

Avoiding common corporate/commercial malpractice errors

Corporate/commercial law accounts for the third highest number of legal malpractice claims in Ontario, after real estate and civil litigation.

Over the last ten years, corporate/commercial-related claims (including bankruptcy, tax, and securities-related claims) averaged 14 per cent of LAWPRO's claims count (279 claims per year), and 23 per cent of our claims costs (\$14.9 million per year). While there has been some fluctuation, the number of claims in this area has remained consistent over this time period (See Figure 1). The cost of resolving claims in this area has increased over the last 10 years (see Figure 2). The costs for 2010 appear low as they have not been fully assessed at this time. On average, resolving a corporate/commercial claim cost LAWPRO \$53,340 over that period.

Figure 1:

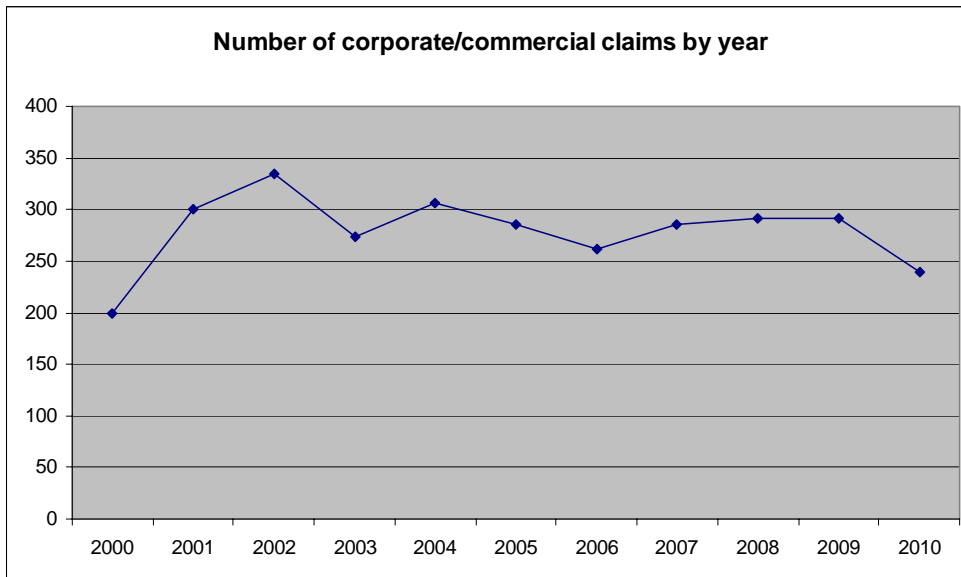
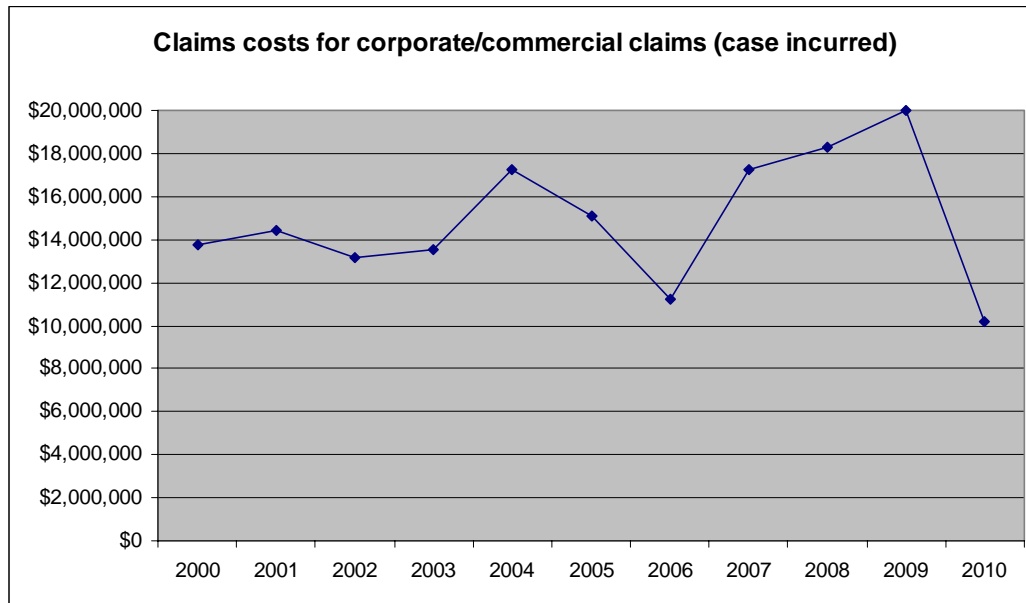


Figure 2:



This paper examines the most common corporate/commercial-related malpractice errors LAWPRO sees, and the steps you can take to reduce the likelihood of a claim.

THE MOST COMMON ERRORS

In the corporate/commercial area, the most common causes of claims are the following:

- lawyer/client communication failures;
- failure to know or properly apply the law;
- conflicts of interest;
- inadequate discovery of facts or inadequate investigation;
- time and deadline-related errors;
- fraud; and
- clerical/delegation errors.

Figure 3:

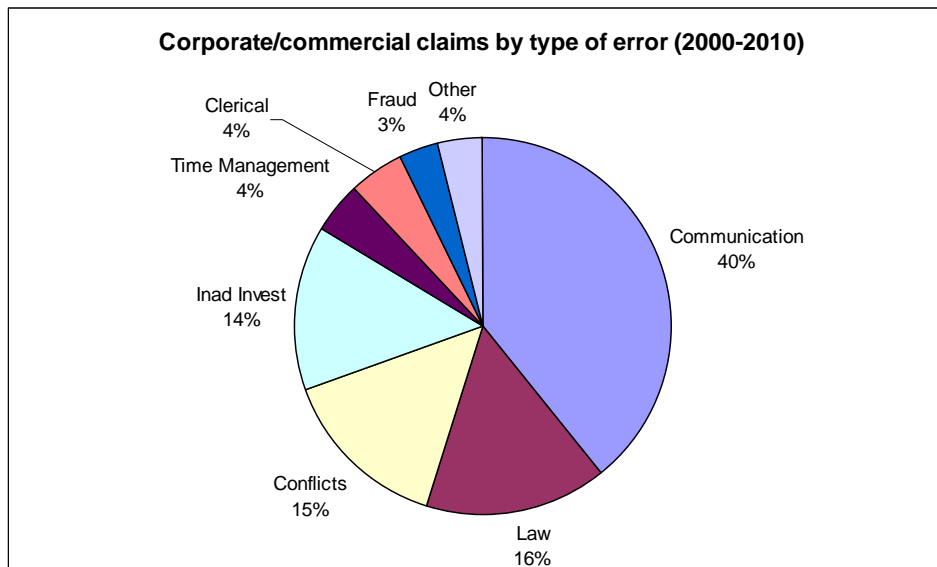


Figure 3 illustrates the relative proportion of these errors. What is surprising to most lawyers is that law-related errors rank second, well behind communication errors. Lawyer/client communication-related errors are actually the most common, representing 40 per cent of the errors in the corporate/commercial area.

COMMUNICATIONS-RELATED ERRORS

The most common cause of malpractice claims on corporate/commercial files is lawyer/client communication-related errors. These errors fall into three general categories:

- A failure to inform the client or obtain the client's consent;
- A failure to follow a client's instructions; and
- Poor communication with the client.

A review of common fact scenarios for each type of error will give you a better understanding of why these errors happen and the steps you can take to avoid a communications-related claim.

Failure to inform client or get consent

The most common type of communications error on corporate/commercial files – 28 per cent of communications-related claims – involves a failure to obtain the client's consent or to inform the client. Examples of this type of error include:

- Failing to explain to a client the consequences of a personal guarantee in a commercial lease, mortgage or other transaction involving security. Failing to make it clear that the client is personally responsible for the borrower's debt.
- Failing to specify the limits of the retainer in writing. Failing to specify in writing which services the lawyer will perform and which things the client will do. For example, if you are involved in a transaction that includes the dissolution of a corporation, ensure that the client is aware of – and agrees to undertake – any final-year filings outstanding after the termination of your retainer.
- Failing to state in writing that a client has not provided sufficient information to complete the retainer on an incorporation and organization of a corporation. Do not allow the client to develop the mistaken impression that the incorporation is proceeding when it is stalled.
- Failing to set out in an accompanying letter the limited purpose of a draft document, together with instructions that it is only to be used for the specified purpose and may not be suitable for other purposes.
- Failing to clearly and unambiguously inform a client in writing that you are declining to act on a particular matter, either because of a conflict of interest or because you don't practise in that area.
- Failing to recommend that the client retain another lawyer to handle that matter. For example, if tax considerations might influence the choice between two different courses of action, but you don't have enough tax expertise to take these considerations into account, document your recommendation that the client obtain tax advice. If the client wants you to take a course of action without the recommended tax advice, document that instruction.
- Failing to clearly and unambiguously inform a client in writing that you are terminating the retainer and failing to recommend that the client find another lawyer. Failing to clearly and unambiguously spell out any tasks you will not be completing and that the client needs to do or retain another lawyer to do.
- Failing to inform a franchisor client about the disclosure requirements under the *Arthur Wishart Act* and the severe consequences of inadequate disclosure.
- Failing to inform a franchisee client about the disclosure requirements and rescission remedies under the *Arthur Wishart Act*.

Failure to follow client's instructions

A "failure to follow client instructions" is the second most common communications-related error and accounts for 35 per cent of communications-related claims. It really amounts to nothing more than a simple failure to follow a client's specific instructions. The most frequent scenarios for this error include:

- Failing to file the requisite notice of change form to remove the old officers and directors when a company is sold. (Failure to do so could, for example, leave the former directors on the hook for tax or other liability.)

- Failing to ensure that all the clauses in a commercial offer to lease are carried over to and appear in the final form of commercial lease.
- Performing additional services for the client that the client did not specifically ask you to do but doing so carelessly, for example, making unsuccessful or incomplete attempts to terminate existing tenancies on behalf of a vendor or purchaser in connection with a commercial lease transaction.

Poor communication with client

Poor communication with the client is the third most common communications-related error and causes 24 per cent of this type of error. Common scenarios for this error include:

- Failing to ensure that the client understands what you are telling him/her and that you understand what he/she is telling you, particularly if there is a language barrier.
- Failing to ensure that the client understands clearly what you will be doing as the lawyer and what the client is responsible for doing.
- Failing to establish clearly who your client is, e.g., where two or more family members have an interest in the transaction. This particular error has conflict of interest implications; see below.
- Making assumptions about a long-standing corporate client's intentions and instructions without confirming these in writing. A long-standing relationship is no substitute for clear communication.
- Failing to document in writing that a client instructed you to take a different course of action in a corporate transaction from the one you recommended.
- Failing to include restrictions on the use and applicability of your advice in an opinion letter, including details of any qualifications or limits to the opinion. Also, a failure to document the assumptions upon which your advice in the opinion letter is based.

AVOIDING COMMUNICATIONS ERRORS

As a means of avoiding communications-related claim, the value of carefully documenting instructions, advice, and steps completed cannot be overstated. While the failure to have written confirmation of instructions and advice is not negligence in and of itself, such written communication can be extremely helpful in defending you in the unhappy event that a claim is made against you (or you are the target of a law society complaint or you are defending your account before an assessment officer).

Why is having something in writing so helpful? Because more often than not, this type of claim involves the lawyer recalling that one thing was said or done, or not said or not done, and a disappointed or upset client who alleges something different. These claims are very hard for LAWPRO to defend successfully, because they tend to come down to a

question of credibility. Judges tend to prefer the client's evidence, as the client usually has a much better recollection of what transpired and what was said.

Remember, most clients are involved in relatively few corporate/commercial transactions in their lifetimes, and they are more likely to remember specific details about what happened. By contrast, lawyers who have handled hundreds of corporate/commercial matters often have little or no specific recollection about what happened on a specific transaction, especially one in the distant past.

Unfortunately, we frequently find inadequate documentation in the lawyer's file to back up the lawyer's version of what occurred. We frequently see files with no notes or correspondence documenting what was said and done, and on occasion, even files with no reporting letters whatsoever.

Communications-related errors are among the easiest to prevent. You can significantly reduce your claims exposure by documenting your work. Confirm the information that your client provided to you, your advice to the client, the client's instructions to you, and what steps were taken on those instructions. Document the time spent reviewing the file and note what issues were discussed with the client. This documentation can take the form of notes to the file, marginal notes on draft documents, comments in interim or final reporting letters, or even in an email message. Admittedly, you can't document everything on every file, but taking the time to document unusual things or issues that seemed to concern the client can be very helpful in the event of a claim, especially if you have a difficult or demanding client.

Some corporate-commercial lawyers do not track or docket the time they spend on files. This is a shame, as there are two benefits of doing so. First, by tracking lawyer and staff time, you can determine the actual amount of time you are spending on each file – a critical piece of information for determining the profitability of the transactions you complete. Secondly, even taking just a few seconds to make detailed docket entries can be a lifesaver in the event of a claim. "Conference with client re need for more information to complete incorporation and organization of Acme Widgets" is much better than just "Conference with client re Acme Widgets incorporation"; "Conference with client re consequences of signing personal guarantee in Smith Co. financing" is much better than just "Conference with client re Smith Co. financing." Weeks, months or even years after a deal is completed, detailed docket entries such as these can serve to confirm that particular issues were discussed with the client.

FAILURE TO KNOW OR PROPERLY APPLY THE LAW

The second most common type of error in the corporate/commercial area is a failure to know or apply the law. This error accounts for 16 per cent of the number and 20 per cent of the cost of claims between 2000 and 2010. The number of such claims has remained fairly constant, but the cost soared sharply upward for 2007 through 2009. In the complex and diverse fields of corporate and commercial law, dabbling beyond one's own expertise can be particularly dangerous.

The law-related mistakes we most frequently see are the following:

- Taking on a complex corporate transaction that the lawyer is not capable of handling, or failing to obtain specialist advice for specialized aspects (for example tax or IP issues).
- Failing to properly protect a security interest or priority status under the *Personal Property Security Act*.
- In franchise matters, failing to understand and comply with disclosure requirements under the *Arthur Wishart Act*.

CONFLICTS OF INTEREST

Conflicts of interest are the third most common source of error in this practice area, accounting for 15 per cent of the corporate/commercial claims reported between 1999 and 2009.

Examples include:

- In general, acting on one or more matters for multiple individuals and/or entities without recognizing the potential for conflicts of interest.
- Acting simultaneously for members of the same family and their business or corporate entities.
- Acting for both a corporation and its individual directors or shareholders.
- Sitting on the board of directors of a corporate client after a history of advising the corporation and/or its suppliers, partners or other contacts.
- Acting for a corporate client and providing legal services on the side to an employee of the client, especially a key employee from whom the lawyer receives instructions on behalf of the corporation.
- When handling a reorganization for a closely held private corporation, failing to advise individual shareholders (especially those who are family members) to obtain independent legal advice (ILA).
- Acting for a group of investors and taking instructions from one individual who purports to represent the group but failing to get consent/directions from the others to take instructions from this individual.

- Failing to obtain waivers of independent legal advice (ILA) when acting for two conflicting parties to an agreement.
- Purporting to act for one party to a transaction, e.g., a purchase and sale of a business, in which the other party is unrepresented, but sending reporting letters to both parties, thus creating the impression that you are acting for both parties.

When it comes to avoiding conflicts, you need to be vigilant from the very start of the matter. Follow firm conflicts checking procedures religiously. In most cases, law firm conflicts checking systems seem to catch potential conflicts, but the warning is ignored because of poor judgment and/or greed. Don't fall into this trap – listen to your instincts. Ask yourself – who is my client? Is there a real or potential conflict? Also, remember that you probably can't objectively judge your own conflicts – get input from someone who is outside the matter.

Lastly, take appropriate action when real or potential conflicts arise. This includes declining the retainer or getting off the matter if it is appropriate to do so, even if it means turning down work from a good client or a matter that will involve substantial fees.

INADEQUATE DISCOVERY OF FACTS OR INADEQUATE INVESTIGATION

The fourth most common malpractice error in the corporate/commercial area flows from inadequate discovery of the relevant facts or inadequate investigation. This category accounted for 13 per cent of both the number and cost of corporate/commercial claims between 2000 and 2010. Examples include:

- Failing to exercise due diligence on an amalgamation of two corporations to ensure that the amalgamated corporation does not inadvertently acquire an outstanding debt of one of the two predecessor corporations.
- Failing to exercise due diligence on an amalgamation of two corporations to ensure that the amalgamated corporation does not inadvertently lose a “grandfathered” exemption or special status that had been acquired by one of the two predecessor corporations.
- Not doing a title search on a commercial lease matter.
- Misreading (or not reading) information on a corporate document or search result.
- Failing to verify the accuracy of information received from someone unknown to the lawyer.

Don't take shortcuts – they can and will come back to haunt you. Lack of attention to detail also arises when there are time pressures created by other lawyers or clients – and details get missed or drafting errors occur. Take the time to do the job right, even if it takes a bit longer or involves coming back on another day.

TIME AND DEADLINE-RELATED ERRORS

Time and deadline-related errors are the fifth most common type of error we see in the corporate/commercial area. They fall into one of two distinct types: (1) missing deadlines

or limitation periods causes 70 per cent of corporate/commercial timing claims, and (2) just not completing tasks in an appropriate amount of time (procrastination) causes 30 per cent of claims in this area.

Commonly-missed deadlines or limitation periods include:

- When acting for a franchisee, failing to rescind the franchise agreement within 60 days after receiving the disclosure document if the franchisor failed to meet the requirements of section 5 of the *Arthur Wishart Act*.
- When acting for a franchisee, failing to rescind the franchise agreement within two years after the date it was signed if the franchisor provided no disclosure document, pursuant to s. 6(2) of the *Arthur Wishart Act*.
- Failing to comply with a notice provision in a contract, lease or licensing agreement (e.g., for termination or renewal).
- Failing to file a notice of change within 15 days after the day the change takes place as required by the *Corporations Information Act*.

The procrastination-related errors we frequently see include:

- Sending draft partnership agreement to clients and not following up to have it signed (usually because the client owes money or doesn't want to incur further legal fees),
- Failing to make filings on a timely basis despite being retained to do so.
- Failure to respond to correspondence from opposing parties.
- Failing to give prompt notice of changes to corporate information as required by legislation.
- Failure to comply with statutory or contractual notice requirements.

As a piece of general advice, it would be a good idea to review your file before closing it and/or putting it into storage to ensure that nothing still needs to be done. If there is, you should ensure that you complete the outstanding work, if it is part of your retainer. If it is not, confirm in writing to the client that it is the client's responsibility to complete the work.

FRAUD

Fraud is tied with clerical/delegation errors as the sixth most common cause of claims in the corporate/commercial area, but fraud ranks fifth in cost. While fraud accounts for three per cent of the *number* of corporate/commercial claims, it is responsible for eight per cent of the *cost* of those claims.

The common types of corporate/commercial frauds we are seeing involve bad cheques. In these frauds the fraudsters will retain the firm on a contrived legal matter that looks legitimate. These frauds are a set-up for the lawyer to run a counterfeit cheque or bank draft through the firm trust account and wire good money to the fraudster. These

contrived matters will look real. The fraudster will provide extensive and very real-looking ID and documents. When the bad cheque or draft bounces, there will be a shortfall in the trust account. Don't be complacent and think you would never be fooled. These frauds are very sophisticated. The matters will look legitimate, the fraudsters will be very convincing and the client ID and other documents you get will look real. The fake cheques have fooled bank tellers and branch managers.

The common frauds we are seeing include:

- Business loan fraud: New client retains you to incorporate and organize new company and to help with loan to buy business equipment or inventory. You are asked to act for both lender (who is in on the fraud) and borrower client. The lender sends a certified cheque that is deposited to your trust account. You disburse the funds to your client and end up with a shortfall in your trust account.
- Debt collection fraud: New client asks you to help with debt collection, providing apparently legitimate documentation such as invoices, demand letters, etc. The debtor (who is in on the fraud) pays up promptly with a certified cheque that looks authentic. You deposit it in your trust account. You're instructed to send funds, minus legal fees, to an offshore account and end up with a shortfall in your trust account.
- IP licensing dispute: Client will contact you alleging that a local entity is breaching an IP licensing agreement involving software, medical equipment etc. You will be provided with a copy of the agreement and it will look legitimate. You contact the party that is in breach and they offer to pay outstanding fees. Shortly thereafter you receive a cheque which you are to deposit into your trust account, deduct your fees and send the remainder to the client.

Examples of the lawyers' errors that open the door to fraud include:

- Not diligently checking the identification of a new and previously unknown client to help prevent identity theft fraud.
- Not challenging and investigating the bona fides of a power of attorney that is suspicious on its face.
- Failing to investigate the authenticity of loaned funds by, for example, contacting the identified lender to confirm their familiarity with the transaction.
- Failing to verify identification of someone you don't know and whose signature you are witnessing or commissioning.

LAWPRO's Fraud Fact Sheet

(<http://www.practicepro.ca/practice/pdf/FraudInfoSheet.pdf>) gives you information on the common types of fraud and the red flags that will help you spot if you are dealing with a fraudulent matter. Visit the AvoidAClaim blog for more information on fraud, including the names of confirmed fraudsters and examples of the communications and documents they will provide. Please consider signing up to receive our RSS feed of AvoidAClaim blog postings in order to be kept up-to-date.

CLERICAL AND DELEGATION ERRORS

Clerical and delegation errors also account for three per cent of the number of corporate/commercial claims. Typical examples include the following:

- Failing to review a draft loan agreement and security documents in detail to ensure consistent and correct identification of the lender/secured party.
- Failing to ensure that documents are signed by an individual in his/her capacity as officer of the corporation and not in his/her personal capacity.
- Failing to notice and correct a clerical error in a document, e.g., on the reorganization of a company, a clerical error in the articles of amendment that either overstates or understates the value of shares.
- Entering information in the wrong field on an electronic form under the *Personal Property Security Act*.
- Failing to file a notice of objection by registered mail by a certain date because a process server either misses the deadline or fails to follow instructions.

EVEN IF NO ALLEGATIONS ARE MADE...TELL US!

If you become aware of a potential claim, you should immediately report it to LAWPRO, even if no allegations of negligence have been made by your client. This is an obligation under the Rules of Professional Conduct and is required by the terms of the LAWPRO policy. Putting us on notice will help us help you understand what your claims exposure might be and may help reduce the damages on any potential claim. We may retain counsel to assist you and protect your interests and to make any necessary repairs. It is interesting to note that we close about 87 per cent of our corporate/commercial claims without any indemnity payments.

YOUR MARCHING ORDERS

You can't totally eliminate the risk of a malpractice claim. However, you can substantially reduce your risk of a claim by improving your lawyer/client communications and documenting your work. Review and consider the types of errors that occur in the corporate/commercial area, and set aside time to integrate the various risk management strategies outlined above into your practice.