COLLECTIVE SCIENTER:

AN UNRECOGNIZED DANGER IN LEGAL MALPRACTICE CASES

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Major litigation against law firms is a relatively recent phenomenon, with its roots in the bank and savings and loan crisis of the mid-1980s. The theories of liability, therefore, have outpaced thoughtful development of defenses. To a large extent this is because very few large legal malpractice cases proceed past motions to dismiss, a stage of the proceedings where courts are often inclined to reject novel arguments made by the defense. Defenses such as causation, case-within-a-case, contributory negligence of corporate counsel, and loss causation, remain formidable barriers to recovery but largely unexplored.[1]

The focus of this article is upon the little-recognized concept of collective scienter, which, when invoked by a plaintiff in a lawsuit against a law firm, can be a formidable weapon. It is an issue most defense lawyers have probably not examined. The term incorporates two distinct but related concepts: whether the knowledge of individual lawyers in the firm can be aggregated and attributed to the firm for the knowledge requirement of various torts, and whether the knowledge and conduct of individual lawyers can be aggregated and attributed to the firm for the "scienter" element of various torts. The concepts are closely related because plaintiffs often try to prove law firm "scienter" by showing that various lawyers in the law firm *knew* a number of facts that together supposedly constituted red flags and from which the fact finder can infer that the law firm consciously intended to further wrongdoing. This collective knowledge or intent thus is used to establish the intent or knowledge element of many of the largest and most serious claims that are asserted against law firms. Collective scienter, to my knowledge, has never been expressly identified or discussed in any legal malpractice opinion. Plaintiffs, however, implicitly utilize the principle in

[1] A number of cases which would illustrate points made in this article were handled by our law firm. We decline to discuss claims against clients unless specifically directed to do so.

fault or contributory negligence defenses that are effective against claims by corporate plaintiffs.[4] The plaintiff has, in effect, placed the corporate officer on the lawyers' side of the "v.".

When these claims are examined carefully, it becomes clear that in order to make their case that the law firm "knew" of the breach of fiduciary duty or "knew" of the fraud, the plaintiffs describe a series of so-called "red flags" typically involving several lawyers over a period of time, and implicitly aggregate all of this conduct to one consciousness — that of the defendant law firm. Thus, associate A saw one suspicious fact, partner B saw a second suspicious fact, counsel C saw a third suspicious fact, etc., and therefore the law firm must have known that the client was engaged in breach of fiduciary duty or fraud. In such circumstances, judges are likely to deny motions to dismiss (thus setting the stage for a large settlement), as they, like the plaintiffs, have implicitly aggregated all of this knowledge and intent to the law firm, as an entity. As we discuss below, that is inconsistent with the theory of vicarious liability for scienter-based liability and with the relatively modest jurisprudence in other areas of litigation.

Historical Background

Prior to the 1980s, legal malpractice cases were relatively infrequent, and were typically mistake-based claims. The savings & loan crisis of 1980s changed that. Federal agencies that had insured deposits at failed financial institutions embarked on a campaign of lawsuits against directors

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[4] Depending on the jurisdiction, the law firm may still possess an *in pari delicto* defense, which can be very powerful in defeating such claims. *See, e.g.*, *Kirschner v. KPMG LLP*, 938 N.E.2d 941 (N.Y. 2010). There are a number of other defenses to aiding and abetting cases, especially arising out of the requirement that the aider and abettor substantially assisted in the primary wrong. In some jurisdictions, the substantial assistance must itself amount to a proximate cause in the wrong. *See, e.g.*, *Lussier v. Bessette*, 16 A.3d 580, 585 (Vt. 2010); *Stanfield Offshore Leveraged Assets, Ltd. v. Metro. Life Ins. Co.*, 883 N.Y.S.2d 486, 489 (App. Div. – 1st Dep't 2009). Moreover, lawyers doing nothing more than performing routine legal services often cannot, as a matter of law, amount to substantial assistance. *See, e.g.*, *Witzman v. Lehrman, Lehrman & Flom*, 601 N.W.2d 179, 188–89 (Minn. 1999); *Ulico Cas. Co. v. Wilson, Elser, Moskowitz, Edelman & Dicker*, 865 N.Y.S.2d 14, 23 (App. Div. – 1st Dep't 2008).

and a rare verdict.[7] For example, several partners at a major Dallas law firm represented failed S&Ls. The firm ultimately paid $18 million to settle a potential FDIC lawsuit and a 1987 legal malpractice action. The Dallas suit was an "inflection point" in litigation against attorneys, and there has been no going back. One legacy of the FDIC cases has been the aiding and abetting theories that persist today.

The focus on attorneys began with the FDIC but has not been confined to the banking agencies. Many of the claims that started to be asserted against law firms were brought by parties other than clients or, as is the case with the FDIC, non-clients that had succeeded to the claims of clients. These parties — be they prosecutors, government regulators such as the SEC, counterparties in transactions, or even customers of the law firm's client — often could only bring claims that contain a knowledge, intent, or scienter element because the lawyer's fiduciary obligations extend only to the client.[8]

Accordingly, the claims are often for aiding and abetting torts committed by the client. Many times, the client will have already failed, therefore leaving plaintiffs primarily focused on the client's outside advisors as a source of compensation. They also will need to show actual knowledge of the client's wrongdoing and intent to further it.[9] The attempt to meet these standards often will lead plaintiffs to argue that the "law firm knew" various facts by aggregating the separate knowledge held by different lawyers.

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[7] *See FDIC v. Mmahat*, 907 F.2d 546 (5th Cir. 1990) (holding attorney and law firm liable for legal malpractice); *FDIC v. Clark*, 978 F.2d 1541 (10th Cir. 1992) (affirming judgment for legal malpractice).

[8] *See generally* Restatement (Third) of the Law Governing Lawyers § 56 (2000) (describing a lawyer's civil liability to non-clients as the same as that owed by a non-lawyer in similar circumstances).

[9] *See* Restatement (Second) of Torts § 876(b).

knowledgeable agent, the agent who made the false statement did not do so intending to defraud the person to whom the statement was made."[12] The Restatement (Second) of Agency was in accord: "If knowledge, as distinguished from reason to know, is the important element in a transaction, and the agent who has the knowledge is not one acting for the principal in the transaction, the principal is not affected by the fact that the agent has the knowledge."[13]

These conclusions spring from foundations of agency law. "Corporations, of course, have no state of mind of their own. Instead, the scienter of their agents must be imputed to them."[14] Because of that, when a cause of action requires both "an essentially subjective state of mind" and "some sort of conduct" — as is the case when dealing with fraud claims or aiding and abetting claims — "the required state of mind must actually exist in the [same] individual."[15]

The Securities Context

Securities litigation is important to the doctrine of collective scienter in that it is one of the few arenas in which the principle has been tested — typically in cases against directors and officers often under the rubric of "group pleading."[16]

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[12] Restatement (Third) of Agency § 5.03 cmt. d(2) (2006). Despite this, the Reporter's Notes cite with approval *Fleming v. U-Haul Co.*, 541 S.E.2d 75 (Ga. Ct. App. 2000), in which corporate malice was established based on knowledge imputed from one agent to a second agent under circumstances suggesting "reckless disregard" or "conscious indifference" by the company.

[13] Restatement (Second) of Agency § 275 cmt. b (1959); *see also id.* § 268 cmt. d & illus. 4.

[14] *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1254 (11th Cir. 2008).

[15] *Southland Sec, Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004).

[16] The "group pleading" or "group published" doctrine has been on uncertain footing since the passage of the PSLRA. *See, e.g., Winer Family Trust v. Queen*, 503 F.3d 319, 336–37 (3d Cir. 2007) (rejecting doctrine and citing case law). Nevertheless, in the jurisdictions that still apply it, the "group pleading" doctrine recognizes, for purposes of a motion to dismiss, that some corporate documents are created by a group of corporate insiders, but does not technically apply to scienter. *See In re BISYS Sec. Litig.*, 397 F. Supp. 2d 430, 439 (S.D.N.Y. 2005).

same conclusion.[19] Indeed, the Sixth Circuit, which had been the one court of appeals that seemingly endorsed collective scienter in the securities context,[20] changed course on October 10, 2014 in *Ansfield v. Omnicare, Inc. (In re Omnicare, Inc. Securities Litigation)*, No. 13-5597, --- F.3d ---- (6th Cir. Oct. 10, 2014).

That is not to say that the decisions are uniform.[21] There is variation among the courts as to which corporate individual's scienter should count in assessing the corporate intent. For example, *Southland* was decided at such an early juncture that it used an open-ended formulation, in which it referred to establishing corporate scienter through the state of mind of those "who furnish information or language for inclusion therein, or the like."[22] The Sixth Circuit in *Ansfield* adopted a similar approach,[23] although it is unclear whether such a sweeping standard is appropriate after the Supreme Court's decisions in *Stoneridge* and *Janus*. *Janus*, in particular, established that drafting or providing information for a statement are not enough to be deemed the maker of the statement.[24]

There is also divergence as to the pleading question of whether the corporate actor who acted with scienter needs to be identified in the complaint. The Fifth Circuit in *Southland* held that the PSLRA's specificity requirements demanded that the corporate actor be identified by name.[25]

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[19] *See Matrix Capital Mgmt. Fund, L.P. v. BearingPoint, Inc.*, 576 F.3d 172, 182 (4th Cir. 2009); *Mizzaro v. Home Depot, Inc.*, 544 F.3d at 1254; *Ezra Charitable Trust v. Tyco Int'l Ltd.*, 466 F.3d 1, 5–11 (1st Cir. 2006); *Aetos Corp. v. Tysons Food, Inc. (In re Tysons Foods, Inc. Sec. Litig.)*, 155 F. App'x 53, 56–58 (3d Cir. 2005).

[20] *See City of Monroe Empls. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 688–89 (6th Cir. 2005)

[21] *See Ansfield*, 2014 WL 5066826, at *14–16; *see generally* Bradley J. Bondi, *Dangerous Liaisons: Collective Scienter in SEC Enforcement Actions*, 6 N.Y.U. J. L. & Bus. 1, 7 (2009).

[22] 365 F.3d at 366.

[23] 2014 WL 5066826, at *17.

[24] 131 S. Ct. at 2303–05.

[25] 365 F.3d at 367.

"flagrantly indifferent" to its reporting obligations and, indeed, whether it was deliberately set up as to be indifferent.[29] Following *Bank of New England*, several courts have rejected its holding.[30]

Claims Against Law Firms

This brings us to law firms. Law firms should be vigilant not to ignore or acquiesce in plaintiffs' attempts to establish knowledge or scienter through a collective approach. Although research has not uncovered a single case where a court has discussed collective scienter issue in a suit against a law firm, the author can attest that it has been used often without attribution or even recognition. The issue should move to the forefront of complex suits against law firms in the years ahead.

The issue arises in law firm cases for the same reason it does in the securities context — it is a useful way for plaintiffs to build a "red flags" case. Plaintiffs recite a compendium of alleged facts that are aggregated across different settings and transactions spread out over a number of years. Often law firms are especially likely to be the victim of such an approach because former clients, or whoever stands in the former client's shoes, such as a trustee or the FDIC, can demand the client file before starting litigation. They can then use the file to piece together a wide-ranging narrative to appear in the complaint.[31] Even in cases where the plaintiff is a non-client, the plaintiff often can still get access to the law firm's client file if the client waives privilege.

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[29] *Bank of New England*, 821 F.2d at 855, 858.

[30] *See United States v. Science Applications Int'l Corp.*, 626 F.3d 1257, 1274 (D.C. Cir. 2010) (rejecting collective knowledge in False Claims Act cases); *United States v. Philip Morris USA, Inc.*, 566 F.3d 1095, 1122 (D.C. Cir. 2009) (per curiam) (in RICO case, noting "the legal soundness of the 'collective intent' theory" as "dubious" but citing *Bank of New England* in support); *United States v. LBS Bank-New York, Inc.*, 757 F. Supp. 496, 501 n.7 (E.D. Pa. 1990); Thomas A. Hagemann & Joseph Grinstein, *The Mythology of Aggregate Corporate Knowledge: A Deconstruction*, 65 Geo. Wash. L. Rev. 210 (1997).

[31] While former clients often do not need to prove knowledge, because they can instead rely on malpractice liability, they sometimes assert such claims, especially if they are alleging that corporate

an expert in law firm conduct to focus the court on this point. Another would be to seek amicus support, even at the motion-to-dismiss stage, to focus the court's attention on the importance of the issue.

As collective scienter is recognized as an important issue in law firm litigation in big cases, one can expect that plaintiffs will either deny the existence of the issue or push back by arguing that a firm deliberately organized its handling of a matter so as to keep knowledge compartmentalized. Such compartmentalization, they would argue, would amount to willful blindness, which is frequently employed as a substitute for knowledge (albeit not intent). Law firms should be sensitive to such arguments, and avoid the criticism that their lawyers could later be accused of putting their heads in the sand. For example, while a law firm's opinion generally speaks only to the knowledge of the lawyers involved in preparing the opinion, those lawyers cannot deliberately refrain from speaking with other lawyers whom they know have additional information relevant to the opinion.[37]

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This is, of course, just one of many issues that may arise as the question of collective scienter becomes more of an issue in law firm litigation. Law firms should keep abreast of the latest developments in this area, both in cases against law firms, and in other contexts.

[37] *Glazer & FitzGibbon on Legal Opinions*, § 4.2.3.3.