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Virginia's "New" New Business Rule

by Robert E. Scully, Jr.

For more than 70 years it has been a truism of Virginia damage law that a plaintiff cannot recover lost future profit damages caused by a defendant's destruction of his new or unestablished business. *Clark v. Scott*, 258 Va. 296, 520 S.E.2d 366 (1999); *Scheduled Airlines Traffic Offices, Inc. v. Objective: Inc.*, 180 F.3d 583 (4th Cir. 1999); *Mullen v. Brantley*, 213 Va. 765, 195 S.E.2d 696 (1973) (collecting cases).

Until quite recently, this New Business Rule was applied with eager vigor in both breach of contract and intentional tort cases. Cf. *Lockheed Information Management Systems Co. v. Maximus, Inc.*, 259 Va. 92, 524 S.E.2d 420 (2000) (for intentional interference with a business expectancy, the degree of proof is relaxed in favor of the injured party); with *Murray v. Hadid*, 238 Va. 722, 385 S.E.2d 898 (1989) (defrauded builder of custom homes denied projected profit he would have made on a townhouse project); and *PBM Products, Inc. v. Mead Johnson & Co.*, 174 F.Supp. 2d 424 (E.D. Va. 2001) (applies in tort cases).

On April 6, 2002, Governor Warner signed into law an act designed to ameliorate the sometimes-harsh results dictated by Virginia's New Business Rule. The new Code section is Va. Code Ann. § 8.01-221.1 "Unestablished business damages; lost profits."

Damages for lost profits of a new or unestablished business may be recoverable upon proper proof. A party shall not

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be deemed to have failed to prove lost profits because the new or unestablished business has no history of profits. Such damages for a new or unestablished business shall not be recoverable in wrongful death or personal injury actions other than actions for defamation.

Will this statute revolutionize contract and business tort damages in Virginia? Will the proverbial floodgates open up, resulting in huge lost future profit damage awards to plaintiffs? Only time will tell. However, the experience in other jurisdictions suggests that the answer is no.

The new Virginia statute eliminates the *per se* rule that a new or unestablished business without a history of profits cannot recover lost future

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Letter from the Chair

The Year in Review

They say the years go by faster as we grow older. If my year as chairman of the Litigation Section's Board of Governors is any indication, they are right.

As I look back on my time on the board, I think mostly of how fortunate I have been to have had the opportunity to work with such a wonderful and talented group of people. The current board is outstanding and has certainly made my job easy. As this issue of *Litigation News* goes to print, the Litigation Section's web page is being set up. It will contain, among other things, all of the informative articles from past issues of the newsletter. Lee Livingston has provided another year of excellent work as editor of the newsletter. Ann Crenshaw has been instrumental in getting the web page up and running.

Every member of the board has provided valuable service to the Section over the course of the year. Board meetings have been well attended, and board members have diligently sought out and written newsletter articles, taken part in special projects, and discussed and resolved a wide variety of Section business. Here is a sampling of some of the activities board members have undertaken this year: William Shewmake has revived the Appellate

Practice Subcommittee, which just completed a very successful program featuring comments from Justice Lacy; Kevin Mottley is spearheading efforts for the Young Lawyers Committee to sponsor an informative and ambitious CLE

program next year; Paul Black has helped put together (with the Bench-Bar Committee) the Section's CLE workshop program at the Summer Bar Conference in Virginia Beach entitled "Jury Orientation and Management: Practical and Ethical Issues and Solutions"; Sam Meekins has been our financial guru; Glenn Pulley, the Section's past chair, took responsibility for the Section's excellent issue of the *Virginia Lawyer* published earlier this year. All of the members of the board have played an active role in keeping the Section on track. In addition, our Section liaison, Pat Sliger, offered invaluable assistance, for which I have been very grateful.

I pass on the ceremonial gavel to Tom Albro. I know

that he will do an outstanding job as chair of the Board of Governors for 2002-03. For me, it has been an enjoyable job because of the people who have been around me. But the time went by very quickly...

Frank K. Friedman
Chair, Litigation Section

Every member of the board has provided valuable service to the Section over the course of the year. Board meetings have been well attended, and board members have diligently sought out and written newsletter articles, taken part in special projects, and discussed and resolved a wide variety of Section business.

Blue-Pencil Clauses in Covenants Not to Compete: Be Careful What You Ask For

by William H. Shewmake

Drafting a covenant not to compete in an employment contract is a difficult and perilous task because of special rules that apply to such covenants. Covenants not to compete in employment contracts are disfavored under Virginia law, and consequently the covenant will be strictly construed against the employer. *Motion Control Systems Inc. v. East*, 262 Va. 33, 546 S.E.2d 424 (2001).

Because covenants not to compete are disfavored, courts will allow an employee to perform post-employment competitive activities so long as there is any plausible basis to strike down the covenant or narrow the scope of the covenant so that it does not apply to the activity in question. This strict construction can take two radically different forms. If the covenant is capable of being narrowly interpreted not to cover the former employee's subsequent activities, the Court will adopt that interpretation. *Clinch Valley Physicians, Inc., v. Garcia*, 243 Va. 286, 414 S.E.2d 599 (1992) (The covenant not to compete prohibited similar employment in a defined geographic location if the employment was terminated for any reason whatsoever. The Court construed the contract to mean that the covenant applied only if the employment contract was terminated by the employer for cause.) *Linville v. Servisoft of Va., Inc.*, 211 Va. 53, 55, 174 S.E.2d 785, 787 (1970). (Covenant not to compete that prohibited employee from working with any competitor does not prohibit employee from competing as

a sole proprietor.) Conversely, if the covenant not to compete is susceptible to two interpretations, one of which would be enforceable and the other which would not, the Court will adopt the broader interpretation in order to strike down the covenant as invalid and unenforceable. *Power Distribution, Inc. v. Emergency Power Engineering, Inc.*, 569 F.Supp. 54 (E.D.Va. 1983). (Court will adopt the broader interpretation in order to strike down the covenant. Subjecting employee to an ambiguous covenant violates sound public policy.)

Faced with such strict construction, many drafters include language in the covenant not to compete that gives a court authority to reduce the scope of the covenant not to compete if the court determines that the covenant is overbroad. This is commonly referred to as a blue-pencil provision. These drafters understand that absent such a provision, Virginia courts will not rewrite an overly-broad covenant but will instead simply strike it down. *Cliff Simmons Roofing, Inc. v. Cash*, 49 VCO 156 (1999).

Drafters will include a blue-pencil provision in the hope that such an express contractual provision will confer upon a court the ability to rewrite the contract. Having included a blue-pencil provision, some drafters will proceed to write a draconian covenant not to compete, relying upon a court to modify it if necessary. These drafters believe such a strategy will maximize the scope of the covenant and intimidate former employees because they will be uncertain as to their rights. Other drafters recognize that the blue-pencil provision may well be unenforceable, but will include the provision in an otherwise narrow covenant in the belief that it will not hurt and might help. As set forth below, both rationales are flawed.

Deciding whether to include a blue-pencil clause in a contract involves a two-step process. The draftsman must first decide whether the clause is enforceable and, if not, whether including the clause represents any risk to the validity

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of the entire covenant not to compete. Although the Supreme Court of Virginia has not decided the issue directly, it likely will find that a contractual blue-pencil provision violates sound public policy. In turn, because the blue-pencil provision is invalid, the entire covenant may well be struck down. Thus, a proper analysis leads to the conclusion that the risks associated with such a clause outweigh the possible benefit.

The Supreme Court of Virginia Probably Will Hold that a Blue-Pencil Clause Is Unenforceable

In the absence of a blue-pencil clause in the covenant not to compete, courts uniformly have held that Virginia public policy prohibits a court from rewriting or narrowing an unenforceable covenant in order to render it enforceable. *Alston Studios, Inc. v. Lloyd V. Gress Associates*, 492 F.2d 279, 283-85 (4th Cir. 1974) (Declining to narrow the covenant.) *Grant v. Carotek, Inc.*, 737 F.2d 410, 412 (4th Cir. 1984). Other federal and Virginia circuit court decisions have followed and adopted this interpretation of Virginia law. *Cliff Simmons Roofing Inc. v. Cash*, 49 VCO 156 (1999); *Roto-Die Co. v. Lesser*, 899 F.Supp. 1515, 1523 (W.D.Va. 1995).

While the Supreme Court of Virginia has not expressly rejected the blue-pencil rule, the

Court, in striking down covenants, has cited and quoted with approval a federal decision that rejected the blue-pencil rule. *Meissel v. Finley*, 198 Va. 577, 579, 95 S.E.2d 186, 188 (1956); *Richardson v. Paxton*, 203 Va. 790, 794, 127 S.E.2d 113, 117 (1962). The

The same public policy that prevents courts from narrowing the covenant absent a blue-pencil clause continues to apply if the covenant contains a blue-pencil clause. A blue-pencil clause likely violates public policy, because it attempts to force a court to draft a contract for the parties. Courts do not render advisory opinions; nor should they be in the business of writing contracts for private parties.

special rules of construction applicable to covenants not to compete, which the Supreme Court of Virginia has enunciated, also implicitly reject any ability to "blue-pencil" an invalid covenant. For example, the Court has held that in addition to general rules of contract construction, special legal principles apply to covenants not to compete, because such covenants are disfavored as restrictions on trade. Under these special legal principles, the employer must prove that the covenant is not overbroad in light of the employer's legitimate interests. The employer must also prove that the covenant is not unduly harsh on the employee. In addition, the covenant cannot violate sound public policy. Finally, if any ambiguity exists in the covenant, it will be strictly construed against the employer. *Motion Control Systems, supra*, 262

Va. at 37, 546 S.E.2d at 425-26.

In applying the above legal principles, the Supreme Court of Virginia has not hesitated to strike down a covenant not to compete that could be interpreted as overbroad. The Court also has refused to analyze the subjective intent of the parties whenever it construes the covenant. *Linville v. Servisoft of Va., Inc.*, 211

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Legal Malpractice Claims After *O'Connell v. Bean*: "Contort" or Contortion?

by Arthur E. Schmalz

The Supreme Court of Virginia's January 22, 2002 decision in *O'Connell v. Bean*¹ represents a noteworthy development in the law of legal malpractice and professional negligence. The Court's ruling establishes that legal malpractice claims are, fundamentally, breaches of contract, despite having some distinctly tort-like attributes. As a result, punitive damages are now unavailable in most legal malpractice cases, and likely other professional negligence suits as well. They can be recovered only where the misconduct at issue amounts to a willful tort that is independent from the professional's duty to follow the appropriate standards of care. *O'Connell* likely will be warmly received by the defense bar and malpractice insurance carriers.

As explained below, just seven years earlier, the Supreme Court had appeared to embrace a tort-oriented view of legal malpractice claims, holding that contributory negligence could be asserted as a defense to such claims.² While *O'Connell* did not reverse that earlier decision, it nonetheless seems to evidence the Court's intent to preclude other tort concepts and remedies from further permeating professional negligence claims. After *O'Connell*, the standards governing legal malpractice claims appear to be an odd blend of tort and contract concepts — a "contort,"³ perhaps. It is also unclear to what extent that the Court's rationale may be applicable to other causes of action, such as breach of

fiduciary duty claims against corporate officers and directors.

The Supreme Court's Decision in *O'Connell*

O'Connell involved claims of professional negligence, breach of fiduciary duty and fraud arising out of O'Connell's representation of Bean in a divorce suit.⁴ Bean's professional negligence and breach of fiduciary duty claims were based upon O'Connell's alleged breach of the appropriate standard of care. By contrast, Bean's actual and constructive fraud counts alleged that O'Connell had misrepresented her skill and ability to handle divorce cases.⁵

The trial court initially entered a default judgment against O'Connell.⁶ O'Connell moved to set aside the default on the ground that she had not been properly served with process.⁷ Although the trial court refused to set aside the default altogether, it did vacate the damages award, and conducted a jury trial limited to the issue of damages.⁸ The jury returned an award of \$71,535.68 in compensatory damages and \$110,000 in punitive damages, which the trial court confirmed in a final judgment order.⁹

On appeal, the Supreme Court reversed the trial court and vacated the default judgment, holding that O'Connell had not been validly served with process.¹⁰ Since that ruling was dispositive of the appeal, the Court did not need to reach any other issues. Yet, because questions concerning an award of punitive damages might arise during the new trial, the Court decided to take an excursion into the propriety of such an award under the facts of the case.¹¹

O'Connell claimed that punitive damages were unavailable as a matter of law because the negligence, breach of fiduciary duty and constructive fraud claims were all founded upon alleged breaches of duty arising from the contract between attorney and client.¹² Bean, on

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