

**MATERIALS ON ETHICAL AND MALPRACTICE CONCERNS  
IN REAL ESTATE DRAFTING**

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## **Biography of Jett Hanna**

Jett Hanna is a Senior Vice President at Texas Lawyers' Insurance Exchange. His duties have included supervision of lawyers' and judges' professional liability claims, underwriting, loss prevention, and computer operations. Mr. Hanna received his B.B.A. Summa Cum Laude in Management Science and Computers from Southern Methodist University in 1980, and his J.D. from the University of Texas School of Law in 1983. Mr. Hanna is a member of the State Bar of Texas and is a Registered Professional Liability Underwriter (RPLU). He lectures and writes on legal malpractice and insurance topics. Recent publications include Threats to Client Confidentiality Lurk in Email, *Texas Lawyer* (American Lawyer Media) February 12, 2007; Selected Legal Malpractice and Ethical Issues In the Use of Current Technology, *BarTech TexasBarCLE*, 2006; How Your Staff Can Help You Avoid Legal Malpractice, *ABA Committee on Lawyers' Professional Liability*, Spring 2004. Susan Saab Fortney and Jett Hanna, Fortifying a Firm's Ethical Infrastructure: Avoiding Legal Malpractice Claims Based on Conflict of Interest, 33 *St. Mary's L. J.* 669 (Symposium: Legal Malpractice and Professional Responsibility 2002); Hanna, Purging with Prudence, *ABA Journal* (January 2001); Hanna, Moonlighting Law Professors: Identifying and Minimizing Professional Liability Risks 42 *S. Tex. L. Rev.* 421 (Spring 2001); Hanna, Handling the Initial Stages of a Claim, printed in *The Lawyers' Desk Guide to Preventing Legal Malpractice* (ABA Standing Committee on Lawyers' Professional Liability, 1999); and Hanna, Legal Malpractice Insurance and Limited Liability Entities: An Analysis of Malpractice Risk and Underwriting Responses, 39 *S. Tex. L. Rev.* 641 (March 1998).



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## Real Estate Closing Practice

By Jett Hanna

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Texas has long had a unique system of real estate closing. This article discusses that system, and what the professional liability risks are for lawyers engaged in real estate closing practices.

### Lawyer Involvement with Title Insurance

Lawyers can be involved in real estate closings in a number of ways. Lawyers may represent parties to the closing, yet not perform the closing. Lawyers are permitted to close transactions on behalf of a title company, subject to particular regulations. Lawyers may own title companies that close transactions. It is not unusual to find some combination of these methods of involvement.

Title insurance is utilized in the vast majority of real estate transactions in Texas. The Title Insurance Basic Manual (“the Manual”) promulgated by the Texas Department of Insurance (TDI), available online at <http://www.tdi.state.tx.us/company/titlemm4.html>, describes the structure of the title insurance industry. Title Insurance Companies stand behind title insurance policies, and usually have authorized Title Insurance Agents who conduct investigation of title and supervise the closing of transactions. Some Title Insurance Companies have direct operations conducted without the use of a distinct entity as agent. Agents and direct operations companies will be referred to in this article collectively as “title companies.”

Escrow officers are individuals who are entitled to close transactions on behalf of title companies. Escrow officers countersign title insurance forms, supervise the preparation and the delivery of title insurance forms, sign escrow checks, and close transactions. Escrow officers who are not attorneys must be licensed by TDI, but attorneys can close transactions without being licensed as an escrow officer. When an attorney is a licensed escrow officer, the attorney may use the name of the title company in their law practice and have employees who are licensed escrow officers. Licensed escrow officers, whether attorneys or bonafide employees of attorneys, must be appointed by a title company.

With permission of a title insurance agent, a lawyer may close transactions without being an escrow officer and receive a fee from a title agent or direct operation. The payment of lawyers who do not have an escrow officer’s license is regulated by Section IV, Procedural Rule P-22. P-22 prohibits payment for closing or title examination to anyone who is not a bonafide employee of a direct operation, agent or escrow officer with certain exceptions. Those exceptions include attorneys who perform closing or title examination services. P-22 requires that the fee paid to attorneys be disclosed on form T-00, that the attorney actually perform services, that a schedule of fees be filed with the title company in advance, all premiums must be remitted to the title company, and no charge by the attorney can be a fee for referring business to a title company.

When an attorney is a licensed escrow officer and chooses to use the name of a title company in his practice, such an operation is known as a fee office. It is not unusual for such operations to have a number of licensed escrow officers who are not lawyers. In general, fee offices are established with an agreement between a title agent or direct operation and a lawyer or law firm. Most fee office agreements now require some level of errors and omissions insurance. TLIE can insure some of these operations, so long as the fee office has adequate supervision of any non-attorney licensed escrow officers who perform closings. TLIE evaluates the ratio of lawyers to escrow officers in the underwriting process. TLIE also looks at the experience of the attorneys involved in such operations. One recent set of claims at TLIE arose when an inexperienced attorney closed a series of real estate transactions in what was alleged to be an improper manner.

Recent actions by TDI have made it almost impossible for P-22 lawyers to perform closings without some type of errors and omissions insurance. Most national lenders now require Insured Closing Letters (ICLs) for every closing. In the past, only large transactions had ICLs. An insured closing letter means that the title insurance company, and not just the local agent, is responsible for fraud in the course of a real estate closing. Commissioner's Bulletin #B-0017-07 issued on April 18, 2007, online at <http://www.tdi.state.tx.us/bulletins/2007/cc14.html>, has indicated that ICLs cannot be issued for transactions closed by P-22 attorneys through their own trust accounts. They must use title agent escrow accounts, and thus must have an escrow officer's license if an ICL is to be issued. Title companies frequently require that all escrow officers they designate have errors and omissions insurance. One effect of this bulletin has been that more attorneys are applying for or increasing malpractice insurance limits so that they can become licensed escrow officers for title agents.

Attorneys who work with title companies need to be aware of professional liability insurance issues that affect them. Some policies have title insurance agent riders, some specifically cover lawyer activities on behalf of a title insurance agent, and some specifically exclude such work. TLIE's policy provides coverage for lawyers providing legal services while acting as an escrow agent. Many policies exclude coverage for legal services related to businesses owned by insureds. When a lawyer owns a title company, such exclusions may apply to any legal work provided to parties to closings at the lawyer's title company.

### **Ethical and Malpractice Risks in Closing Transactions**

Documenting who is and is not the client is a critical step for lawyers involved in closings. "Closing" the transaction is a title company function, so a closing attorney represents the title agent or direct operation, as noted in Texas Ethics Opinion 408, online at [http://www.txethics.org/reference\\_opinions.asp?opinionnum=408](http://www.txethics.org/reference_opinions.asp?opinionnum=408). Whenever there are unrepresented parties to the closing, which is the case in most closings, a document clarifying that the lawyer closer represents only the title company is critical. Lawyers do not "represent the situation" when closing transactions.

Ancillary legal services are often provided by lawyers beyond the scope of the closing function. The most common of these is drafting of legal documents related to a closing, such as contracts, deeds and mortgage instruments. On occasion, clients ask that lawyers perform the closing for a portion of title insurance premium and discount or eliminate their fee for other legal services provided in connection with a real estate transaction. Providing ancillary legal services creates ethical risks that lawyers must evaluate fully.

When lawyers own title agents and provide legal documents for closings, there is often a danger that lay persons are becoming involved in unauthorized practice of law. In *Amarillo Abstract and Title vs. Unauthorized Practice Committee*, 332 S.W.2d 349 (Tex. Civ. App.—Amarillo 1960), the court determined that if the lawyer adequately separated his law practice from title operations then no unauthorized practice was likely to occur. The lawyer in that case disclosed his relationship to the title agent to his clients, did not channel legal work to his legal practice from the title business and specifically instructed his title employees not to do so, maintained separate books for the title company and the law practice, did not share fees from the law practice with title employees, and typed his own documents. Keeping title and legal operations separate avoids claims of unauthorized practice.

Both lawyer owned title agents and fee offices face other ethical risks when providing documents for real estate transactions. The title company is probably not authorized to provide legal documents drafted by its lawyer since that would be corporate practice of law. See *Hexter Title & Abstract Co. v. Grievance Committee*, 142 Tex. 506, 179 S. W.2d 946 (Tex. 1944) (title company cannot practice law by rendering legal services to third parties). The title company is thus probably not the client with respect to drafting of legal documents.

When legal documents and ancillary services are provided by any lawyer closing a transaction on behalf of a title company, the situation should be analyzed as a multiple representation of clients. If a closing lawyer is providing documents to one or more parties to the closing, then the lawyer must “reasonably believe... the representation of each client will not be materially affected” by the multiple representation. Texas Disciplinary Rules of Professional Conduct Rule 1.06(c)(1). If this threshold is met, then the lawyer must obtain consent from the potential clients to the multiple representation and disclose the possible adverse consequences and advantages of the representation. Texas Disciplinary Rules of Professional Conduct Rule 1.06(c)(2).

The nature of the potential adverse consequences from multiple representation in closings can vary widely. In the vast majority of transactions commercial lenders will have their attorneys draft deeds and mortgage documents, eliminating any potential conflict for the closing attorney. In less routine transactions, however, it is common for closing lawyers to be called upon to draft notes, deeds, deeds of trust and curative documents. Escrow agents have fiduciary duties to multiple parties in the transaction. One of the risks is that the lawyer will discover something in the course of closing that aids or affects only one party to the transaction. If it is not disclosed to appropriate parties, the lawyer may violate the duties owed by the title company.

Another potential conflict arises from how the lawyer is paid in closings. Generally, lawyers and fee offices are paid a portion of the premium charged by the title company. The lawyer only gets paid if the transaction is completed. When the lawyer represents a party to the transaction, it may appear to be in his or her best interest to make sure the deal is completed rather than raising issues that might stop the transaction. Since the title company also is paid only if the transaction is completed, the potential for conflict is significant.

Lawyers who operate fee offices have the same obligations to supervise staff as other lawyers. Lawyers must instruct their non-lawyer staff, including escrow officers, about the ethical aspects of their jobs and must supervise their work. In some cases, it appears that lawyers with little experience in the title business hire an escrow officer and let them run a title operation with little supervision.

## Arbitration Clauses in Fee Agreements

By Jett Hanna

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Arbitration clauses in fee agreements have been used by many Texas lawyers. This article will discuss the state of the law regarding the validity of such agreements, and will note some of the practical issues that should be considered before including such agreements in contracts with clients.

### The Law

Texas law permits use of arbitration clauses in client fee agreements. The Texas Supreme Court compelled arbitration of a legal malpractice claim under an arbitration clause in a fee agreement in *Porter Clements v. Stone*, 935 S.W. 2d 217 (Tex. 1996). In subsequent cases, there is a split of authority in the Texas courts of appeal over whether legal malpractice can be exempted from arbitration as a “personal injury” claim. In *Taylor v. Wilson*, 180 S. W. 3<sup>rd</sup> 627 (Tex. App.-Houston (14<sup>th</sup> Dist) 2005, writ denied), the court found that a legal malpractice claim with mental anguish allegations is not a personal injury. Most other appellate courts have reached the same conclusion as the Taylor court. In the exception, the Corpus Christi court of appeals determined that a claim of legal malpractice in a medical malpractice case did qualify as a personal injury and that arbitration could not be compelled. *In re Godt*, 28 S.W.3d 732, 738-39 (Tex.App.-Corpus Christi 2000, no pet.) Nationally, courts and ethical opinions have on occasion invalidated arbitration clauses for a number of reasons.

No Texas opinions address the validity of arbitration agreements applicable to malpractice claims under the rules of ethics. In ABA Formal Ethics Opinion 02-425, the ABA approved of such arbitration agreements with regard to malpractice claims, but only if certain disclosures are made to the client. The ABA opinion requires the lawyer to advise the client that the arbitration clause waives right to trial by jury, appeal, and broad discovery. Several state ethics opinions have placed additional restrictions use of arbitration agreements. In Alabama, for example, an arbitration clause including malpractice claims is unethical unless the client is independently represented when signing it. Alabama Ethics Opinion 2002-4 (November 2002). Since it is not unusual for Texas attorneys to work in other states and there are no Texas ethics opinions on arbitration agreements, it is prudent to consider the analysis of ethics opinions in other jurisdictions in drafting arbitration clauses.

It should be noted that arbitration clauses confined to fee issues are generally treated more favorably than broader clauses including malpractice claims by courts nationwide. Many bar associations have established fee arbitration procedures on a voluntary basis. Comment 19 to Rule 1.04 of the Texas Disciplinary Rules of Professional Conduct states that

If a procedure has been established for resolution of fee disputes, such as an arbitration or mediation procedure established by a bar association, the lawyer should conscientiously consider submitting to it.

Keep in mind that malpractice claims are mandatory counterclaims in a fee dispute. Utilizing voluntary bar fee dispute facilities may avoid such counterclaims.

### Practical Concerns

While arbitration has been hailed as a method for reducing the costs of litigation, in practice arbitration results are sometimes perceived as unfavorable. From a cost standpoint, the cost of the arbitrator or arbitrators can be significant. Many arbitration clauses call for a panel of three arbitrators—two appointed by the interested parties, and a third neutral arbitrator picked by the non-neutrals. Hourly fees for

arbitration, which are not incurred in a court trial, can be significant. The cost of discovery often is not significantly reduced by arbitration, particularly if there are complicated disputes requiring many rulings from the panel.

Another potential problem with arbitration is the lack of appellate remedies. While this may reduce costs, when the decision is very unfavorable to a party, there is little recourse. At TLIE, we have noted in some cases what seems to be a “split the baby” effect. Some arbitrators seem less willing to grant the equivalent of summary judgments that might be granted in a judicial setting. Perhaps this is because of the near impossibility of appellate review.

One recent Texas arbitration matter has raised concerns about the use of arbitration clauses in fee agreements. In this matter, lawyers had disputes with clients in mass tort litigation over expenses. The clients invoked the arbitration clause in fee contracts to essentially create a class action. Many observers of this particular matter have argued that class action status would not have been granted in a judicial setting based on recent Texas court decisions. The arbitrators in this situation required the lawyers to return certain amount collected as expenses, and to return a portion of fees based on breach of fiduciary duty.

Should you use arbitration clauses?

Arbitration clauses may or may not be right for your practice. We suggest the following steps in deciding whether and how to use arbitration clauses.

1. On a nationwide basis, arbitration clauses appear to be more likely to be upheld when dealing with sophisticated clients.
2. Follow ABA Opinion 02-425 if you choose to use an arbitration clause that includes malpractice claims, including:

Making the arbitration clause conspicuous

Warning about loss of right to trial by jury, broad discovery, and appeal

3. Be specific if you intend an arbitration clause to include malpractice claims. Some courts have found failure to specify malpractice in the list of matters that can be arbitrated as a reason to deny arbitration.
4. Consider including a provision advising the potential client of their right to seek counsel to review the arbitration clause.
5. Check the law of states where you may ultimately try to enforce the clause. Federal arbitration law does not always apply to arbitration agreements in attorney fee agreements. Note that the Porter case cited above found that the Texas Arbitration Act applied, not federal law.
6. Consider the procedure to be used carefully. Don't create a clause which might entail higher costs than you expected.
7. Don't try to make an arbitration agreement after you begin representing a client, or after a claim has been suggested, unless the client is represented by other counsel.
8. Don't assume that you are better off in arbitration just because you will be in a defensive situation. While judges and juries are sometimes unkind to lawyers, there are many checks on their powers. Make sure you can live with the lack of appellate and judicial checks inherent in arbitration.

## **Avoiding Malpractice with Proper Documentation**

**By Jett Hanna**

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Lawyers frequently fail to take the advice they give most often. The heart of most client consultations outside a litigation context is creation of proper documentation. Documentation suggested by a lawyer generally accomplishes several things for a client:

- Documenting can provide a checklist of things that should be done.
- Documenting can avoid difficulties with human recall.
- Documenting provides an opportunity to create good evidence in advance of a problem.
- When a bona fide problem arises, documentation often allows a matter to be resolved more quickly.

The need for documentation to avoid the legal consequences of a malpractice claim is similar. This article will discuss several of the most common types of documentation that we like to see in a legal malpractice case.

### **Before representation**

Lawyers need a client intake form for several reasons. Client intake forms permit the lawyer to gather critical information necessary to decide whether or not to engage in the representation. Firms may have types of cases they do not want to take, and gathering information related to intake policies is an important step. Potential conflicts of interest can be identified based on information gathered on intake forms.

Client intake forms should not ask for every bit of information needed to carry out representation, but should instead be focused on gathering information sufficient to decide if the lawyer is willing to receive confidential information. Once confidential information has been received, a potential client is entitled to protection of the confidence, even if the lawyer subsequently rejects the matter.

If the lawyer declines to take a matter, the declination should be documented with a letter to the declined party. Many malpractice claims arise out of apparent misunderstandings about whether a lawyer has decided to accept the engagement.

### **Commencement of representation**

If a lawyer decides to accept a matter, documentation is critical. The heart of an engagement letter or client contract should focus on:

- Client identity
- Scope of the engagement
- Fee arrangements
- Disclosure and consent to potential conflicts

Establishing client identity in initial documentation forces a lawyer to analyze confusing client situations up front. For example, when a group of persons seeks to form a corporation, the lawyer can determine whether one or more of the individuals should be the client, and can analyze if individual needs may conflict with the corporate interest. Another common situation that can be addressed is when a third party is paying for the legal services. A letter to the third party disclaiming any attorney client relationship can avoid claims that the lawyer failed to act in the interest of the third party. Establishing client identity may require disclaimers of representation as well as affirmative statements of identity in an engagement letter or contract.

The scope of the engagement must be established early, and may need to be altered as a matter progresses. The scope of engagement includes a definition of the tasks to be undertaken by the lawyer, the client, and by third parties. If the client has been warned in the engagement letter about the work they will have to do in connection with discovery, the chances that the lawyer will be sanctioned for the client's lapses diminishes. When the services of an accountant are necessary to obtain the benefit of a tax reduction strategy such as formation of a Subchapter S corporation, including this in the scope of engagement documentation can avoid lawyer liability for the accountant's errors.

Documenting the fee agreement is always a good idea, but is often required by the disciplinary rules as well. Contingent fee agreements must be in writing. Even when not required by the rules, the rules do suggest that putting fee arrangements in writing is preferable. Fee issues often are a prelude to client dissatisfaction and malpractice claims. When clients have multiple opportunities to understand the basis of fees, they are less likely to become dissatisfied and consider malpractice claims.

Documenting disclosure and consent to potential conflicts is not always required by the disciplinary rules, though it is required in certain situations. Even when not required, relying on oral discussion of potential conflicts is dangerous, as the client's recollection is almost guaranteed not to match the lawyer's recollection.

When client identity, scope of representation, fee arrangements and potential conflicts are documented, the lawyer must then act consistent with the documentation to gain full benefit of that documentation. Giving off hand advice beyond the scope of the initial representation after creation of the documentation can change the scope of the lawyer's responsibilities. The issues addressed by engagement letters and contracts should be reconsidered as circumstances change. Too often, lawyers fail to understand that subsequent events can render terms of an engagement document meaningless. Addition of new parties to litigation should force a re-examination of conflict issues, for example.

### **Documentation during representation**

As suggested above, initial documentation may need to be revisited during the representation. When unrepresented parties are encountered during the representation, it may be necessary to inform them that they are not clients and should seek separate counsel.

The advice given during representation should usually be documented. Clients may better understand the advice given if it is in writing as well as orally. In some cases, the client is given a range of alternatives and potential consequences. Making clear that there are advantages and disadvantages to various strategies can avoid claims that the lawyer failed to recommend a particular course of action.

One of the most critical times that advice should be documented is when it appears the client will not follow the advice. What will be remembered if your advice is oral is that you were the lawyer, and not that you advised the client differently than they acted.

### **Concluding representation**

Whenever representation concludes, a letter clearly stating that no further services will be provided in connection with the matter is critical. Whether the matter has come to a natural conclusion or amounts to a withdrawal, it is important to make clear that the client must seek to engage the lawyer on any subsequent matter and that the lawyer is not assumed to be some sort of general counsel, if that is not the lawyer's role.

When concluding a matter, a lawyer should detail what the client must do to obtain the benefits of representation and matters that must be addressed later. When a lawyer withdraws from a matter, the

lawyer should provide the client with a detailed description of the status of the matter and urge them to seek other counsel.

If a lawyer firm has a file destruction policy, notify the client in a conclusion letter about when the file will be destroyed unless they want it. This can avoid the need to track down clients later.

## What is a conflict?

By Jett Hanna

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The following is a brief, limited review of the law of conflicts of interest in Texas. Should you have a question about a particular situation, please review applicable rules and case law. All rules cited below are the Texas Rules of Professional Conduct.

### **Conflicts between current clients (simultaneous representation).**

An attorney may not represent two or more clients simultaneously if the matters are "substantially related" and the clients' interests are "materially and directly adverse." Rule 1.06(b)(1). Representing opposing parties in litigation is strictly forbidden. Rule 1.06(a). Disclosure and consent to these conflicts will not change the prohibition, even if a suit between parties is "friendly."

A lawyer may not represent two or more clients simultaneously if representation of a client "reasonably appears to be or becomes adversely limited" by the lawyer's responsibility to the other clients. Rule 1.06(b)(2); see Rule 1.07(a)(2 and 3). If the lawyer reasonably believes that the representation of each client will not be materially affected, the clients can consent to the multiple representation after "full disclosure of the existence, nature, implications and possible adverse consequences of common representation and the advantages, if any." Rule 1.06(c); see Rule 1.07(a)(1). A lawyer who has engaged in multiple representation cannot later represent any of the parties in a later dispute arising out of the matter without the consent of all of the parties. Rule 1.06(d), 1.07(c).

Disclosure and consent often fails to insulate an attorney from malpractice claims. A dispute often arises about whether the lawyer reasonably believed that the representation of each client would not be materially affected by the conflict. The sufficiency and clarity of disclosure is often questioned. Almost no lawyer can anticipate every scenario, and juries often side with clients on the issue of sufficiency.

Some commentators have suggested that the rule permitting representation of one client in a later dispute permits obtaining such consent at the outset of the multiple representation. Whether this interpretation is accurate or not, if the clients' interests were materially and directly adverse at the outset, the consent does not cure the conflict.

### **Conflicts between current clients and former clients (successive representation).**

Representation of a client in a matter materially adverse to a former client is prohibited if the attorney's previous work is in question, if confidential information of the former client could be revealed or used in the representation, or if the matter is the same or substantially related. Rule 1.09(a). Consent of the former client waives this type of conflict. Rule 1.09(a). As a practical matter, however, the former client may claim that the attorney advised them as to the prudence of entering into such consent, creating a current conflict of interest or allegation of malpractice not subject to the former client rule. Successive government and private employment is subject to special conflict rules. Rule 1.10.

### **Conflicts between the interests of the attorney and a client.**

An attorney may not represent a client if the clients' interests are "materially and directly adverse" to the interests of the attorney or his firm. Rule 1.06(a)(1). Disclosure and consent to this type of conflict does not remove the prohibition.

A lawyer may not represent two or more clients simultaneously if representation of a client "reasonably appears to be or becomes adversely limited" by the lawyer's or law firm's own interests. Rule 1.06(a)(2). Disclosure and consent can theoretically cure this type of conflict, Rule 1.06(c), but juries often find decide adversity and sufficiency issues in favor of the client.

A number of specific rules prohibit certain types of transactions between an attorney and a client. Business transactions with clients are prohibited unless several specific conditions are met. Rule 1.08(a). A lawyer cannot prepare an instrument which gives the lawyer or a close relative a gift, unless the lawyer is preparing the instrument for their own relative. Rule 1.08(b) Media rights of a client, financial assistance to a client, payment for services from third parties such as insurers, aggregate settlements, aggregate pleas, prospective limitations on liability, and acquisition of proprietary interests in litigation are all subject to special conflict rules. Rules 1.08(c-h).

### **Imputed conflicts.**

The imputed conflict rule is quite harsh in Texas. In general, "if a lawyer would be prohibited" by one of these rules "from engaging in particular conduct, no other lawyer while a member of the firm may engage in that conduct." Rules 1.06(f), 1.07(e), 1.08(i). Court decisions in Texas have not provided any exception for the creation of "Chinese Walls" shielding new attorneys from receipt of confidential information, though such Chinese Walls have been approved when non-attorney firm personnel are involved.

The former client rule modifies the general imputed conflict rule slightly, but the impact is similar. No attorney may represent a client if any other lawyer in the firm is prohibited from doing so by the former client rule. Rule 1.09(b). If an attorney prohibited from representing a client under the former client rule leaves a firm, other attorneys in the firm who did not personally represent the former client may represent a client against the former client only if the prior attorney's work is not in question and a breach of confidences is unlikely. Rule 1.09(c). If the attorneys at the prior firm have discussed, viewed or retained confidential information in files about the former client, a breach of confidentiality might occur. Rule 1.09, Comment 6. Courts have mandated disqualification in former client situations despite apparent permission granted by the former client conflict disciplinary rule. Malpractice claims are common when firms decide former client conflicts in favor of adverse representation.

## Conflict Avoidance Systems

By Jett Hanna

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Conflicts of interest are the "silent killers" of legal malpractice. A 1999 ABA study of legal malpractice claims indicates that conflict of interest was the primary alleged error in only 5.12% of legal malpractice claims. TLIE's statistics indicate, however, that conflicts often are alleged in conjunction with other errors. In a study of TLIE's claims between 1996 and 2001, 16.4% of all claims reflected an allegation of conflict of interest, with 22.5% of all losses and defense costs involved a conflict of interest.

Conflicts of interest are often treated harshly by the judicial system. Trial advocates for clients frame conflicts as issues of loyalty, and juries can react severely to perceived betrayal. As a result, conflict claims can exacerbate any small mistakes, or even close calls, made by an attorney.

This article makes basic practical suggestions regarding avoidance of conflicts of interests through systematic practices. While following these practices cannot guarantee avoidance of conflicts, they can increase awareness of conflicts and minimize their impact.

### Formulate policies first

Before a firm creates conflicts of interest avoidance procedures, the firm's goals in creating the system should be considered. Almost every lawyer and firm wants to avoid the fallout from grievances and malpractice claims, but other considerations are important for a workable system. Lawyers want to have a conflict system that is not too burdensome or expensive, and want to be able to give potential clients quick responses to requests for representation. "Conflicts" to be addressed by a system may well exceed the scope considered in analyzing liability exposure and disciplinary risk. A firm may wish to avoid certain types of representation to concentrate on a particular kind of expertise. A system designed to help avoid conflicts can serve other firm goals such as avoiding risky types of practice and clients who are likely to be dissatisfied.

### Develop Necessary Information

One of the basic purposes of a good conflict system is to provide information sufficient to analyze whether a potential conflict exists. Analyzing potential conflicts of interests requires knowing the relationships among parties. The information needed to identify relevant relationships can come from several sources.

*Client knowledge.* An interview of the client prior to acceptance of a matter can establish critical information regarding potential conflicts. Such information includes the exact name of the potential client and the relationships the client has that are relevant to analyzing conflicts and potential conflicts. In order to avoid later conflicts based on the potential client's disclosure of privileged information, the information obtained for initial conflict checks should be the minimal information necessary. In some cases, client knowledge may be incorrect and should be verified early in representation. As errors are discovered, potential conflicts need to be re-examined. As a matter develops, new relationships may need to be analyzed.

*Firm knowledge.* Firm knowledge can come from a variety of sources within the firm, including files concerning previous representations and the general knowledge of firm members. Such knowledge can be made more accessible through searches of databases maintained by a law firm and memoranda circulated among firm members prior to accepting a new matter.

Critical to the establishment of an appropriate firm database are rules designed to assure that information is entered into the database at appropriate times and to assure that reports of relationships are prepared. One effective method to enforce conflict checking is for the accounting department to prevent billing on a matter until database entries are made and reports reviewed. This method should not, however, mean that conflict checking should be considered an accounting task. In a firm audit, TLIE discovered that an insured used its accounting system to check conflicts. Many types of relationships that could result in conflicts were not entered. Rather than entering all adversaries in litigation matters, "et. al" was entered. In transactional matters, adverse parties were not entered at all.

Attorneys often think narrowly about the type of information that can assist in avoiding conflicts. Most firms understand that the database should include clients and adversaries, but fail to understand the importance of other relationships. For example, a lawyer's own investments could create a serious conflict of interest with a new client. It could be embarrassing, and possibly expensive, for a firm to undertake representation adverse to a business interest owned by another firm member. The inset below provides a list of types of relationships that a firm should consider including in its database.

Items to consider including in firm conflict databases

- attorneys and staff of the firm
- prior law firms of attorneys and staff of the firm
- business and organizational interests of attorneys and staff
- clients
- clients of attorneys and staff at prior law firms
- persons declined as clients
- adverse parties
- co-plaintiffs or co-defendants
- witnesses and experts
- persons named in wills and transaction documents
- subject matter of representation
- known allies and competitors of either clients or adverse parties
- known relatives of anyone listed in the database
- corporate parents or subsidiaries of entities in the database
- trade names of entities in the database
- directors and officers of entities in the database
- partners or known shareholders of entities in the database
- third parties financing representation, such as insurers
- known employees of entities in the database
- attorneys for any party in the database

Conflict database software should support flexible input and reporting. Soundex and wildcard search options help avoid errors in spelling. The software should allow creation of categories considered critical by the firm, not just client and adversaries. Case management software often provides powerful conflict database searching and reporting capabilities. Larger firms may need to consider specialized conflict software capable of integrating case management information utilized in various sections of the firm.

While a solo practitioner has little need for a new matter memoranda, having a database is still critical. Reliance on memory alone is foolhardy. Even an attorney with a perfect memory today may not have such a perfect memory tomorrow. Also, if a solo later joins a firm, having a database of prior clients will make conflict checking processes much easier.

New matter memoranda provide a way to tap information about relevant relationships that has not been entered into a firm database. As with the client knowledge gained, the new matter memoranda should

require as little confidential information as possible, but provide firm personnel with enough information about proposed representation to allow an initial analysis of potential conflicts. As new information is obtained about other relationships, the names of the related parties should be circulated as well.

Deadlines for review of new matter memoranda should be considered. Some sources recommend review of new matter sheets by all firm personnel within 24 hours, but far more common is a policy which assumes no conflict if a response is not sent within a short period of time. Unfortunately, timely attention to new matter memoranda is hard to achieve.

*Extrinsic knowledge.* In certain circumstances, the risk posed by conflicts of interest may justify research regarding relationships between a client and other persons related to the firm. A representative of a large public corporation may be unaware of critical relationships that can affect conflict analysis, such as the identity of subsidiaries and constituents. Many firms are now conducting some level of extrinsic research on their clients prior to accepting representation.

### **Analyze and Respond to Information**

A proper conflict of interest system should address how attorneys should respond to potential conflicts of interest. Depending on the nature of the potential conflict, further analysis by a conflicts committee or ethics counsel may be appropriate. For potential conflicts in matters that the firm decides to accept, written disclosure to the client and consent from the client should be required. Disclosure and consent, however, should be viewed with a skeptical eye.

Too often, lawyers view the ethics rules as simply another legal issue that they can toss aside with well reasoned legal arguments accompanied by disclosure and consent. Unfortunately, a legalistic approach often fails to consider the possible role of a lay jury in analyzing the conflict. Being on the cutting edge of conflict analysis is a dangerous place to be. Even meticulous written disclosure and consent may be judged by juries in hindsight, and few attorneys can fathom every problem that might arise.

The disciplinary rules do not always require written disclosure and consent. In legal malpractice claims, without a written disclosure and consent a lawyer may find that the client recalls that no disclosure was made or consent obtained. Juries often get to decide such fact issues, and often find in favor of clients.

Disclosure to the client should include the advantages and disadvantages of multiple representation. One of the most common reasons for entering into multiple representation is frequently ignored in disclosures, to the detriment of attorneys. Multiple representation reduces legal fees. Disclosures should indicate to the client that saving legal fees is an advantage, but should also indicate that if the attorney must later withdraw when a potential conflict becomes untenable that the legal fees incurred could be substantial.

When a firm member believes a conflict has become untenable, procedures should give the attorney support for taking appropriate actions. Review by a conflict committee or ethics counsel should be mandatory. Withdrawal from the case should be undertaken as soon as possible after identification of an untenable conflict.

### **Feedback and Education**

Conflicts systems are useless if firm personnel do not understand and use the system. It is critical that firms educate lawyers and assistants on how to use the system and why it is important. When errors are detected in the system, the firm must have clear to bring errors to the attention of management. Lawyers should be educated on new developments in conflict issues, and changes in systems may be necessary as conflict law changes

*In re Cerberus*, 164 S.W.2d 379 (Tex. 2005).

**IN THE SUPREME COURT OF TEXAS**

NO. 04-0732

IN RE CERBERUS CAPITAL MANAGEMENT, L.P., CERBERUS PARTNERS, L.P.,  
CERBERUS ASSOCIATES LLC, CRAIG COURT, INC., CRT SATELLITE  
INVESTORS LLC, AND STEPHEN A. FEINBERG, RELATORS

ON PETITION FOR WRIT OF MANDAMUS

**PER CURIAM**

JUSTICE JOHNSON did not participate in the decision.

The issue in this original proceeding is whether the trial court abused its discretion in disqualifying the relators' counsel based on a conflict of interest. Because the real party in interest executed a written waiver of any potential conflict of interest, we hold that the trial court abused its discretion and we therefore conditionally grant mandamus relief.

On January 26, 2001, WSNet Holdings, Inc., hired Vinson & Elkins ("V&E") attorney Patrick Breeland to draft an asset purchase agreement for certain assets of Classic Communications, Inc. Breeland prepared an asset purchase agreement and, on January 28, 2001, forwarded it to WSNet. The next day, WSNet instructed V&E that all work on the purchase agreement should cease.

In February 2002, a WSNet shareholder instituted a shareholder derivative suit against the relators and others, alleging that the relators had usurped WSNet's corporate opportunity to purchase assets of Classic Communications and another company, Galaxy Telecom Inc. At the inception of the derivative action, the relators contacted V&E regarding representation. Before appearing in the case, Charles Schwartz, then a partner at V&E and now a partner at Skadden, Arps, Slate, Meagher & Flom LLP, contacted WSNet's general counsel to inquire whether WSNet would waive any potential conflict arising

from V&E's prior work for WSNet. At the time of the request, Schwartz disclosed to WSNet's general counsel the factual basis of the potential conflict. WSNet's general counsel verbally agreed to waive any potential conflict of interest.

Schwartz subsequently sent a letter to WSNet's general counsel summarizing their discussion and commemorating that WSNet had "agreed . . . to waive any conflict of interest arising from" the representation of the relators in this action. The letter stated in part:

I write to confirm that, as you stated during our conversation last week, you have agreed, on behalf of WSNet Holdings, Inc. ("WSNet"), to waive any conflict of interest arising from representation of [the defendants] in the above-titled matter based on the fact that Vinson & Elkins LLP ("V&E") previously represented WSNet, Inc. in the matter described below. After full disclosure of relevant facts, you have consented to V&E representing the Defendants in the above-titled action.

WSNet engaged V&E in a limited capacity in connection with WSNet's proposed (but not consummated) acquisition of certain cable TV systems of Classic Communications, Inc. WSNet's proposed acquisition of these systems is described on pages 11 and 12 of the Petition in this matter. Cary Ferchill, then CEO of WSNet, contacted V&E attorney Patrick Breeland on a Friday in late January 2001 and requested that Mr. Breeland prepare a generic asset purchase and sale agreement in connection with WSNet's proposed acquisition of these systems. Mr. Ferchill requested that Mr. Breeland prepare this documentation over the weekend. On the following Monday, however, Mr. Ferchill informed Mr. Breeland that WSNet would not be acquiring any assets from Classic Communications, Inc. Mr. Breeland's and V&E's only participation in the transaction was to draft generic transaction documents. Mr. Breeland did not participate in any negotiations concerning the proposed transaction.

WSNet's Chief Financial Officer and Executive Vice President, Randall Jonkers, signed the letter agreement at the behest of WSNet's general counsel, to whom the letter was addressed. It is undisputed that Jonkers had reviewed the petition in the derivative action and chose not to consult with WSNet's outside counsel before signing the waiver. V&E appeared on behalf of the relators in March 2002.

In October 2002, WSNet filed a Chapter 11 bankruptcy petition, and a trustee was appointed. The trustee replaced the original plaintiff in the derivative suit but retained the same law firm to continue prosecuting the shareholder derivative suit. The derivative suit was removed to the bankruptcy court in January 2003, and later remanded to state court in August 2003. An automatic stay was imposed until October 6, 2003.

On November 14, 2003, twenty months after V&E appeared on the relators' behalf, the trustee sought V&E's disqualification based on its prior work for WSNet. The trial court ordered V&E's disqualification, holding that

V&E's prior representation of WSNet was substantially related to the representation in this case, the bankrupt trustee did not waive the right to seek V&E's disqualification, and any purported prior waiver of a conflict by WSNet was ineffective. The court of appeals denied the relators' request for mandamus relief, and the relators now seek mandamus relief in this Court.

A writ of mandamus will issue only if the trial court has committed a clear abuse of discretion and the relators have no adequate remedy by appeal.<sup>1[1]</sup> A trial court abuses its discretion if “it reaches a decision so arbitrary and unreasonable as to amount to a clear and prejudicial error of law”<sup>2[2]</sup> or if it clearly fails to correctly analyze or apply the law.<sup>3[3]</sup>

The Disciplinary Rules, although promulgated as disciplinary standards rather than rules of procedural disqualification, provide guidelines relevant to a disqualification determination.<sup>4[4]</sup> Rule 1.05 prohibits the use of a former client's confidential information to that client's disadvantage, unless the client consents or the information has become generally known.<sup>5[5]</sup> Rule 1.09(a) provides:

*Without prior consent*, a lawyer who personally has formerly represented a client in a matter shall not thereafter represent another person in a matter adverse to the former client:

- (1) in which such other person questions the validity of the lawyer's services or work product for the former client; or
- (2) if the representation in reasonable probability will involve a violation of Rule 1.05. [sic]
- (3) if it is the same or a substantially related matter.<sup>6[6]</sup>

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<sup>1[1]</sup> *Walker v. Packer*, 827 S.W.2d 833, 839-40 (Tex. 1992).

<sup>2[2]</sup> *Id.* at 839 (quoting *Johnson v. Fourth Court of Appeals*, 700 S.W.2d 916, 917 (Tex. 1985)).

<sup>3[3]</sup> *Id.* at 840.

<sup>4[4]</sup> *Anderson Producing Inc. v. Koch Oil Co.*, 929 S.W.2d 416, 421 (Tex. 1996); *Spears v. Fourth Court of Appeals*, 797 S.W.2d 654, 656 (Tex. 1990).

<sup>5[5]</sup> TEX. DISCIPLINARY R. PROF'L CONDUCT 1.05(b)(3), reprinted in TEX. GOV'T CODE, tit. 2, subtit. G app. A (TEX. STATE BAR R. art. X, § 9).

<sup>6[6]</sup> *Id.* 1.09(a) (emphasis added).

We have recognized that “[d]isqualification is a severe remedy”<sup>7[7]</sup> that can cause immediate and palpable harm by depriving the party of its chosen counsel and disrupting court proceedings.<sup>8[8]</sup> Therefore, “[m]ere allegations of unethical conduct or evidence showing a remote possibility of a violation of the disciplinary rules will not suffice” to merit disqualification.<sup>9[9]</sup>

The relators argue that disqualification was improper because V&E obtained valid oral and written waivers before appearing in this lawsuit on the relators’ behalf. The bankruptcy trustee contends that the waiver letter signed by Jonkers, WSNet’s Executive Vice President and Chief Financial Officer, at the behest of the company’s general counsel was ineffective because it did not fully and accurately disclose the conflict. We disagree. Comment 10 to Rule 1.09 provides that “[a] waiver is effective only if there is consent after disclosure of the relevant circumstances, including the lawyer’s past or intended role on behalf of each client, as appropriate.”<sup>10[10]</sup> The waiver letter in this case disclosed V&E’s proposed representation of the relators in the shareholder derivative suit, the subject matter of its prior work for WSNet, the time period involved, the attorney involved, the nature of the discussion with WSNet’s general counsel, and how the prior representation concluded. This disclosure meets the requirements set forth in comment 10 of Rule 1.09.<sup>11[11]</sup> Furthermore, it is undisputed that Jonkers signed the waiver letter after reviewing the petition and chose not to consult WSNet’s outside counsel before signing the waiver. The record reveals that WSNet’s files contained information regarding V&E’s prior work for WSNet, including an email from V&E partner Patrick Breland to a WSNet representative disclosing his work for WSNet and a draft of the asset purchase agreement. In addition, it is undisputed that WSNet’s general counsel verbally agreed to waive any potential conflict of interest, which is a permissible, albeit inadvisable, manner of

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<sup>7[7]</sup> *Spears*, 797 S.W.2d at 656.

<sup>8[8]</sup> *In re Nitla S.A. de C.V.*, 92 S.W.3d 419, 423 (Tex. 2002).

<sup>9[9]</sup> *Spears*, 797 S.W.2d at 656.

<sup>10[10]</sup> TEX. DISCIPLINARY R. PROF’L CONDUCT 1.09 cmt. 10.

<sup>11[11]</sup> *Id.*; see also *In re B.L.D.*, 113 S.W.3d 340, 346 n.5 (Tex. 2003) (discussing waiver for joint representation), *cert. denied*, 541 U.S. 945 (2004).

providing disclosure and obtaining consent under the Disciplinary Rules.<sup>12[12]</sup> Accordingly, WSNet was adequately informed of V&E's prior representation and knowingly waived any conflict.

“Mandamus is appropriate to correct an erroneous order disqualifying counsel because there is no adequate remedy by appeal.”<sup>13[13]</sup> Accordingly, without hearing oral argument,<sup>14[14]</sup> we conditionally grant a writ of mandamus and order the trial court to vacate its order disqualifying the relators' counsel. We have every confidence the trial court will act in accordance with this opinion.

OPINION DELIVERED: May 13, 2005

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<sup>12[12]</sup> See TEX. DISCIPLINARY R. PROF'L CONDUCT 1.06 cmt. 8 (“While it is not required that the disclosure and consent be in writing, it would be prudent for the lawyer to provide potential dual clients with at least a written summary of the considerations disclosed.”).

<sup>13[13]</sup> *In re Sanders*, 153 S.W.3d 54, 56 (Tex. 2004) (orig. proceeding).

<sup>14[14]</sup> TEX. R. APP. P. 52.8(c).

## General Legal Malpractice and Legal Ethics URLs

Please report bad links to Jett Hanna, [jhanna@tlie.org](mailto:jhanna@tlie.org).

### Ethics-Selected Sites:

Texas general-Texas Center for Legal Ethics and Professionalism..

<http://www.txethics.org>

Texas Disciplinary Rules of Conduct-membership required:

[http://www.txethics.org/reference\\_rules.asp?view=conduct](http://www.txethics.org/reference_rules.asp?view=conduct)

Texas Rules of Disciplinary Procedure-membership required

[http://www.txethics.org/reference\\_rules.asp?view=procedural](http://www.txethics.org/reference_rules.asp?view=procedural)

Texas Ethics Opinions-behind at the moment, good through end of 2006:

[http://www.txethics.org/reference\\_opinions.asp](http://www.txethics.org/reference_opinions.asp)

National general: ABA Center for Professional Responsibility

<http://www.abanet.org/cpr>

ABA Model Rules

[http://www.abanet.org/cpr/mrpc/mrpc\\_toc.html](http://www.abanet.org/cpr/mrpc/mrpc_toc.html)

ABA Formal Ethics Opinions (abstracts only)

<http://www.abanet.org/cpr/pubs/ethicopinions.html>

ABA list of other ethics resources. This list includes opinions and rules in other states.

<http://www.abanet.org/cpr/links.html>

### Ethics Blogs:

Freivogel on Conflicts (a great site for cases and analysis of conflicts)

<http://freivogelonconflicts.com/>

Legal Ethics Forum (many outstanding law professors)

<http://www.legalethicsforum.com/>

Ben Cowgill's Legal Ethics Newsletter

<http://cowgill.blogs.com/>

Legalethics.com (David Hricik, Peter Krakauer)

<http://www.legalethics.com>

### Malpractice Avoidance-Selected Sites:

ABA Standing Committee on Lawyers Professional Liability

<http://www.abanet.org/legalservices/lpl/>

Texas Lawyers' Insurance Exchange. Newsletter articles on loss avoidance, with emphasis on Texas practice.

<http://www.tlie.org>

Oregon State Bar Professional Liability Fund (username and password is guest). This site has many detailed suggestions and forms that can be adapted to Texas practice.

<http://www.osbplf.org>

LawPro (Canadian mandatory insurance company for several provinces-does have lots of material good for any law firm)

<http://lawpro.ca/>

Hinshaw & Culbertson. While subscription gives you more information, there is good information in free areas.

<http://lawyeringlaw.com/index.cfm>

### **Malpractice Blogs:**

Bluestone Law Firm

<http://blog.bluestonelawfirm.com>

Illinois Legal Malpractice Blog

<http://www.illinoislegalmal.com/>

### **Some recent large verdicts and settlements:**

\$11 million judgment in Montana malicious prosecution case was upheld

[http://www.hinshawlaw.com/knowledge/alert\\_detail.aspx?id=1292&type=5303](http://www.hinshawlaw.com/knowledge/alert_detail.aspx?id=1292&type=5303)

\$1.4 million verdict against Texas firm, infliction of emotional distress by pursuing claim for fees under contingent fee contract. Judgment was not entered for plaintiff.

<http://www.law.com/jsp/law/sfb/lawArticleFriendlySFB.jsp?id=1188982951187>

\$35.7 mil arbitration award in 2007 against Texas firm, alleged misallocation of expenses in class action. Not malpractice, but was a breach of fiduciary duty claim. Some fees forfeited.

<http://www.law.com/jsp/article.jsp?id=1184956608195>

\$30 mil judgment in patent matter 2004, affirmed 2006.

<http://www.thelawyer.com/cgi-bin/item.cgi?id=118637&d=122&h=24&f=46>

\$30 mil Enron settlement by Texas firm:

<http://www.chron.com/dispatch/story.mpl/special/enron/3921779.html>

\$10.8 mil Maine-bottlers whose attorneys allegedly abandoned them for more lucrative class action clients in related matters

<http://blog.bluestonelawfirm.com/articles-10-million-legal-malpractice-poland-springs-verdict.html>

\$81 mil tax shelter settlement by Texas firm, followed by \$76mil in fines, breakup of the firm

<http://www.nytimes.com/2007/03/30/business/30shelter.html?ex=1332907200&en=b8ac>

\$5 million settlements by Texas firm involved in investor real estate closings

<http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=1139997910950>

\$36 million judgment against lead firm in class action accused of favoring one set of clients over another

<http://query.nytimes.com/gst/fullpage.html?res=9405E1DE1E3AF937A35754C0A9659C8B63>