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Law Firm Owed Various Duties Stemming From Investigation Into Insider Wrongdoing

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Lawyers for the Profession® Alert

Kirschner v. K & L Gates LLP, 46 A.3d 737 (Pa. Super. 2012)

Brief Summary

The Superior Court of Pennsylvania held that: (1) an attorney-client relationship existed between a law firm and a corporation (despite a disclaimer); (2) the company's liquidation trustee sufficiently alleged a legal malpractice action against the firm; (3) the trustee sufficiently alleged that the firm and an investigative company had master-servant relationship, which would allow for vicarious liability of the firm; and (4) the defense of imputation, under the *in pari delicto* doctrine, did not bar the action.

Complete Summary

Three senior members of a corporation's board, including its chief financial officer (CFO), submitted their resignations to the company's chief executive officer (CEO) because of financial improprieties and the CEO's refusal to allow access to the pertinent financial records. The company's auditor declined further participation absent an investigation of the allegations and a report by independent legal counsel. The board appointed a special committee of independent, nonemployee directors, which did not include the CEO, and which in turn retained a law firm. The law firm's engagement letter provided:

You have asked us to represent the Special Committee ("Special Committee") of the Outside directors of Le–Nature's Beverages, Inc. ("Company") 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 the client whom we represent, the nature of our undertaking on behalf of that 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. (Retention Ltr. – emphasis added).

Attorneys

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In turn, the law firm retained an auditing firm as its consultant to provide financial accounting, and to perform investigative or other advice as requested. In 2003, the law firm presented its draft report to the CEO, who provided comment. The law firm stated that it "found no evidence of fraud or malfeasance with respect to any of the transactions" that were the subject of the investigation. The CEO then called a board meeting for approval, although the special committee had not seen the report.

In 2006, the minority shareholders, including the three independent directors, filed an injunctive action against the allegedly wrongdoing insiders. This was followed by an involuntary bankruptcy initiated by creditors because of hundreds of millions of dollars in improper expenditures. The liquidation trustee brought the present action against the law firm, the auditor it had retained, and others.

The trial court sustained demurrers to all counts, but the appellate court reversed, rejecting the argument that there was no attorney-client relationship between the law firm and the corporation. The court explained that under Delaware law, the board could delegate tasks to a committee, although the ultimate responsibility ran to the entity. Thus, not only was the law firm unable to disclaim that obligation to the corporation, but also its billing to the company and its direct dealings with the CEO – the target of the investigation – were inconsistent with and negated its disclaimer.

The trial court also concluded that the minority shareholders were not harmed because the corporation was insolvent when the law firm was retained, although that insolvency increased by $500 million thereafter. Referring to federal case law and predicting Pennsylvania law, the court found support for the damage concept of "deepening insolvency," which was an injury to the corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life. The damage premise is that taking on additional debt causes injury through "operational limitations, strained corporate relationships, diminution of corporate assets, and the legal and administrative costs of bankruptcy." The court concluded that in any event, the increased insolvency did not negate the harm caused by the law firm as a substantial factor, which if the wrongdoing was properly reported, would have enabled action that could have avoided expanded debt and preserved assets.

The appellate court also upheld other counts, including those for breach of contract, breach of fiduciary duty and negligent misrepresentation. In doing so, the court noted plaintiff's allegations that the lead lawyer had misrepresented his investigation experience, and that the law firm channeled all document requests to the person they were supposed to be investigating, and referenced multiple other violations of its duties of loyalty and competence owed to the corporation. Further, the law firm could be vicariously liable for the conduct of the auditing firm that it engaged and directed.

Significance of Opinion

This decision is significant because it addresses the expansive scope of duties a law firm may undertake when retained to investigate insider wrongdoing at a corporation, despite a disclaimer in the retention agreement.

For further information, please contact Terrence P. McAvoy.

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