8 (quoting *In re* Greater Southeast Community Hospital Corp., 333 B.R. 506, 529 (Bankr. D.D.C. 2005)).
[9] *Id.*
[10] 792 F.3d 789 (7th Cir. 2015).
[11] 2013 WL 2634767 (N.D. Ind. June 12, 2013).
[12] *Id.* at *8

same; business advice was not included in the services that come with an attorney client relationship.[13] In circumstances where failure to consider alternative options to the business decision could lead to adverse consequences, the court stated that lawyers should provide advice on the alternatives.[14] While clients need to understand the risks with business transactions, the court only extended the obligation to advise on the alternatives where there could be adverse consequences.[15] The clients would have to demonstrate that they would have reasonably acted differently in their ultimate decision if they received the advice than if they were not provided the risks. [16]

Many courts have further held that if a debtor assumes the risk then they are just as much at fault for the results.[17] When the debtors assume the risk, they cannot bring a valid legal malpractice claim against their lawyers.[18] In *Behrens v. Wedmore*, the Supreme Court of South Dakota defined the standard to determine if a debtor had assumed the risk of one's own loss as: "a person must know that danger exists, appreciate the character of the danger and voluntarily accept such risk by having sufficient amount of time, knowledge, and experience to make an intelligent choice."[19] Many businesses have the necessary amount of knowledge and experience to make an intelligent choice without the advice of someone else. This is due to their experience over the years making business decisions. After a certain amount of years, businesses should be able to determine if the investment could potentially be a poor business decision. Businesses, even knowing the risks, still go through with the business transaction in the hope that it will

[13] *Id.*
[14] *Id.* at *9 (quoting *In re* JTS Corp., 305 B.R. 529, 552 (Bank. N.D. Cal. 2003)).
[15] *See id.*
[16] *Id.*
[17] *See* Behrens v. Wedmore, 698 N.W.2d 555, 572–73 (S.D. 2005); Peterson v. Winston & Strawn LLP, 729 F.3d 750 (7th Cir. 2013).
[18] *See Behrens*, 698 N.W.2d at 572–73.
[19] *Id.*

successfully benefit the company. The gains could be worth the risk. But if they are going to take the risk, then they have to assume the responsibility for their actions and cannot blame attorneys for failing to give business advice.[20] As stated above, lawyers are not business consultants and thus it would not be fair to hold them responsible for their clients' assumption of the risks.[21]

Courts have referred to this defense as *in pari delicto*.[22] *In pari delicto* states that when the client, in many cases the debtor, is just as much at fault for knowing the poor business situation then there cannot be a valid legal malpractice claim.[23] Businesses that have the knowledge to make their own business decisions should have known the risks of the poor business situation and thus cannot pass the blame to someone else, especially when it is an attorney who does not have the proper business knowledge to give such advice in the first place. To this extent, debtors have to assume responsibilities for their business decisions.

B. Duty to advise clients after Peterson v. Katten

The Seventh Circuit in *Peterson v. Katten* decided not to extend the holdings from several of the other courts stated above with regard to this issue.[24] The court acknowledged that lawyers are not business consultants, yet still extended the lawyer's duty to include the duty to advise clients on the risks and different legal options concerning business decisions, whether or not it would have an adverse consequence.[25] The Seventh Circuit did not stick to a bright line rule between business and legal advice.[26] The court described the duties as overlapping and interrelated to

[20] *See id.*
[21] *See* Abrams v. DLA Piper (US) LLP, *supra* n. 9.
[22] *See* Peterson v. Winston & Strawn LLP., 729 F.3d 750 (7th Cir. 2013).
[23] *Id.*
[24] *Compare* Peterson v. Katten Muchin Rosenman LLP., 792 F.3d 789 (7th Cir. 2015) *with DLA Piper*, 2013 WL 2634767, and *also with* Behrens v. Wedmore, 698 N.W.2d 555 (S.D. 2005).
[25] *See Katten*, 792 F.3d at 793.
[26] *See id.* at 791–93.

each other.[27] It is important to acknowledge, however, that the court was not holding the law firm liable for failing to give business advice.[28] The law firm was held liable for "failing to inform its clients of the different legal forms that are available to carry out the business and how risks differ with different legal forms."[29] The Seventh Circuit wanted to make sure that lawyers were at least advising their clients of the risks even if the clients have the requisite knowledge of business decisions which should have made them aware of the risks.[30]

Clients do not have to take the advice of their attorneys, but attorneys need to advise them.[31] For example, if the lawyers advised the clients of the risks but the client decided to take the risk and it resulted in a Ponzi scheme that led to bankruptcy, the law firm cannot be held liable. Law firms cannot be held responsible for client's poor business choices when they were informed of the legal risks and alternatives.[32] In *Peterson v. Katten*, the court held that the law firm should have known that the end result of entering into a potential Ponzi scheme was bankruptcy.[33] There, it was alleged that the attorneys "did not recognize the risk from the combination of no contacts and no direct payments, plus the potential that all paperwork purporting transactions with Costco had been forged."[34] The court found these indicators should have alerted any competent transactions lawyer to the possibility of fraud.[35] "Advising clients how best to maintain security for their loans using legal devices is a vital part of a transactions lawyer's

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[27] *See id.*
[28] *See* Peterson v. Katten Muchin Rosenman LLP., 792 F.3d 789, 791–93 (7th Cir. 2015).
[29] *Id.* at 793.
[30] *See id.*
[31] *See id.*
[32] *See* Peterson v. Katten Muchin Rosenman LLP., 792 F.3d 789, 791–93 (7th Cir. 2015).
[33] *See id.* at 793.
[34] *Id.* at 790. "There were two forms for the security for the Funds' advances: paperwork showing inventory Petters furnished and a lockbox bank account into which Costco would deposit its payments for the Funds. However, Costco never actually put money into the account. All of the money came from a Petters entity. The setup left the Funds at Petters's mercy and Petters never actually had any dealings with Costco." *Id.*
[35] *Id.* at 791.

job."[36] The court in *Peterson* held Katten should have explained to the Funds "how to structure the transactions in a less risky way."[37] The transactions between the debtors and the defendant who defrauded the debtors should have triggered to the lawyers that the process by which the money was being transferred was possibly a Ponzi scheme and could result in bankruptcy.[38] As a result, the court held that the law firm should have at least given the debtors advice on the legal ramifications that would result from entering into a business transaction that was not favorable to their clients.[39]

So far, this recent holding has only been used by the Seventh Circuit. The prior holdings, however, are not far off from the reasoning in this case, and it is possible that other circuits will follow this line of reasoning. In order to avoid the potential for legal malpractice claims in cases where clients are entering into business decisions that are likely not favorable to clients, law firms should follow the ruling set forth in *Peterson v. Katten*.[40] It does not create a high burden on law firms to give clients the legal advice on the risks and alternatives associated with their business decisions. The advice given is in regards to the different legal forms that may be associated with business transactions. The extent of business knowledge required by *Peterson* is only to recognize if the transaction has the potential to be unfavorable and advise accordingly.

Law firms should advise on the possible legal outcomes that generally result from poor business transactions, even if the firm does not have the requisite knowledge to know if the decisions could be adverse to their client.[41] Because the court in *Peterson* imposed this duty to advise clients on potential legal ramifications, a transactional lawyer should provide their clients

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[36] *Id.* at 792.
[37] *See* Peterson v. Katten Muchin Rosenman LLP., 792 F.3d 789, 793 (7th Cir. 2015).
[38] *See generally* Peterson v. Katten Muchin Rosenman LLP., 792 F.3d 789.
[39] *See id.* at 793.
[40] *See id.* at 791–93.
[41] *See id.*

with the risks, even if they are not certain of what the business decision will definitely result in.[42] For example, a client could make a poor business decision and either knowingly or unknowingly enter into a Ponzi scheme.[43] If an attorney becomes aware of a possible problem with the security for advances, such as the no contact and no direct payment in *Peterson*, then the attorney should advise the client of the legal risks associated with that business transaction.[44] As part of the services provided, lawyers can make clear that they are in no way providing business advice as such is not a duty they owe to them. Although it is an extra step for lawyers to take, it would be better to advise their clients of the risks then to possibly face a legal malpractice suit.

II. Routine Legal Services Cannot Constitute the Substantial Assistance Required For an Aiding and Abetting Claim

Law firms that advise or assist their client in breaching a fiduciary duty can be held liable for aiding and abetting that breach of fiduciary duty.[45] To state a claim for aiding and abetting a party must show the following:

(1) The party whom the defendant aids must perform a wrongful act which causes an injury;
(2) The defendant must be regularly aware of his role as part of the overall or tortious activity at the time that he provides the assistance;
(3) The defendant must knowingly and substantially assist the principal violation.[46]

To determine if the assistance is enough to establish liability under aiding and abetting, the court can consider the following five factors: (1) the nature of the act encouraged; (2) the amount of assistance given by the defendant; (3) the presence or absence of the defendant at the time of the tort; (4) the defendant's relation to the other; and (5) the defendant's state of mind.[47]

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[42] *See id.* at 793.
[43] *See id.*
[44] *See id.* at 790.
[45] RESTATEMENT (SECOND) OF TORTS § 876(b) (1979).
[46] Abrams v. DLA Piper (US) LLP, 2014 WL 3361802, *7 (N.D. Ind. July 9, 2014) (quoting Thornwood, Inc. v. Jenner & Block, 799 N.E.2d 756, 767 (III.App.Ct. 2003)).
[47] RESTATEMENT (SECOND) OF TORTS § 876 cmt. d (1979).

When determining whether a lawyer has provided substantial assistance in the breach of fiduciary duty, courts have decided that for the same policy reasons in prohibiting attorneys from participating in a conspiracy with their clients, attorneys can be held liable for "knowingly and substantially assisting clients in the commission of a tort."[48] The assistance must be *substantial* in order to be considered aiding and abetting. Courts have held that substantial assistance "means something more than the provision of routine professional services."[49] If the law firm provides its routine legal services to the company, even if a breach of fiduciary duty happens to occur, the firm cannot be held liable for aiding and abetting. The law firm has to have done something to help and not just fail to prevent the breach from occurring.[50] The kind of assistance required to classify as substantial assistance must be "active or direct, rather than passive and indirect."[51]

The *Abrams v. McGuireWoods* court held that there was no valid allegation that the firm, McGuireWoods, did anything more than provide what is considered routine legal services.[52] In the complaint, the plaintiff alleged that the firm substantially assisted the company's managers by "failing to take any steps to ensure Heartland received business advice, never advising Heartland's selling shareholder that they were breaching their fiduciary duties and not taking any steps to protect Heartland from the breach."[53] However, the court ruled that this did not constitute substantial assistance.[54] The court acknowledged the importance of creating a substantial assistance standard. "If the law were otherwise, it would be nearly impossible for an

[48] *Thornwood*, 799 N.E.2d at 768. "One may not use his license to practice law as a shield to protect himself from the consequences of his participation in an unlawful or illegal conspiracy." *Id.*
[49] Abrams v. McGuireWoods LLP, 518 B.R. 491, 503 (N.D. Ind. 2014) (citing Meridian Horizon Fund, LP v. KPMG (Cayman), 487 Fed. Appx. 636, 643 (2d Cir. 2012)).
[50] *Id.*
[51] *Id.*
[52] *McGuireWoods*, 518 B.R. at 503.
[53] *Id.* at 504.
[54] Abrams v. McGuireWoods LLP, 518 B.R. 491, 504 (N.D. Ind. 2014) (stating that the inaction does not constitute substantial assistance because "silence, inaction, or failure to investigate does not constitute substantial assistance" (quoting El Camino Res., LTD. v. Huntington Nat'l Bank, 722 F.Supp.2d 875, 914 (W.D.Mich. 2002)).

attorney, no matter how scrupulous to avoid liability for a client's misdeeds."[55] The interpretation of "substantial assistance" was more restrictive on liability than expansive.[56]

It is important to note that not all jurisdictions follow this rule; some dissent from this rule. In California, for example, the courts have held that "ordinary business transactions can constitute substantial assistance so long as the aider and abettor knows the services will help their client commit the breach."[57] In *McGuireWoods*, Indiana had not decided the issue before, so the court decided not to follow an expansive interpretation creating more liability.[58] New York courts have held that it is insufficient to show substantial assistance when the law firm's acts "fall within the scope of their duties as counsel."[59] New York has expanded more on the importance of the "knew or should have known" element for aiding and abetting.[60] The courts in New York have held that for actual knowledge, the fact that the lawyers should have known is only enough for constructive knowledge not actual knowledge.[61] To be sufficient, the plaintiffs would have to demonstrate the lawyers knew or should have known coupled with specific allegations of actual knowledge.[62]

In general, law firms that act within the scope of their employment and follow the duties owed to their clients will not be found liable for aiding and abetting. In jurisdictions where even ordinary business transactions can constitute substantial assistance, law firms need to be aware that there is a chance of being held liable for aiding and abetting if they have actual knowledge

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[55] *Id.*
[56] *Id.*
[57] *See* Casey v. U.S. National Bank Ass'n, 26 Cal.Rptr.3d 401, 406 (2005).
[58] Abrams v. McGuireWoods LLP, 518 B.R. 491, 504 (N.D. Ind. 2014).
[59] Lumen at White Plains, LLC v. Stern, 2016 WL 237578, *1 (N.Y. App. Div. Jan. 21, 2016). "Further, plaintiffs' allegations that defendants failed to act are insufficient to show 'substantial assistance,' as plaintiffs do not sufficiently allege that defendants had a duty to act to protect plaintiffs' interests." *Id.*
[60] *See* Gregor v. Rossi, 120 A.D.3d 447, 448 (N.Y. App. Div. 2014).
[61] *See id.*
[62] *See id.* at 449 (quoting Weinberg v. Mendelow, 113 A.D.3d 485 (1st Dept. 2014)).

that their services will help their clients commit a breach of duty. "Silence, inaction, or failure to investigate does not constitute substantial assistance."[63] Further, knowing of a violation combined with inaction is still not enough to constitute substantial assistance.[64]

In the case of transactional lawyers, a big part of the legal services provided is papering the deal. As long as it is merely "papering the deal," law firms will not encounter a substantial assistance problem, even if the result does end in a breach of fiduciary duty.[65] For example, in *Abrams v. McGuireWoods*, the court held the firm merely papered the deal when it "performed the legal work necessary to structure and document the merger and provided the legal services necessary to negotiate and document the merger."[66] If a transactional law firm remains within these types of services, necessary in any complicated transaction, then the lawyers' actions will not be enough to constitute a basis for liability.[67]

Conclusion

For law firms representing business corporations and clients involved in business transactions, the firm needs to be especially aware of the duties they owe to their clients. This expansion on their legal duty to clients presents a low burden to lawyers compared to the risks of a legal malpractice claim. By simply advising of the risks, lawyers will avoid liability to every client that will claim their poor business decision that resulted in bankruptcy was all at the fault of their attorneys for not providing the risks. By giving advice of the risks it puts the client on notice and if they decide to go through with the transaction which later causes bankruptcy, the fault is on the client not the attorney. Because this duty to advise has become part of the routine

[63] El Camino Res., LTD v. Huntington Nat'l Bank, 722 F. Supp. 2d 875, 914 (W.D.Mich. 2002).
[64] *See* Benford v. City of Minneapolis, 2012 WL 6200365, at *6 (D.Minn. Dec. 12, 2012).
[65] *See* Abrams v. McGuireWoods LLP, 518 B.R. 491, 504 (N.D. Ind. 2014).
[66] *Id.*
[67] *See id.*

legal services attorneys provide their clients, law firms do not have to worry that these actions will constitute as “something more” for substantial assistance in connection with an aiding and abetting claim. As long as attorneys are aware of their actions and properly following their duties to clients, they will be able to avoid an aiding and abetting claim and a legal malpractice suit.