



Alerts

Federal District Court Holds That Engagement Letter Limited Scope of Law Firm's Duties

April 4, 2023

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Damian v. SmithAmundsen, LLC, No. 22 C 2830, 2023 WL 319524 (1/19/23)

Brief Summary

The United States District Court for the Northern District of Illinois, Eastern Division, granted defendant law firm's motion to dismiss the complaint filed by plaintiff—Today's Growth Consultant Inc.—a former client of the firm. The complaint alleged that defendant committed legal malpractice and aided and abetted a breach of fiduciary duty in connection with defendant's prior representation of plaintiff in an SEC subpoena compliance matter. The court disagreed with plaintiff, however, holding that there was no breach of duty because defendant had fulfilled its obligations to plaintiff as defined in the engagement letter. Further, the court ruled that plaintiff failed to sufficiently allege that defendant was the proximate cause of its damages (investigation and prosecution by the SEC for operation of a Ponzi scheme). Accordingly, the court granted defendant's motion to dismiss the complaint due to plaintiff's failure to state a claim.

Complete Summary

In May 2015, the plaintiff received a subpoena from the Securities Exchange Commission (SEC) related to the SEC's investigation of Smart Money Financial Group, Inc. (SMFG). The subpoena requested that plaintiff produce documents and information related to certain "Consulting Performance Agreements" (CPAs) that plaintiff entered into with its investors.

Under the CPAs, investors would provide plaintiff with upfront and continuing payments in exchange for "revenue generating websites" that plaintiff created and maintained. Plaintiff was ultimately unable to make necessary investor payments and resorted to paying old investors with new investors funds, not with earned revenue.

Production of the CPAs was problematic for plaintiff because the SEC might deem the CPAs to be investment contracts—*i.e.*, securities. If the CPAs were deemed securities, they would be subject to SEC registration and regulation.

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In June 2016, plaintiff retained defendant law firm as its "primary securities counsel." The parties agreed to an engagement letter that limited the scope of defendant's representation to: (1) analyzing whether the CPAs constituted "securities" subject to state/federal registration and regulation, or whether the CPAs otherwise required plaintiff or its employees to be licensed, and (2) counseling plaintiff in complying with the SEC subpoena.

Defendant analyzed the agreements, advised plaintiff that the CPAs were in fact securities, and counseled plaintiff on how to respond to the SEC subpoena. Defendant warned plaintiff that it could become a target of SEC investigation because it was in the same basic business as SMFG, which was a Ponzi scheme. Thereafter, the SEC filed an action against plaintiff for operating a Ponzi scheme.

Plaintiff filed a complaint against defendant, alleging that defendant committed legal malpractice and aided and abetted a breach of fiduciary duty in connection with defendant's representation of plaintiff in the SEC subpoena compliance matter. In essence, the complaint alleged that plaintiff would not have been charged by the SEC but for the poor legal advice that it received from defendant.

Defendant moved to dismiss the complaint for failure to state a claim. Defendant argued that the complaint should be dismissed because it owed no duty to plaintiff and did not proximately cause the alleged injury. The court agreed, ruling that defendant had fulfilled its duty to plaintiff under the scope of representation articulated in the engagement letter. The court noted defendant did exactly what was set forth in the engagement letter—provided a legal opinion about whether the contracts were securities and how to respond to the subpoena. Plaintiff sought to impose a general duty to investigate TGC, uncover a complex Ponzi scheme, assist them in complying with the law, and undertake any other measures necessary to avoid the (inevitable) SEC action. The court rejected plaintiff's argument, however, and noted that the words of the contract simply could not bear the obligations plaintiff sought to impose.

Next, the court noted that plaintiff raised two unconvincing reasons why defendant's duties extended beyond the engagement letter's limits: (1) defendant breached certain implied duties, including "the duty of every attorney to inform a client of the available options for alternative legal solutions," and (2) defendant impliedly expanded its duty beyond the letter by rendering legal advice not related to the specific issues the firm addressed. The court first observed that plaintiff made an understandable legal error. Under Illinois law, attorneys do owe clients a duty of fidelity, honesty, loyalty, good faith, and informing clients of "available options for alternative legal solutions." *Keef v. Widuch*, 747 N.E.2d 992, 997 (2001); ILCS S. Ct. Rule of Prof. Conduct 1.7. But these duties are professional, implicit in any contract for legal services, and more closely related to the standard of care. The court stated:

[t]hese free-floating responsibilities do not, however, obligate attorneys to engage in any substantive area that may arise in a case. See *Majumdar*, 653 N.E.2d at 918. The legal contract between the attorney and client sets out the limits of representation, and so long as an attorney executes these duties with competence, loyalty, and fidelity, nothing more is required.

The court also ruled that plaintiff had failed to sufficiently allege that defendant "substantially assisted" plaintiff in the Ponzi scheme. Plaintiff could thus not prove the aiding and abetting claim. The dismissal was without prejudice to plaintiff filing an amended complaint if it was able to do so by February 10, 2023. Plaintiff did so, and defendant has not yet filed its responsive pleading to the amended complaint.

Significance of Decision

The decision is significant because it demonstrates how tailored engagement letters may shield firms from professional liability claims, at least in part, by clearly defining the terms and scope of representation.