

PROFESSIONAL COUNSELSM

A CLAIM STUDY FOR LAWYERS

Investigating the Hidden Risks
of Business Transactions Practice

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Introduction

Business transactions/commercial law (“BT”) representations are a staple of practice for many lawyers in all areas of the country, especially in small to midsize firms. This study analyzes claims asserted against sole practitioners and law firms with fewer than 35 attorneys maintaining professional liability insurance with CNA.

BT matters represent a diverse area of practice, including the negotiation and drafting of sales agreements, agency agreements, entertainment contracts, and commercial transactions. It also comprises matters related to financing where real estate is not the major subject.¹

In direct contrast to the popular perception that BT is a “safe” area of practice, in this segment of law firms insured with CNA, BT claims have consistently been among the top loss drivers for many years. In fact, CNA has incurred BT claim losses approaching nearly \$50 million over the last ten years.

In addition, BT claims typically result in payments of more than twice the amount paid on claims arising from other areas of practice.² The data reveals that there are many factors which contribute to the higher severity of these claims.

One of the most problematic factors relates to attorneys engaging in a BT representation with minimal or no experience. Nearly 70% of all BT claims are instituted against attorneys who reported that BT practice generated 5% or less of their annual revenues.

Since 2001, the number of attorneys maintaining professional liability insurance with CNA has more than doubled. The number of attorneys that reported representing clients in BT matters has also increased. With the greater number of attorneys practicing in this area, a significant increase in the volume of claims related to this practice has resulted.

A key conclusion from this study is that BT practice presents greater professional liability risk for attorneys than many other practice areas. Moreover, the level of an attorney’s experience in this practice area bears a significant relationship to both the frequency of such claims and the related financial exposure.

1 CNA classifies business transactions/commercial law as a separate area of practice from corporate and business organization representations. Corporate and business organization includes all aspects of the formation, operation, sale and dissolution of corporations, partnerships (general and limited), agency and other forms of business organizations.

2 Claim amounts include indemnity and defense costs.

Glossary

Key terms or abbreviations used throughout this study:

- **AOP:** Abbreviation for Area of Practice.
- **Average Claim:** Total amount paid on all business transactions claims divided by the number of business transactions claims.
- **BT:** Abbreviation for Business Transactions/Commercial Law.
- **Business Transactions/Commercial Law:** Includes representations related to sales agreements, agency agreements, entertainment contracts and commercial transactions, including financing where real estate is not the major subject.
- **Claim Experience:** Refers to losses or occurrence of claims.
- **Corporate and Business Organization:** Includes representations related to all aspects of the formation, operation, sale and dissolution of corporations, partnerships (general and limited), agency and other forms of business organizations. It does not include representations related to other types of business transactions involving the negotiation and drafting of sales and employment agreements or commercial transactions.
- **Defense Costs:** Total amount paid to defense counsel, as well as cost of investigation and expert witness retention.
- **Frequency:** The rate at which claims occur as compared to revenue earned from the related professional service.
- **Incurred Claim:** Any reported claim that incurs any form of loss, including indemnity payment and/or payment of defense costs.
- **Incurred Loss:** Total amount paid on a claim, including indemnity and defense costs.
- **Indemnity:** Amount paid on a claim, excluding defense costs.
- **LPL:** Abbreviation for Lawyers Professional Liability.
- **Reported Claim:** Any claim or potential claim reported to CNA by a policyholder, regardless of the ultimate outcome.
- **Severity:** Average amount of loss and claim expense for a claim.

Database and Methodology of Claim Study

This claim study examined BT claim data to gain an in depth understanding of BT claims and incurred losses in law firms with fewer than 35 attorneys.

The main purpose of the study was to determine the primary factors contributing to claim outcomes in this practice area, and to identify business scenarios and attorney conduct leading to claims.

The study examined 998 closed claims coded as originating from business transactions practice between 1987 and 2009. From this group, 130 claims alleging a document handling error were examined, and 100 files were randomly selected for a more detailed review and analysis. In addition, claims alleging a conflict of interest were examined.

The study also included an analysis of aggregate statistical data used routinely for actuarial purposes in the program across all AOPs from 2002 to 2010.

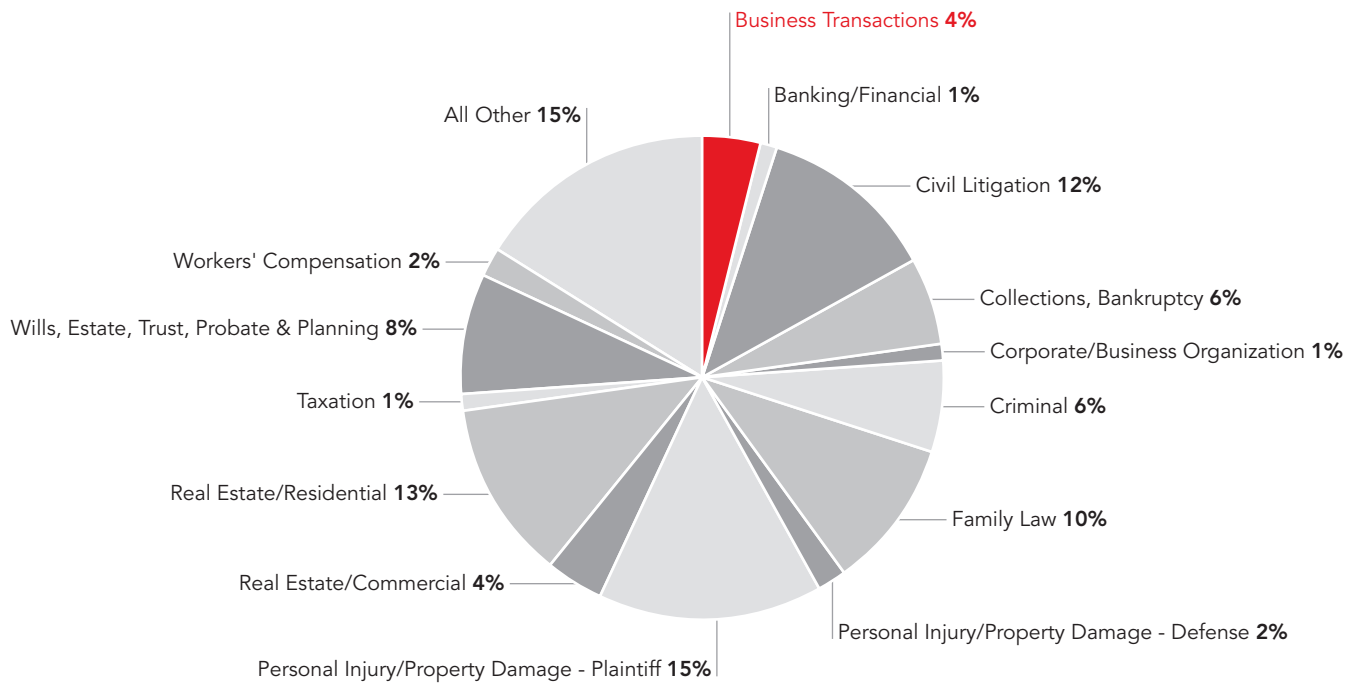
Business Transactions Practice is a High Risk Practice

Business Transactions: The Numbers Don't Add Up

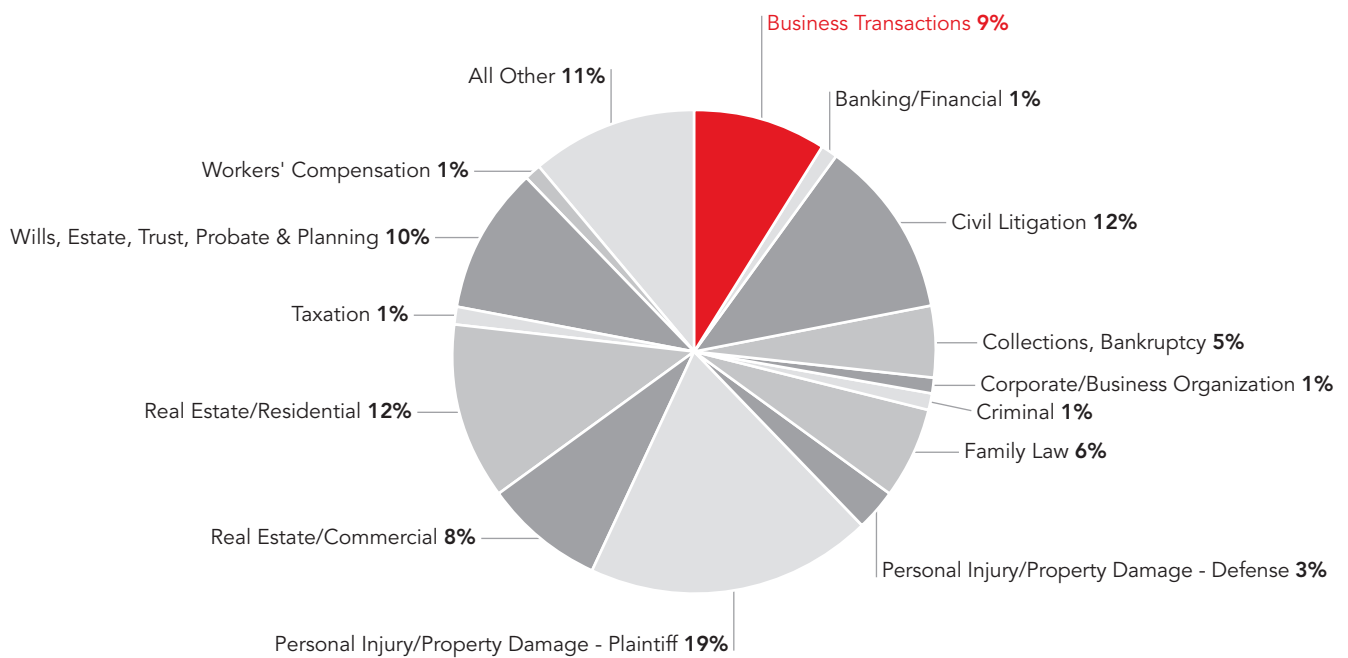
Historically, the claim experience in the CNA Lawyers Professional Liability Program has demonstrated that an AOP generates a similar percentage of reported claims and incurred losses. However, in BT practice, the percentage of incurred losses is more than twice the percentage of reported claims in the program as a whole. In fact, a comparison of the percentages of reported claims and incurred losses for each AOP shows that BT practice is the AOP generating the highest percentage of incurred losses compared to reported claims.

The main purpose of the study was to determine the primary factors contributing to claim outcomes in this practice area, and to identify business scenarios and attorney conduct leading to claims.

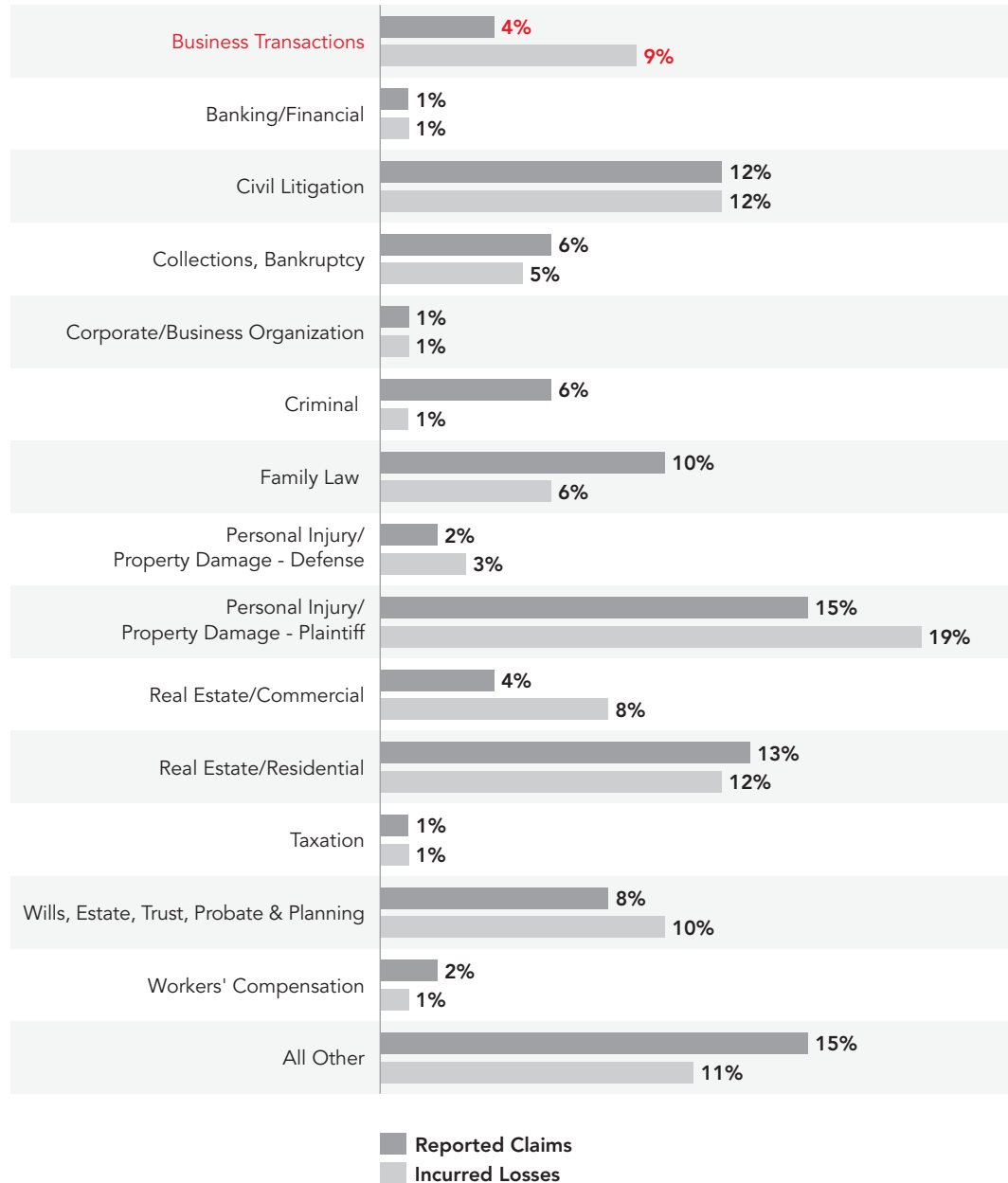
Distribution of Reported Claims 2002-2010



Distribution of Incurred Losses 2002-2010



Comparison of Reported Claims and Incurred Losses 2002-2010



Business Transactions: Greater Average Severity than Claims from Other Areas of Practice

BT claims typically result in larger incurred losses and defense costs than claims arising from other AOPs. Attorneys facing a claim incur costs in the form of the applicable insurance deductible. However, even defensible claims can impose an additional burden on attorneys. There are time costs associated with defending a claim, even with representation. For example, attorneys will incur time assisting defense counsel in propounding and answering discovery, submitting to deposition, and attending settlement conferences and trial. BT claims typically result in payments of more than twice the amount paid on claims arising from other areas of practice.

Business Transactions: Claim Expenses Greater than Other Areas of Practice

The costs to defend a BT claim are more than twice the costs in claims resulting from other AOPs. The complexity of BT representations – which typically involve multiple parties, extensive documentation, and the need to engage multiple subject matter experts for the defense – contributes to higher defense costs. Most or all of the deductible may be paid for defense costs, even in defensible claims.

The costs to defend a business transactions claim are more than twice the costs in claims resulting from other areas of practice.

Business Transactions: Attorney Experience Affects Risk

The level of BT experience of the attorney affects claim experience. Those with less experience generate the majority of claims arising from this practice area. More experienced attorneys generate fewer claims, but those claims generate higher levels of severity.

Approximately 70% of the claims arising from BT practice were instituted against attorneys who devote no more than 5% of their practice to this practice area. These claims generated the majority of related incurred losses.

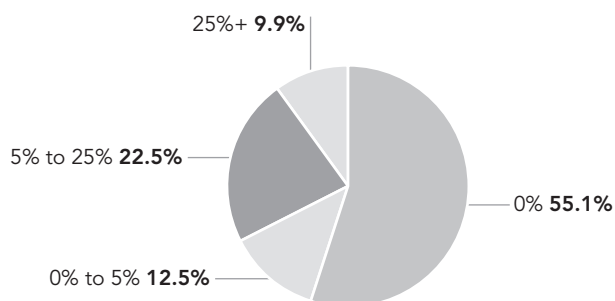
A review of claims in this category indicates that attorneys inexperienced in BT representations may underestimate the complexity of these matters. In addition, such attorneys may not have the appropriate resources to effectively manage the activities associated with BT clients, such as adequate staffing and the ability to properly process, prepare, handle and review all of the necessary documents in the transaction.

Furthermore, attorneys who are not fully committed to a more significant BT practice may be reluctant to invest in appropriate equipment, software, hardware and informational resources integral to delivering legal services in this AOP.

While attorneys who devote more than 25% of their practice to BT are less likely to have a claim asserted against them, those claims are on average much more expensive than those brought against attorneys who devote 5% or less of their practice to BT. In fact, such claims result in almost twice the incurred loss as claims brought against the less experienced attorneys.

The review of these claims indicated that attorneys more experienced in BT matters generate potentially higher severity claims arising from correspondingly larger and more complex BT representations.

Distribution of Incurred Losses by Percentage of Business Transactions Reported



Activities Generating Business Transactions Claims

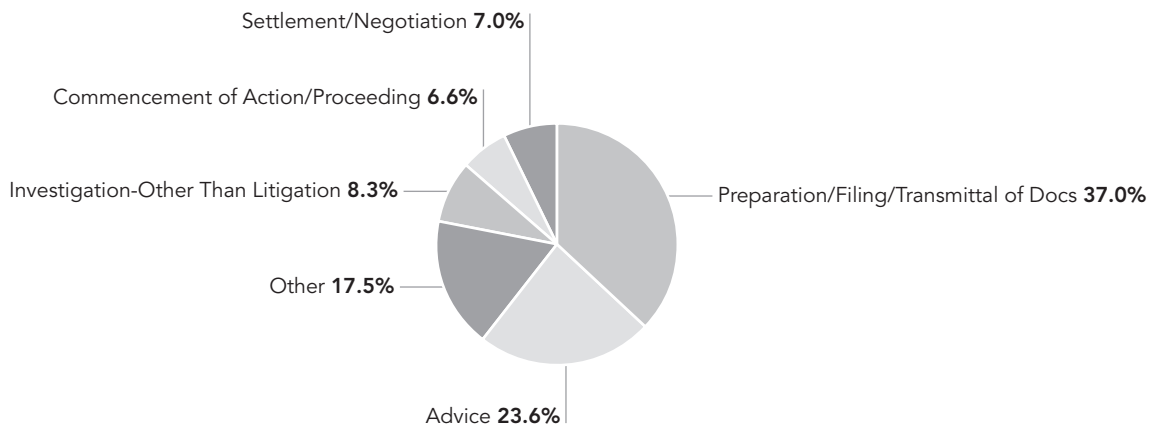
There are many activities involved in a BT representation. The preparation, filing and/or transmittal of documents are the most common activities associated with BT claims.³ As BT representations tend to focus on contract drafting, this aspect of rendering professional legal services to BT clients can heighten exposure to claims. The preparation, filing, and/or transmittal of documents are the most common activities leading to incurred claims arising from BT practice.

Activities Leading to Reported Business Transactions Claims

Examples of such document-related claims are those alleging that documents were improperly drawn or improperly recorded, meaning that either the attorney's drafting or filing/recording was insufficient or flawed. Examples include the omission of an important contractual provision or the failure to acquire the appropriate license, signature or approval before recording. Other examples include claims alleging a failure to file or record a document, meaning the attorney either did not attempt to file or record the document, or efforts to do so were unsuccessful. Claims thus may emanate from the failure to timely file the documents with a required authority.

The failure to provide appropriate legal advice represents approximately one-fourth of all BT claims. These claims typically involve an allegation that the client was damaged as a result of following the attorney's advice.

Distribution of Reported Claims by Activity

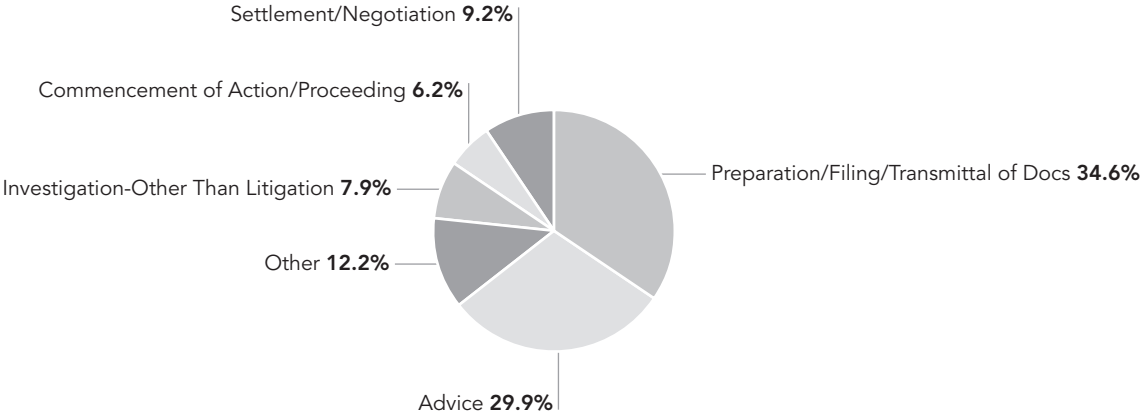


³ The activities represented in the above chart were listed as the primary activity alleged in a claim.

Activities Leading to Business Transactions Claims Involving an Incurred Loss

Claims that resulted in incurred losses involving document-related errors represent almost 35% of all BT claims. Failure to provide appropriate advice constitutes nearly one-third of claims that resulted in incurred losses.

Distribution of Incurred Losses by Activity



Alleged Errors Leading to Business Transactions Claims

The top two alleged errors in BT claims are inadequate representation and conflict of interest.

17.5% of all BT claims allege inadequate representation as the principal error leading to the claim. These claims include, for example, situations in which an attorney allegedly overlooked a significant issue in a transaction, or did not raise the matter as a significant issue with the client.

Inadequate representation claims also include allegations that the attorney should have successfully persuaded the client against the acceptance of various agreement provisions or entering into transactions that were against the client’s best interests.

Other examples include representations where the attorney allegedly failed to advise the client about the disadvantages of the transaction, and thus breached the fiduciary duty to protect the client’s interests.

Conflict of Interest Allegations in Business Transactions Claims

Conflict of interest is an allegation that may be asserted against attorneys in any AOP, but it is especially prevalent in BT claims.

As a percentage of all incurred claims, this allegation occurred more frequently in BT claims than in claims from all other practice areas, and more than four times the average for all other practice areas combined.

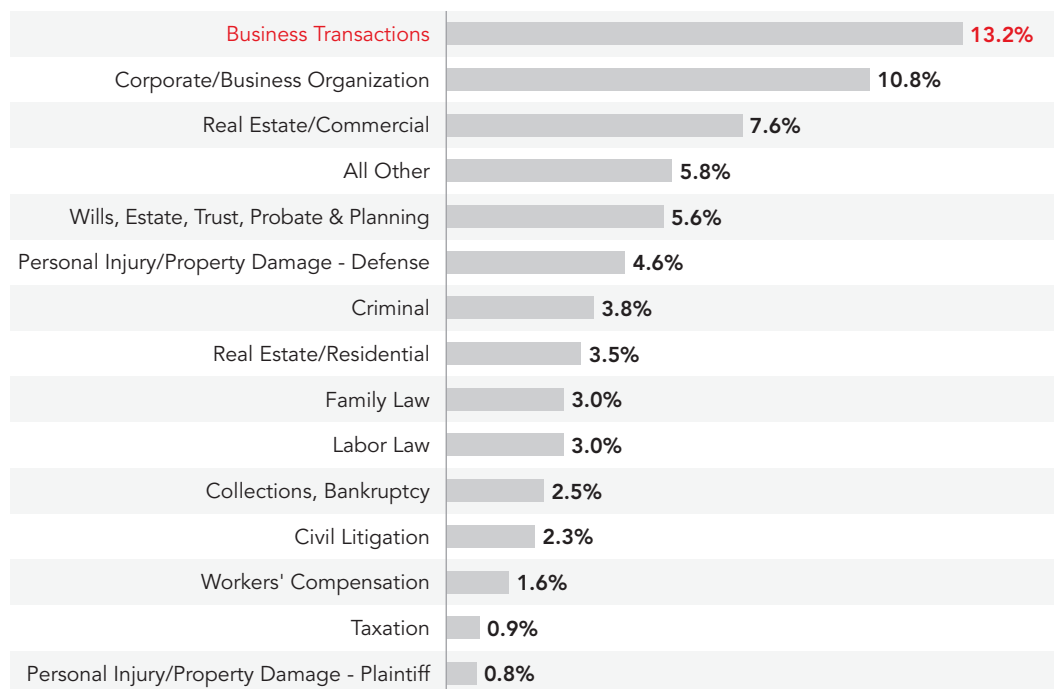
Thirteen percent of BT claims included allegations of conflict of interest. Of these, more than half of the claims generated incurred losses, which totaled \$7 million.

Engagements in which the attorney represents multiple parties present significant risk of conflict of interest claims. Multi-party representations that include an individual or entity engaged in a pre-existing attorney-client relationship with the attorney retained for the BT matter increases the risk of claims alleging a conflict of interest.

Typical allegations in these claims include:

- The parties had actual conflicts at the beginning of the representation, and the attorney should have recognized this vulnerability and declined to represent all parties jointly.
- The attorney should have noticed developing conflicts and communicated them to the various parties, directing them to seek their own separate counsel.
- The attorney failed to recognize that an individual was in a conflict with the entity represented, and neither informed the parties nor withdrew from the representation.

Conflict of Interest Claims as Percentage of All Incurred Claims Within Each AOP



Business Transactions: “Red Flag Representations” and Risk Control Techniques

Red Flag Representations: Client Issues

- Representing a client who is more experienced than the attorney in the industry or type of transactions involved in the underlying representation. The attorney is at greater risk of making errors and ensuing legal malpractice claims.
- Representing a possible “bad actor” client who engaged in fraud in connection with the underlying transaction, or had a criminal history. (An attorney representing a client engaged in deceit or fraud is more likely to be sued by third parties and/or “innocent” common clients who are seeking a source of recovery and relief after being victimized.)
- Representing all parties in a BT matter, including both an established client and new clients.
- Representing only the established client in the transaction while the other parties are unrepresented.
- Representing a party in a transaction in which the opposing party pays the attorney’s fees.
- Agreeing to scrivener representations – matters in which the attorney is employed to draft contracts or agreements previously negotiated and agreed upon between the parties. (Often, the parties may not have been represented during negotiations. Document-related claims thus may arise from such representations.)

Risk Control Techniques to Manage the Risk

First, evaluate whether the benefits of accepting the representation are outweighed by the risks of the representation. Questions to consider include:

- Does the attorney have the requisite time to manage the matter, such as conducting needed investigation and performing all required research?
- Does the attorney possess the requisite tools to accept the engagement?
- How much experience does the attorney have in BT representations generally?
- What is the attorney’s level of experience relative to the industry that is the subject of the BT matter?
- How sophisticated and experienced is the client in BT matters, or in the industry that is the subject of the transaction?
- How reliable, honest and responsible is the client?

Second, if it is determined that the benefits outweigh the risks, take the following steps to minimize the risk of a claim.

- Create a checklist.
- Do not rely solely upon the client’s representations.
- Document the scope and specifications of the engagement.
- Document all instructions to and from the client.
- Avoid scrivener representations.
- Avoid clients who want to “cut corners”.

- In multi-party representations, thoroughly discuss with all parties the potential for conflicts to develop later, and document these discussions.
- Prepare and execute comprehensive written conflict waivers.
- Remain alert to the possibility that potential conflicts can change to actual conflicts in multi-party transactions, and be ready to withdraw if necessary.
- Regularly discuss the clients' understanding of the attorney's relationship with all parties to the transaction, and document these discussions.
- Act swiftly to correct misconceptions concerning whom the attorney represents and to whom the duty of loyalty, as well as fiduciary obligations, are owed.
- Do not give legal advice to non-clients, or inadvertently create or give rise to the mistaken belief that an attorney-client relationship exists.
- Do not favor the interests of a long-term client over those of a newer joint client.

Third, in the event a BT claim is received or an insured is made aware of a potential claim, early reporting helps to mitigate expenses and losses, reducing the risk of losing valued clients. Additionally, early reporting of a potential claim may allow the claim professional to identify possible strategies to preclude the assertion of a claim.

Conclusion

This study concludes that the business transactions area of practice is fraught with higher risk than is often perceived by attorneys. Moreover, the attorney's level of experience in representing clients in business transactions has a significant effect on the frequency and severity of claims.

In addition, document-related errors, failure to give proper advice and failure to investigate properly often comprise activities that lead to claims. The types of alleged errors that lead to claims are inadequate representation and conflicts of interest.

By recognizing the most common risks that practitioners encounter in business transactions matters and utilizing proper risk control techniques, attorneys can help minimize their overall risk and reduce the potential exposure of business transaction claims.



For more information, please call us at 866-262-0540 or email us at lawyersrisk@cna.com.

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