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Civil LITIGATION

Clearly defining the scope of representation—reducing malpractice risk through the engagement letter

A recent decision by the Southern District of New York reminds practitioners of the importance of a well-crafted and detailed engagement letter. On Sept. 12, Judge William H. Pauley III denied Seward & Kissel, LLP's Motion to Dismiss the $10 million malpractice claim brought by Mitchell Barack, the founder and sole owner of ESCO Energy Services Company Inc. (ESCO). See *Barack v. Seward & Kissel, LLP,* 16-cv-09664 (S.D.N.Y. Sept. 12, 2017). Barack's claims arise from Seward & Kissel's representation of ESCO in its $7.5 million sale to ForceField Energy, Inc. (ForceField).

The engagement letter entered into by Barack, ESCO and Seward & Kissel describes the scope of the engagement as follows:

Representation of the Client as lead transaction counsel in connection with the proposed sale of Client's common stock to ForceField Energy, Inc. and related agreements, documents and transactions.

While Seward & Kissel performed due diligence on ESCO, it did none for ForceField, nor did it discuss whether due diligence should be prepared on ForceField with its client—even after the purchaser showed signs of financial distress.

According to the terms of the sale, ESCO was to receive a $2.5 million cash payment at closing, $2.5 million in a deferred payment note collateralized by ForceField's restricted common

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stock, and $2.5 million in ForceField's restricted common stock. A week before closing, ForceField informed Seward & Kissel that it could not pay the $2.5 million cash payment at closing and sought to delay payment of $1.5 million until several months after consummation of the transaction. Seward & Kissel advised Barack to proceed with the closing and that ForceField's lack of cash was "routine" and "not unusual."

Approximately six months after the closing, the executive chairman of ForceField's board of directors was arrested for securities fraud and conspiracy, and a securities fraud class-action was filed against ForceField. The price of ForceField's stock plummeted, and the SEC suspended public trading of ForceField's shares. ForceField ultimately delisted itself from public trading.

Barack's restricted stock and deferred payment notes were rendered worthless, and he ultimately repurchased ESCO from ForceField for $900,000 and resold it to another buyer for $1 million—much less than the original $7.5 million purchase price.

In denying Seward & Kissel's Motion to Dismiss, the court notes that the engagement letter is "facially broad" and does not "explicitly carve out specific due diligence responsibilities" or "shed light on the scope of Seward & Kissel's responsibilities."

Essentially, Seward & Kissel's failure to clarify whether due diligence on ForceField was included in its representation, and subsequent failure to even discuss whether due diligence on the purchaser was appropriate in light of ForceField's apparent lack of cash, precluded the court from dismissing the malpractice action.

This matter serves as a stark reminder of how important it is for the practitioner, whether a solo or a partner of a large New York City firm, to narrowly and specifically define the terms of his or her representation.

Rule 1.2 of New York's Rules of Professional Conduct governs the "Scope of Representation and Allocation of Authority Between Client and Lawyer". Subsection (c) states: "A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances, the client gives informed consent and where necessary notice is provided to the tribunal and/or opposing counsel."

While it is natural to want to craft an engagement letter with broad language in the hopes of generating additional legal work, defining the scope of the

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engagement broadly exposes an attorney to malpractice claims.

Clearly identifying the client is also essential for avoiding risk in a well-crafted engagement letter. One of the fastest growing areas of malpractice litigation against attorneys is third-party claims made by individuals or entities with no direct representation relationship to the attorney. Clearly defining the client and that the lawyer's duties are only to the client will also help to reduce the exposure from third-party suits.

When an attorney, for whatever reason, does not intend to establish a client relationship—a non-engagement letter can be just as important as an engagement letter. An attorney can stumble into an attorney-client relationship by receiving confidential information or promising to look into a legal issue.

We've all had a potential client call, listened to that potential client give their version of events and then declined to take on representation. If the attorney does not make clear to the potential client that representation is declined, the potential client may think an attorney-client relationship has been established by virtue of the initial consultation.

Essential to declining a potential client is the non-engagement letter, especially after an initial consultation has taken place. The non-engagement letter should clearly state that no attorney-client relationship has been established and that you are not representing the potential client with regards to the issue discussed. No assessment of the potential client's claims or defenses should be given. Do include any applicable statute of limitations and a list of local resources that the potential client can use to seek alternate representation. The Monroe County Bar Association's Lawyer Referral Service is an excellent resource to recommend.

When in doubt, narrowly define the scope of your representation—it can always be broadened by an addendum to the engagement letter—and be sure to clearly advise those potential clients whom you cannot represent that no attorney-client relationship has been established.

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