

# Legal Advice or Business Advice?

Liability for legal malpractice can arise from the giving of legal advice. But, at least in theory, it cannot arise from harm resulting from giving business advice. Sometimes, however, the distinction between the two is not so apparent, and the judiciary may not always agree as to where to draw the line. A recent decision provides one example of where a court did draw such a distinction, although not favorably to the defendant law firm in that instance.

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In *Peterson v. Katten Muchin Rosenman*, 792 F.3d 789 (7th Cir. 2015), the defendant law firm represented a group of mutual funds over a period of six years with respect to loans made to various entities controlled by one person. These loans were used to finance some of a third party's consumer-electronics inventory. Not until after the funds made the loans was it revealed that these aforementioned entities were, in fact, Ponzi schemes, which later collapsed. As a result a substantial portion of the loans was never repaid, which prompted the funds to go into bankruptcy. A trustee who was appointed to marshal the funds' assets then, in turn, commenced a malpractice action against the defendant law firm.

The trustee criticized the legal advice given with respect to how to structure the security for the loans. They were secured by paperwork showing the inventory that the entities financed and the third party was to pay for, which was to be accomplished by the third party depositing payments into a "lockbox" bank account for the funds to draw on. This supposedly eliminated any risk that the entities could intercept the payments. In reality, the method of payment was a lie to the funds' investors. In fact, the third party never made any payment into the account; the money was deposited instead by the Ponzi-scheme entities. The person who controlled the entities had also "insisted that the funds not contact (the third party); doing that, he said, would upset his favorable business relations with it."

According to the trustee's complaint, the defendant law firm breached its duty to its clients by failing to inform them that it was the Ponzi-scheme entities and not the third party that made the payments into the account and

that this arrangement posed a risk that the Ponzi-scheme entities were not in fact legitimate businesses. According to the trustee, part of the defendant law firm's duty in structuring the deals "entail[ed] telling the client what contractual devices are appropriate to the situation" so as to achieve the most security. In the trustee's view, when the deal was first negotiated the defendant law firm should have recommended "to ask for additional protections" because the trustee believed that the defendant law firm "did not recognize the risks from a combination of no contacts and no direct payments, plus the potential that the paperwork reporting transactions [with the third party] had been forged." Moreover, when the Ponzi-scheme entities fell behind in their payments to the lockbox (falsely stating that the third party was late in its payments), the trustee contended that the defendant law firm breached its duty when it recommended that "the funds ... defer the due dates on the payments, and that no other change was necessary, even though the delay, coupled with the other indicators, should have alerted any competent transactions lawyer to the possibility of fraud, and the lawyer should have counseled the client to obtain better security."

The district court granted the defendant law firm's motion to dismiss. Accordingly, the trustee appealed to the 7th U.S. Circuit Court of Appeals, which reversed the judgment and remanded.

The circuit court noted that the district court had based its decision on the facts as contended by the defendant law firm and not as alleged in the complaint. In the court's view, the defendant law firm "had to alert its client to the risk of allowing repayments to be routed through [the Ponzi-scheme entities] and drafting and negotiating any additional contracts necessary to contain that risk." The advice should have been offered and, according to the complaint, it had not been. The court did observe, however, that the lawyer is not responsible if the client doesn't follow the offered advice.

Although the court recognized that there can be no bright-line distinction between business advice and legal advice, it found that "it is in the realm of legal advice to tell a client [that] the best security in a transaction such as this one is direct verification with [the third party] plus direct deposits to a lockbox; the second best is direct deposit to a lockbox; and the worst is relying wholly on papers over which [the Ponzi-scheme entities' manager] had complete control." After all, the court noted, those papers may be shams containing forged signatures of third-party personnel who have never heard of the entities or their purported controller. The court indicated that only after being advised of these different legal structures "by a competent lawyer" can the client then make the business decision with respect to how much risk he or she is willing to take.

The court recognized one distinction drawn by the trustee between business advice and legal advice. Specifically, the

## Avoiding Liability



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trustee found no fault in the defendant law firm's failure to advise the funds against doing business with the Ponzi-scheme entities because that would have constituted business advice. Instead the trustee found fault with the firm's failure to give legal advice by not explaining the availability of various legal devices that would have provided greater protection for the loans.

Since the adequacy of the advice depends in part upon the sophistication of the client, the court could not see how the advice could be judged at the motion-to-dismiss stage, especially when the complaint did not allege the level of the client's sophistication. Moreover, the complaint did not specifically allege what advice the funds retained the defendant law firm to provide or what advice the defendant law firm had promised to provide.

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Accordingly, a lawyer is not responsible for bad business advice because, as this court noted, "a lawyer is not a business consultant." Notwithstanding, this case teaches the importance of defining in detail in the engagement letter the scope of representation, specifically including the kind of advice that the client seeks. When defending one from a legal malpractice claim, this will avoid the need to ask the court to draw a distinction between business advice and legal advice because that line will already have been drawn in the engagement letter.