

[LEGAL ethics]

COLLECTABILITY, DEDUCTIBILITY AND RECOVERABILITY

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In *Akin, Gump, Strauss, Hauer & Feld, L.L.P. v. National Development and Research Corp., et al.*, the Texas Supreme Court faces three issues that, if decided, could substantially affect how courts handle legal malpractice cases in Texas: collectability of underlying judgments, deduction of contingent fees from damages and recoverability of attorneys' fees that were paid in the underlying suit.

The first issue the court could resolve concerns collectability. As noted in *Cosgrove v. Grimes*, a 1989 Texas Supreme Court decision, in a legal malpractice case a plaintiff has the burden of proving it would have obtained a judgment but for the alleged error — and the judgment would have been collectible.

The Texas Supreme Court has the opportunity to add a substantial amount of clarity to the law on the issue of collectability. For instance, is a simple balance-sheet test for determining collectability sufficient? A defendant in an underlying suit that spawns legal malpractice allegations would pass the balance-sheet test if the assets on its financial statement exceeded its liabilities.

The problem with a simple balance-



sheet test is that it does not take into account assets' liquidity. Some companies have assets that are illiquid; thus, if a defendant cannot sell the asset for what the defendant lists that asset as worth on a financial statement, then any hypothetical judgment the plaintiff may have gotten is not actually collectable.

But courts should require more than just a balance-sheet test. Otherwise, even many of the present bailout recipients might qualify. After all, their assets may be illiquid and might never

attain a value even closely approximating the value shown on their balance sheets.

The better alternative to a balance-sheet test is to add an evaluation of an underlying defendant's liquidity. Under this standard, a plaintiff would need to prove that a defendant in an underlying suit could pay the judgment by liquidating assets. The plaintiff also would need to offer proof of the amounts for which the defendant could sell those assets. Additional issues could affect liquidity: Is the asset subject to another creditor's

lien? Do economic conditions mean there is no market for the sale of the asset?

A related question the high court could answer is: At what time must a plaintiff show collectability of a judgment? During the lifespan of some suits, companies can lose and regain their ability to pay a judgment. If the rationale behind a legal malpractice case is to restore a plaintiff to the position it would have occupied if the alleged error had not occurred, then why would the time to measure collectability be different from that involving any other judgment creditor's claim?

The second issue in *Akin, Gump* — one of first impression in Texas — involves the deduction of contingent fees from damages. This issue has far-reaching implications because it could affect most contingent-fee cases that give rise to malpractice claims.

THE BETTER ALTERNATIVE TO A BALANCE-SHEET TEST IS TO ADD AN EVALUATION OF THE UNDERLYING DEFENDANT'S LIQUIDITY.

Notably, courts in three jurisdictions — South Dakota, Wyoming and the 1st U.S. Circuit Court of Appeals — have adopted the view that a malpractice plaintiff's damages are reduced by the hypothetical contingent fee the plaintiff would have paid to its lawyers if the case had been successful.

However, other courts disagree. Courts in three jurisdictions — New Hampshire, New York and Minnesota — have adopted the view that an award should not be reduced by contingent fees, because a plaintiff should not bear the cost of another set of attorneys' fees.

There also is a hybrid approach adopted in other jurisdictions — Tennessee, Indiana and New Jersey — in which damages are not automatically reduced by the amount of the contingent fee but rather by the value of the services rendered to the client.

The last issue before the Texas Supreme Court in *Akin, Gump* involves whether a plaintiff may recover attorneys' fees paid in the underlying suit. There is a split among the

intermediate appellate courts in Texas on this issue. The 5th Court of Appeals in Dallas, the 14th Court of Appeals in Houston, the 2nd Court of Appeals in Fort Worth and the 8th Court of Appeals in El Paso all have held that attorneys' fees are not recoverable in a legal malpractice action. These courts have held that attorneys' fees are only recoverable when provided for by statute or agreement between the parties, consistent with the Texas Supreme Court's 1964 decision in *Turner v. Turner*.

In contrast, the 4th Court of Appeals in San Antonio, the 1st Court of Appeals in Houston, the 6th Court of Appeals in Texarkana, the 9th Court of Appeals in Beaumont and the 11th Court of Appeals in Eastland have allowed a plaintiff to recover attorneys' fees as damages. The rationale underlying these decisions is the equitable argument that either an attorney's negligence rendered the services of no value,

or the attorney's fees are the legal consequence of the original wrongful conduct and should be permitted as damages. A decision by the Texas Supreme Court in

Akin, Gump could end the split among these intermediate appellate courts.

The Texas Supreme Court could resolve each of these three issues, affecting how lower courts handle legal malpractice claims throughout the Lone Star State. The question is: Will the court reach each of these issues? Attorneys will have to wait and see. **TML**



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