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This Week's Feature

Detailed Retainer Agreement Key in Law Firm Securing Dismissal of $500 Million Legal Malpractice Claim

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The chances of a non-client bringing a legal malpractice case are significantly reduced when there is a well prepared detailed engagement letter in place. This issue was at the forefront of a $500 million legal malpractice case that was recently dismissed by the trial court in Allegheny County, Pennsylvania.

I. Background Facts

In the matter of *Kirschner v. K&L Gates LLP*, 2010 Pa. Dist. & Cnty. Dec. LEXIS 387 (Dec. 28, 2010 Allegheny County), the liquidating trustee of Le -Nature's Beverages, Inc. asserted legal malpractice claims against K&L Gates LLP, asserting the law firm failed to exercise ordinary skill, care and diligence in conducting an investigation of the facts and circumstances surrounding the resignation of the corporation's chief financial officer, chief administrative officer and vice president of administration in August 2003. Each resigned after Le-Nature's outside auditor was conducting a routine quarterly review of Le-Nature's finances. At the time, the corporation consisted of two groups of equity holders: the founder and chief executive officer (who was looting the company) and investors who held preferred stock. In his letter of resignation, the chief financial officer stated the company's CEO made it impossible for him to discharge his duties because the CEO maintained almost absolute control over the corporation's detailed financial records and denied him access to the documentation supporting the corporation's general ledger.

At the request of the minority directors, Le-Nature's Board of Directors consented to the creation of a Special Committee to conduct an investigation into the allegations and circumstances of the resignation of the three senior financial managers. The Special Committee was composed of the three nonemployee directors on the Board who represented the interests of the minority shareholders. The Special Committee retained K&L Gates to assist in the investigation of the corporation. The terms of the engagement were set forth in an August 28, 2003, letter from K&L Gates to the Chair of the Special Committee which, in relevant part,stated: "You have asked us to represent the Special Committee of Outside Directors of Le-Nature's Beverages, Inc. in connection with a review of the circumstances attendant upon the recent resignation of three members of the finance staff of the Company. It is our Firm's practice to confirm in writing the identity of any client whom we represent, the nature of our undertaking on behalf of the client and our billing and payment arrangements with respect to our legal services. We understand that we are being engaged to act as counsel for the Special Committee and for no other individual or entity, including the Company or any affiliated entity, shareholder, director, officer or employee of the Company not specifically identified herein. We further understand that we are to assist the Committee in investigating the facts and circumstances

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surrounding the aforementioned resignations and assist the Special Committee in developing any findings and recommendations to be made to the full Board of the Company with respect thereto…."

K&L Gates' investigation found no evidence of fraud with respect to any of the transactions it reviewed and no evidence that the transactions identified by the three members of the finance staff as being of concern were problematic or improperly reported on the financial statements. K&L Gates recommended remedial actions that should be taken due to weaknesses in Le-Nature's management structure.

In November 2006, Le-Nature's creditors initiated involuntary liquidation proceedings under Chapter 7. The custodian subsequently converted the proceeding to a Chapter 11 proceeding.

Suit was brought by the liquidating trustee on behalf of the creditors of Le-Nature asserting legal malpractice because K&L Gates failed to discover the massive fraud and they gave the CEO a clean bill of health allowing him to continue the looting of the company, increasing its debt and wasting funds on unnecessary transactions. The company was insolvent when the report K&L Gates' report was prepared in December 2003, but due to mismanagement, it was not discovered until December 2006. The plaintiff sought damages of more than $500 million.

II. Court's Analysis

The court first determined whether the plaintiff (i.e. the liquidator trustee on behalf of the creditors of Le-Nature) had standing to institute a legal malpractice case against K&L Gates.

In Pennsylvania, in the absence of special circumstances, the only persons who may bring a legal malpractice action are clients. *Wachovia Bank, N.A. v. Ferretti*, 935 A.2d 965, 570 (Pa. Super. 2007). An implied attorney-client relationship exists, absent an express contract, where (1) the purported client seeks advice or assistance from the attorney; (2) the advice is within the attorney's professional competence; (3) the attorney expressly or implicitly agrees to render such assistance; and (4) the putative client reasonably believes the attorney was representing it. *Cost v. Cost*, 677 A.2d 1250, 1254 (Pa. Super. 1996).

The court found there was no implied attorney-client relationship between K&L Gates and the creditors because the engagement letter was an express contract. The engagement letter specifically recited who the firm was representing and explicitly stated it was not representing the corporation. Since K&L Gates was instructed by the Special Committee to determine whether the CEO was looting the company, the investors had a reasonable belief that the law firm was representing their interests, and only these interests, in investigating whether there was merit to the concerns of mismanagement on the part of the CEO.

Since the trustee was not bringing the lawsuit on behalf of the investors whom K&L Gates was retained to protect, the trustee had no standing to assert a cause of action for legal malpractice. Thus, the retention agreement which expressly identified K&L Gates' clients prevented the court from undergoing analysis to determine whether an implied attorney-client relationship existed between the corporation's creditors and K&L Gates. K&L Gates used the retainer agreement to obtain a dismissal at an early stage and to quickly avert a $500 million claim against it even though the court stated the CEO was looting the company and K&L Gates did not detect it.

Although the court did not address whether K&L Gates in fact breached its duty owed to the investors because they were not a party to the litigation, it appears such claims would also likely be unsuccessful because the investors sustained no damages. To prevail in a malpractice action, the plaintiff-client must establish the failure of the defendant-attorney to exercise ordinary skill and knowledge was a proximate cause of actual damages to the plaintiff-client. *Captial Care Corp. v. Hunt*, 847

A.2d 75, 82 (Pa. Super. 2004). At the time the investigation was conducted, Le-Nature was insolvent. As a result of the CEO's additional looting following the dissemination of K&L Gates' report the company became much more insolvent. Although no Pennsylvania appellate case law considered whether increased insolvency constitutes a loss to the corporation, based on Delaware law, the *Kirschner* court rejected the concept of deepening insolvency as actual damages to sustain a malpractice claim.

III. Conclusion

Well crafted detailed retention letters which clearly identify the clients and the scope of the attorneys' engagement are critical. Retention letters can limit malpractice suits when they clearly specify who the law firm owes a duty to and can prevent the court from determining whether an implied attorney-client relationship exists between a person who the firm may have thought was a non-client. This is important when a law firm is retained by a small group of associated entities, corporations or persons.

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