Avoiding Liability

No Malpractice Claim Unless the Actual Client Sustains Damages

By Jeffrey P. Lewis

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It is a well-settled principle that to establish a legal malpractice claim one must prove an "actual loss rather than a breach of a professional duty causing only nominal damages, speculative harm or the threat of future harm." A limited exception to this rule has been carved out judicially by application of an intended third-party beneficiary theory and, even then, only based upon breach of contract. Notwithstanding any exception, a third party to the attorney/client relationship who sustains damages as a result of the attorney's negligent conduct generally lacks privity to assert a claim. But what about in instances where the attorney represents only one member of a corporate family of companies but his or her negligence causes another member of that corporate family to incur damages? Can the first corporation assert the malpractice claim notwithstanding that it was another member of the corporate family that incurred the damages? A recent federal district court opinion addresses this issue.

In *General Nutrition Corporation v. Gardere Wynne Sewell, LLP*, 2010 WL 2891247 (W.D.Pa.), a lawyer and his law firm were retained to represent a corporation that wished to repudiate two contracts. That corporation was a separate entity from its two parent corporations. All three corporations were part of "a family of numerous companies that operate retail stores, and sell vitamins, nutritional supplements and diet products." The client corporation acts as the operating entity of the business. It owns the retail stores, employs thousands of employees and signs the leases in its corporate name. It does not maintain a bank account; all bills are paid by another corporate entity.

The operating company sought advice with respect to two contracts it had with an outside company that produced for it two magazines, which were a large part of the corporate family's marketing strategy and budget. New management of the corporate family wanted to repudiate the operating company's contracts and it sought legal advice with respect to the possible consequences of the anticipated lawsuit from the outside company that would result from such an action. The issue was not whether the client would be in breach of contract — the consensus was that the client would be found in breach. Instead, the issue concerned the damages that the outside company could establish. This involves a legal determination concerning whether the outside company could recover for consequential damages, and whether it could depends upon whether the Uniform Commercial Code (UCC) applies to these contracts. Under the UCC, consequential damages cannot be recovered. But whether the UCC would apply rests upon a determination of whether "the contracts predominantly involved the sale of services, not goods." The UCC applies only if the contracts predominantly involved goods.

Members of the law firm drafted a series of legal memoranda in which they conclude that the UCC did apply to these contracts and, as a result, the outside company would be unsuccessful in its attempts to assert a claim for consequential damages. Counsel had made it clear, however, that neither he nor his law firm could make any guarantee of this result in view of the vagaries of courts and juries. The combined boards of directors of the parent companies met with counsel and with a senior partner in a private investment fund that had purchased the entire family of corporations. The fund's senior partner expressed the view that counsel's opinion was overly optimistic. Based upon the advice given by the defendant law firm, the boards nonetheless resolved that the operating company would repudiate the contracts.

As expected, the outside company brought suit, in Ohio, against the operating company, which retained the same counsel who had opined that the UCC does apply. What was not expected, however, was that the Ohio court ruled that the UCC does not apply to these contracts. As a result, the outside company could recover consequential damages. The operating company then fired its counsel and hired replacement counsel, who advised "that there was a high probability of a significant adverse monetary outcome" in the case. As a result, the operating company settled the case for $12 million. But the operating company did not pay for the settlement. Instead, another corporate family member paid the settlement proceeds.

The operating company then brought a malpractice action against counsel and his law firm in state court for counsel's mistaken (at least according to the Ohio court) advice that the UCC did apply. The suit was removed to federal district court based upon diversity.

The defendant lawyers moved for summary judgment based upon the premise that the operating company cannot satisfy the damages element. They argued that the operating company had sustained no actual monetary loss because the settlement was not paid out of its pocket and that it involves speculation, based upon the summary judgment record, to say that there will ever be an internal adjustment within the corporate family so that the operating company will bear this loss.

Judge Terrence F. McVerry granted the summary judgment motion, noting Pennsylvania Supreme Court case law emphasizing that "courts will disregard the corporate entity only in limited circumstances when used to defeat public convenience, justify wrong, protect fraud or defend crime." This case, in the court's view, did not constitute one of those circumstances; the mere fact that the two corporations in question are "related or closely affiliated" or "intertwined" does not create standing by one to assert a claim belonging to the other. Therefore, the court found that the operating company cannot show any damages.

This case teaches a clear lesson: When anticipating bringing a legal malpractice action against former counsel whose negligence forced the client to settle a lawsuit and the settlement draft is not on the client's account (such as a related corporation or even a family member in the instance of an individual client), inquiry must be made to determine whether the settlement has actual adverse financial consequences upon the named client. Would the result have been different if the parent company loaned the settlement proceeds to the named client rather than having paid on its behalf? If a settlement is being funded by other than the actual client, even by a family member, consideration should be given to structure the payment as a loan to the client.

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