

Lawyer Liability to Non-Clients for Negligence in Transactions

BY ROY SIMON

When is a lawyer or law firm liable to a non-client for the lawyer's negligence in a transaction? This article reviews cases relevant to answering that question in New York, and looks briefly at New Jersey's more liberal approach. In New York, the bottom line is that courts still require privity – or something very close to privity – before they will hold lawyers liable to nonclients for negligence in transactions.

An early case rejecting lawyer liability to nonclients is *National Savings Bank v. Ward*, 100 U.S. 195 (1879), referred to in the Reporter's Note to § 51 of the RESTATEMENT OF THE LAW GOVERNING LAWYERS as the "leading United States case applying the privity doctrine to legal malpractice." Chapman hired attorney Ward to examine and certify Chapman's good title to some Washington, D.C. real estate that Chapman wanted to use as collateral for a bank loan. Although Ward held himself out to the public as "skilled in the examination of titles to real estate situated in the District of Columbia," he overlooked a properly recorded deed showing on its face that Chapman had already conveyed the same property to another person in fee-simple. Because of his negligence, Ward gave Chapman a certificate stating that Chapman had good title to the property and that the property was unencumbered. Chapman showed the certificate to The National Savings Bank, which loaned Chapman \$3,500 in reliance on Ward's certificate. When Chapman defaulted on the loan, the bank attempted to foreclose on its collateral – only to find that Ward's certificate was erroneous. The bank sued Ward and lost at a jury trial, but the trial court took the verdict away because the bank was not in privity with attorney Ward. The bank appealed.

The Supreme Court affirmed. The Court recognized that attorneys promise to employ "a reasonable degree of care and skill" in their professional work, and can be sued by clients who are injured by an attorney's negligence, but in this case "the defendant was never retained or employed by the plaintiffs, nor did they ever pay him anything for making the certificates, nor did he ever perform any service at their request or in their behalf." In fact, the defendant never met with anyone from the bank, and the bank conceded that attorney Ward did not know that Chapman would show his certificate to the bank. Citing English opinions by Lord Chanworth, Lord Wensleydale, and Lord Chelmsford, the Supreme Court said:

By the law of England the right of action depends entirely upon the question between whom the relation of principal and agent, client and attorney, subsists. ...it is impossible to support, by a single case ..., so extraordinary a proposition as that persons who were not, by themselves or their agents, employers of law agents to do an act, could have remedy against such agents for the negligent performance of it.

The Court noted limited exceptions, such as fraud or collusion– "but where there is neither fraud or collusion nor privity of contract, the party will not be held liable, unless the act is one imminently

dangerous to the lives of others, or is an act performed in pursuance of some legal duty." Since these exceptions did not apply, the Court affirmed the judgment for attorney Ward.

The dissent, written by Chief Justice Waite, would have taken a far more liberal approach:

I think if a lawyer, employed to examine and certify to the recorded title to real property, gives his client a certificate which he knows or ought to know is to be used by the client in some business transaction with another person as evidence of the facts certified to, he is liable to such other person relying on his certificate for any loss resulting from his failure to find on record a conveyance affecting the title, which, by the use of ordinary professional care and skill, he might have found.

Justice Cardozo Weighs In

New York generally adhered to the privity requirement stated in *National Savings Bank v. Ward*, but in the granddaddy of non-client professional liability cases, *Glanzer v. Shepard*, 233 N.Y. 236, 135 N.E. 275 (1922), Justice Cardozo began chipping away at the privity requirement in actions against professionals. Glanzer Bros. ("Buyer") was a middleman who contracted to buy 905 bags of beans from a wholesaler, Bech, Van Siclén & Co. ("Seller"). The price depended on the weight of the beans, so Seller asked a public weigher (Shepard) to weigh the beans when they arrived at the dock and to give Buyer a copy of the weight certificate. Seller soon told Shepard that the beans had arrived, that they had been sold to Buyer, and that Shepard should arrange with Buyer a time to weigh the beans before delivery. Shepard did so and certified the weight of the 905 bags of beans. Shepard was paid by Seller and sent a certificate to Seller (with a copy to Buyer) reciting that the certificate was made by order of Seller "for G. Bros." Buyer paid Seller for the beans at the weight shown on the certificate.

When Buyer attempted to resell the beans, however, it learned that the beans weighed nearly six tons less than the weight shown on the certificate supplied by Shepard. Buyer sued Shepard for the amount it had overpaid for the beans. The trial court granted Buyer a directed verdict, but Appellate Term reversed on the ground that Buyer had no contract with Shepard. The Appellate Division reversed and restored the verdict, but a further appeal landed the issue in the lap of the Court of Appeals. For a nearly unanimous court, Justice Cardozo wrote:

We think the law imposes a duty toward buyer as well as seller in the situation here disclosed. The plaintiffs' use of the certificates was not an indirect or collateral consequence of the action of the weighers. It was a consequence which, to the weighers' knowledge, was the end and aim of the transaction.... The defendants held themselves out to the public as skilled and careful in their calling. They knew that the beans had been sold, and that on the faith of their certificate payment would be made. They sent a copy to the plaintiffs for the very purpose of inducing action. ...In such circumstances, assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed. We do not need to state the duty in terms of contract or of privity. ...Given the contract and the relation, the duty is imposed by law. [Emphasis added.]

Justice Cardozo summed up the holding of *Glanzer* pithily: "Diligence was owing, not only to him who ordered, but to him also who relied."

Ultramares Becomes the Ultimate Authority

Nine years later, however, in the even more famous case of *Ultramares Corporation. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), reliance alone proved insufficient. A rubber importer named Fred Stern & Co., Inc. ("Stern") had hired the public accounting firm of Touche, Niven & Co. ("Touche") to prepare and certify a balance sheet showing the condition of Stern's business at the end of 1923. Touche knew that Stern financed its operations by borrowing money, and Touche knew that "in the usual course of business the balance sheet when certified would be exhibited by the Stern Company to banks, creditors, stockholders, purchasers, or sellers ... as the basis of financial dealings." Accordingly, when Touche finished its work on the balance sheet, it supplied the Stern Company not with one copy but with thirty-two copies. However, Touche and Stern did not discuss any specific transactions in which Stern would use the certificates or to whom Stern would show them. In particular, Stern made no mention of Ultramares Corp., a factor that had never before loaned any money to the Stern Company.

By and by, Stern asked Ultramares for a substantial loan to finance the sales of rubber. Ultramares agreed, but only on condition that it receive a balance sheet certified by public accountants. Stern provided the certificates signed by Touche, which showed that the Stern Company had a net worth of more than \$1,000,000 at the end of 1923. On the faith of that certificate Ultramares made a loan, followed by many others.

Unfortunately, the balance sheet prepared by Touche was incorrect. Stern did not have a net worth exceeding \$1,000,000. In reality, both capital and surplus had been wiped out. Stern had fooled Touche's auditors by falsifying the books with fictitious accounts receivable and other assets. When Stern defaulted on the loans, Ultramares sued Touche for negligence. At trial, the jury awarded Ultramares the then-enormous sum of \$187,576. The trial judge overturned the verdict, but the Appellate Division reinstated it, and the case was taken to the Court of Appeals by a team of legal titans, including the legendary John W. Davis (founder of Davis, Polk & Wardwell) on behalf of Touche and Roger Baldwin (founder of the ACLU) and J. Harry Covington (founder of Covington & Burling) on an amicus brief filed by the American Institute of Accountants.

Writing for a unanimous court, Justice Cardozo agreed that the evidence supported a finding that Touche had been negligent, but he refused to find that Touche owed a duty to Ultramares. If a duty were imposed in these circumstances, Justice Cardozo saw a bleak future:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. [Emphasis added.]

But what of *Glanzer v. Shepard*? Wouldn't the principles of that case require liability by Touche? No, said Justice Cardozo:

[In *Glanzer*] the transmission of the certificate to another was not merely one possibility among many, but the "end and aim of the transaction," as certain and immediate and deliberately willed as if a husband were to order a gown to be delivered to his wife ... The bond was so close as to approach that of privity, if not completely one with it. Not so in the case at hand. No one would

be likely to urge that there was a contractual relation, or even one approaching it, at the root of any duty that was owing from the defendants now before us to the indeterminate class of persons who, presently or in the future, might deal with the Stern Company in reliance on the audit. In a word, the service rendered by the defendant in *Glanzer v. Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the benefit of the Stern Company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it hereafter. ... [Emphasis added.]

Justice Cardozo refused to extend liability any further. "The extension, if made," said Justice Cardozo, "will so expand the field of liability for negligent speech as to make it nearly, if not quite, coterminous with that of liability for fraud. ... A change so revolutionary, if expedient, must be wrought by legislation."

The \$92,000,000 Misunderstanding in Prudential

Glanzer and *Ultramares*, of course, were not suits against lawyers. In fact, the New York Court of Appeals did not address lawyer liability to non-clients until it decided the tragi-comic case of *Prudential Ins. Co. of America v. Dewey, Ballantine, Bushby, Palmer & Wood*, 80 N.Y.2d 377, 382, 605 N.E.2d 318, 320, 590 N.Y.S.2d 831, 833 (1992). In 1978, Prudential Insurance Company loaned mountains of money to U.S. Lines. When U.S. Lines got into financial trouble in the late 1980's, it asked Prudential to restructure its \$92,885,000 debt, which was secured by a first preferred fleet mortgage on some of the ships owned by U.S. Lines. Prudential agreed to restructure the debt on the condition that Prudential receive the "favorable opinion" of Gilmartin, Poster & Shafto, a law firm which was counsel to U.S. Lines, "to such effect as shall be satisfactory to Prudential." U.S. Lines promptly instructed the Gilmartin firm to draft the required letter and deliver it directly to Prudential. The Gilmartin firm's opinion letter assured Prudential that the mortgage documents that were to be recorded in connection with the debt restructuring (which had all been prepared by other counsel) represented "legal, valid and binding" obligations of U.S. Lines and that neither Federal nor State law would interfere "with the practical realization of the benefits of the security intended to be provided" by the mortgage documents. Prudential accepted Gilmartin's opinion letter as satisfactory, and permitted the recording of the mortgage documents.

Unfortunately for Prudential, one of the recorded documents had erroneously stated that the outstanding balance of the first mortgage securing the debt was \$92,885, rather than the correct sum of \$92,885,000 – an error of more than \$92 million. As a result, Prudential suffered a loss of \$11,400,000. Prudential sued the Gilmartin firm for negligence.

Prudential acknowledged that it was not in privity with Gilmartin, but contended that the relationship between Prudential and the Gilmartin firm was "sufficiently close" to support a cause of action for negligence. The Court of Appeals agreed. Citing both *Glanzer* and *Ultramares* with approval, and quoting language from *Glanzer* that the Court said was "as applicable now as it was then," the Court said it had "long held that before a party may recover in tort for pecuniary loss sustained as a result of another's negligent misrepresentations there must be a showing that there was either actual privity of contract between the parties or a relationship so close as to approach that of privity." That requirement was "necessary in order to provide fair and manageable bounds to what otherwise could prove to be limitless

liability." Citing *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985), the Court stated "three critical criteria" for imposing fair and manageable liability on a lawyer:

- (1) an awareness by the maker of the statement that it is to be used for a particular purpose; (2) reliance by a known party on the statement in furtherance of that purpose; and (3) some conduct by the maker of the statement linking it to the relying party and evincing its understanding of that reliance

Prudential – like *Glanzer* but unlike *Ultramares* – satisfied all three criteria. First, the Gilmartin firm was "well aware that the opinion letter was to be used by Prudential in deciding whether to permit the debt restructuring." Thus, the "end and aim of the opinion letter" was to provide Prudential with the financial information it required. Second, as the Gilmartin firm "fully expected," Prudential relied on the opinion letter in agreeing to the debt restructuring. Third, by addressing and sending the opinion letter directly to Prudential, the Gilmartin firm "clearly engaged in conduct which evinced its awareness and understanding that Prudential would rely on the letter, and provided the requisite link between the parties." Accordingly, the bond between Gilmartin and Prudential was "sufficiently close to establish a duty of care"

The star-crossed Prudential lost in the Court of Appeals on other grounds. But the *Prudential* case still defines the modern criteria for imposing third-party liability on lawyers in New York state courts. And federal courts have embraced the criteria set forth in *Prudential*, usually refusing to find a relationship between lawyers and third parties sufficiently close to establish a duty of care. See, e.g., *Mason Tenders District Council Pension Fund v. Messera*, 4 F.Supp.2d 293 (S.D.N.Y. 1998) (the criteria stated in *Prudential* "have been applied strictly by New York courts, including this one, to extend attorney liability only in the most limited of circumstances.").

Occasionally, however, New York courts do find a relationship close enough to privity to allow a negligence action against lawyers to go forward. For example, in *Gaddy v. Eisenpress*, 1999 WL 1256242 (S.D.N.Y. 1999), plaintiff Gaddy sued his former attorneys Sherri Eisenpress and Timothy Costello for legal malpractice in a probate matter. Gaddy approached only Ms. Eisenpress, but she urged Gaddy also to hire Costello, an expert in trusts and estates, in order to resolve the matter as quickly as possible. Gaddy authorized Eisenpress to hire Costello, and Gaddy then entered into a retainer agreement with Eisenpress indicating that Eisenpress and Costello would investigate and dispose of the estate matter. Costello never entered into a formal agreement with Gaddy, but the complaint alleged that Costello accepted the appointment and understood that he was being retained to provide advice to Gaddy. Moreover, both Costello and Eisenpress billed Gaddy for their services. Costello moved to dismiss for lack of privity, but Judge Batts denied the motion. She noted that the Court of Appeals had opened a "narrow exception to the historic requirement of privity for attorney malpractice suits" by ruling in *Prudential* that such an action may also stand where there exists "a relationship so close as to approach that of privity." She noted that the Court of Appeals had also cautioned in *Prudential* that "to open the privity exception any further would unfairly impose 'limitless liability' without any 'manageable bounds,'" but – although plaintiff Gaddy conceded that Costello did not enter into a formal agreement – the complaint alleged that Costello agreed to represent him, appeared at meetings, and billed Gaddy for his services. On this record the court refused to conclude that no privity existed, but "even if Costello was not in strict contractual privity with Plaintiff, this does not preclude recovery for legal malpractice"

because the relationship was "so close as to approach that of privity." But we should not read too much into the Gaddy case because Judge Batts granted Costello's motion to dismiss a general negligence claim against him. "To permit Plaintiff's general negligence claim against Defendant Costello," the judge said, "would in effect, permit Plaintiff to make an end run around New York privity requirements."

At least two New York state court opinions have also held that a lawyer's relationship with a third-party plaintiff was sufficiently close to permit an action against the lawyer to proceed. In *Town Line Plaza Associates v. Contemporary Properties, Ltd.*, 223 A.D.2d 420, 636 N.Y.S.2d 57 (1st Dep't 1996), one general partner in a partnership retained attorney Douglas Lustig to file a petition in bankruptcy for a limited partnership. The complaint alleged that attorney Lustig knew, at the time he filed the bankruptcy petition, that "the plaintiff's personal liability as general partner would be accelerated, yet did not apprise him of such filing." The trial court denied Lustig's motion to dismiss and the First Department affirmed, saying the trial court had "properly found that, if proven, such relationship would sufficiently approach privity to enable plaintiff to recover." In another case, *Good Old Days Tavern, Inc. v. Zwirn*, 259 A.D.2d 300, 686 N.Y.S.2d 414 (1st Dep't 1999), the court reversed the Supreme Court's dismissal of a legal malpractice claim filed against an attorney by the president and sole shareholder of the corporation that had hired the attorney. The First Department recognized that "privity of contract is generally necessary to state a cause of action for attorney malpractice," but cited *Town Line*, supra, for the proposition that "liability is extended to third parties, not in privity, for harm caused by professional negligence in the presence of fraud, collusion, malicious acts or other special circumstances." The court then said:

The requisite special circumstances exist here since it is clear that plaintiff Day had a relationship with defendant attorney Zwirn tantamount to one of contractual privity. Indeed, plaintiff Day was for all intents and purposes a foreseeable third-party beneficiary of the contract pursuant to which he retained defendant attorney Zwirn to represent Good Old Days Tavern, Inc. ...

Other Jurisdictions Disagree with New York Approach

Many other jurisdictions have rejected New York's insistence on privity or near-privity before holding lawyers liable to non-clients. In a noteworthy case, *Petrillo v. Bachenberg*, 139 N.J. 472, 655 A.2d 1354 (1995), for example, the New Jersey Supreme Court held that a lawyer could be liable to a real estate purchaser for negligent misrepresentation where the purchaser relied on misleading documents the lawyer had furnished to a real estate broker. Specifically, the court held that "attorneys may owe a duty of care to non-clients when the attorneys know, or should know, that non-clients will rely on the attorneys' representations and the non-clients are not too remote from the attorneys to be entitled to protection." The court stated that the "imposition of defined liability to third parties comports with general principles of tort law." The New Jersey approach is echoed in § 51 of the RESTATEMENT OF THE LAW OF GOVERNING LAYWERS, which provides in relevant part as follows:

§51 Duty of Care to Certain Non-clients

For purposes of liability...a lawyer owes a duty to use care ...in each of the following circumstances: * *

* * *

(2) to a non-client when and to the extent that:

(a) the lawyer or (with the lawyer 's acquiescence) the lawyer 's client invites the non-client to rely on the lawyer 's opinions or provision of other legal services, and the non-client so relies; and

(b) the non-client is not, under applicable tort law, too remote from the lawyer to be entitled to protection.

Conclusion: Lawyers (and Doctors) Love New York

Now that New Jersey and the RESTATEMENT OF THE LAW OF GOVERNING LAYWERS have adopted liberal criteria for finding lawyers liable to non-clients, will New York follow? Personally, I doubt it. I expect New York to continue to adhere to the philosophy of *Glanzer, Ultramares, and Prudential*, making it difficult for non-clients to win negligence suits against lawyers. I base my opinion partly on the recent decision of the Court of Appeals in *McNulty v. City of New York*, 2003 WL 21057383 (N.Y. May 13, 2003), which cut back on a recent expansion of physicians' liability to non- patients. For the foreseeable future, in my view, the risk of lawyer liability to non-clients for negligence in transactions, like the risk of physician liability to nonpatients, remains remote.

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