Ethical Issues Facing Corporate Counsel in Closely Held Business Disputes

By Paula Bagger – February 23, 2015

The Winter 2014 issue of *Commercial & Business Litigation Newsletter* (log-in required) was devoted to complications that abound when the owners of a small business become embroiled in litigation. One important set of concerns—in keeping with the ethics theme of this current newsletter issue—involves a lawyer’s ethical obligations to avoid conflicts of interest and fulfill his or her fiduciary obligations. When counsel represents a closely held entity, it is not always easy to discern when a conflict of interest has arisen or where a fiduciary duty may be owed. This article reviews the issues that a lawyer must consider before wading into an intracorporate dispute among the stakeholders of a closely held entity.

For purposes of this article, a “closely held entity” means a business organization in which there are a small number of owners and a substantial overlap between “owners” and “management,” i.e., most if not all owners are also employees and company management owns a significant portion of the entity. This is most often a corporation but could also be a limited liability company or a limited partnership.

The Applicable Ethical Rules

The ABA *Model Rules of Professional Conduct* (Model Rules), adopted in some form in a majority of U.S. jurisdictions, follow an “entity representation” approach to questions concerning an attorney’s representation of an organization. *Model Rule 1.13* (Organization as Client) provides that “[a] lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.” The organization is the client, not its “constituents,” a broad term that includes directors, officers, shareholders or members, and employees. A lawyer who represents a corporate entity may also represent one or more “constituents,” but the lawyer does so subject to the conflict of interest rules for multiple representations found in *Model Rule 1.7*, that is, the lawyer may not undertake a representation that (1) is directly adverse to a current client, or (2) may “be materially limited by the lawyer’s responsibilities to another client,” absent consent after consultation.

The application of ethical rules based on “entity representation” is relatively straightforward in the case of large, public corporations. Corporate management may need to be reminded in some circumstances that corporate counsel represents the corporation and not particular managers, and this is addressed in the Model Rules. *See* Model Rule 1.13(f). But a shareholder of a large, public corporation is unlikely ever to meet the corporation’s lawyer and will rarely labor under the misconception that the corporation’s lawyer is the shareholder’s lawyer as well. By contrast, in a small family business or a startup tech firm, the same individual very often is an officer, a director, and a shareholder (controlling or minority)—and the lawyer a familiar face with whom the individual has worked in a number of capacities. In these circumstances, a “constituent” may far more easily develop a reasonable belief that corporate counsel represents the constituent as well.

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Who Is Your Client?
An attorney-client relationship may be formed by express agreement or it may be created by implication. The issue arises with frequency when there is a falling out among shareholders in a closely held corporation, and corporate counsel aligns itself with one faction (typically, the controlling shareholders). The following are factors that have led courts to decide an implied-in-fact attorney-client relationship has been formed between corporate counsel and a constituent:

- frequent contact between corporate counsel and the constituent during counsel’s representation of the corporation
- past representation of the constituent by corporate counsel, whether or not the matters were related
- particular interest of the constituent in the matter at issue
- failure of the constituent to retain his or her own lawyer
- advice provided by corporate counsel to the constituent
- disclosure of confidences by the constituent to corporate counsel
- payment by the constituent of some portion of corporate counsel’s fees
- absence of any statement by corporate counsel about which entities or constituents were his or her clients

Whether an implied attorney-client relationship exists is highly fact-intensive. As the list above reflects, it depends to a significant degree on whether the individual could reasonably have understood himself or herself to be represented by corporate counsel. Compare Detter v. Schreiber, 610 N.W.2d 13 (Neb. 2000) (finding it reasonable for plaintiff 50 percent owner of corporation to have assumed that corporate attorney represented him individually where he had met with and disclosed confidences to corporate counsel, who never said he did not represent plaintiff, and defendant shareholder had once advised plaintiff that attorney represented plaintiff’s interests), with TJD Dissolution Corp. v. Savoie Supply Co., 460 N.W.2d 59, 62 (Minn. Ct. App. 1990) (finding it unreasonable for individual to have assumed attorney was representing him when his interests differed from the interests of his brothers, the controlling shareholders; the individual knew the attorney had represented the corporation for several years; and the individual was advised, on at least one occasion, to get his own lawyer).

In the context of intracorporate disputes, a constituent may try to establish an attorney-client relationship with corporate counsel for a number of different reasons. The constituent may wish to assert a claim against counsel, to claim that a conflict of interest disqualifies counsel from representing the entity or a different constituency, to shield confidences the constituent made to counsel by asserting an attorney-client privilege, or to pierce an assertion of privilege by the entity or another constituent.

What Duties Do You Owe?
In some jurisdictions, the inquiry starts and ends with “entity representation,” but the results in these cases do not always satisfy. For instance, in Skarbrevik v. Cohen, England & Whitfield, 282 Cal. Rptr. 627 (Ct. App. 1991), a 25 percent shareholder of a closely held corporation was forced
out by the three-member majority, which reneged on an agreement to purchase his shares and then amended the articles of incorporation to eliminate his preemptive rights against dilution. The plaintiff sued corporate counsel, asserting that it had breached an obligation to inform him of the majority’s skullduggery. The court rejected the idea that corporate counsel had owed any duty to the plaintiff while he was a shareholder because there was no attorney-client relationship, no professional duty to the plaintiff as a nonclient, and no basis for the plaintiff to have placed special trust or confidence in counsel or to have relied on it to act in his best interests.

Courts in other jurisdictions have explored ways to temper this harsh result, thus muddying the bright-line rule about the absence of a duty owed by counsel to nonclient constituents of closely held entities.

In some jurisdictions, corporate counsel may be found to owe a fiduciary duty to each of the owners of the closely held client. See Johnson v. Superior Court, 45 Cal. Rptr. 2d 312, 322 (Ct. App. 1995) (finding an attorney’s representation of limited partnership imposed an obligation of loyalty to all partners with respect to their entitlement to partnership benefits: “Whether this constituted [him] an attorney, literally, for the individual limited partners, is of no great moment. He had a duty to the partnership to look out for all the partners’ interests.”); Schaeffer v. Cohen, Rosenthal, Price, Mirkin, Jennings & Berg, P.C., 541 N.E.2d 977, 1002 (Mass. 1989) (finding “logic in the proposition” that counsel for closely held corporation, who “does not by virtue of that relationship alone have an attorney-client relationship with the individual shareholders, . . . nevertheless owes each shareholder a fiduciary duty”) (dicta); Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C., 309 N.W.2d 645, 648 (Mich. Ct. App. 1981) (holding a fiduciary duty to corporate constituents arises “when one reposes faith, confidence, and trust in another’s judgment and advice”).

In other jurisdictions, shareholders and other constituents of a corporate client may in some circumstances have been considered third-party beneficiaries of the attorney-client relationship. See Chem-Age Indus., Inc. v. Glover, 652 N.W.2d 756 (S.D. 2002). As with the imposition of a fiduciary duty, the idea is that in a small, closely held entity, legal services could plausibly be performed for the benefit of some or all of the shareholders, although this theory has more often been employed to find a duty of care, rather than loyalty.

A third approach focuses on the allegation that corporate counsel knowingly participated in the controlling shareholders’ improper activities, thus aiding and abetting breaches of fiduciary duty by the latter. Granewich v. Harding, 985 P.2d 788, 790 (Or. 1999) (holding lawyer liable for acting in concert with majority shareholders of closely held corporation to effect a “squeeze out” of a minority shareholder in breach of their fiduciary duties).

Fulfilling Your Duty to the Entity
Even after counsel to a closely held business has clearly delineated the scope of representation and educated himself or herself about possible obligations to nonclients, the very nature of the
closely held client requires continuing vigilance to ensure that counsel consistently acts in the best interests of the corporate client.

Assume, for example, that corporate counsel is advising executive management about a personnel decision that counsel concludes would be a violation of law likely to damage the corporate entity. Model Rule 1.13(b)–(d) provides a road map for counsel to follow: unless the lawyer concludes that it is in the entity’s best interests not to do so, counsel must report the matter to a higher authority and escalate as necessary.

In the context of a closely held corporation, however, matters can become more complicated. Now assume that corporate counsel is advising executive management (the controlling shareholders) concerning the termination of an employee (the minority shareholder), and counsel becomes concerned about the possibility of a freeze-out. What action would be in the “best interests” of the corporation? To whom does counsel owe a duty, and how does he or she fulfill it? It would not be prudent to assume that the matter will begin and end, as it did in the *Skarbrevik* case above, with the reflexive response that the corporation’s best interests lie in whatever the majority decides. And if counsel does sometimes owe a fiduciary duty to the constituents of a closely held corporate client, does that duty obligate counsel to inform the minority shareholder of the majority’s plans—despite the confidentiality obligations imposed by Model Rule 1.6?

Corporate counsel needs to understand the limitations of the Model Rules in answering the questions that arise with closely held entities’ intracorporate disputes, to proceed with deliberation, and to make a clear record of counsel’s dealings with all of a closely held corporation’s constituencies. In that vein, here follows a list of important things to remember when representing closely held business entities.

### 10 Important Considerations When Representing Closely Held Entities

1. No matter how small the noncontrolling interest, a closely held corporation is a separate entity from its shareholders and is entitled to separate representation.

2. Every shareholder must understand that, unless a joint representation has been undertaken, corporate counsel’s primary obligation is to the corporation.

3. Corporate counsel should confirm in a written engagement letter the identity of his or her client.

4. Particularly if there are any special circumstances (e.g., the corporation is very small or a third party is paying the fees), corporate counsel should confirm in writing who is *not* his or her client.
5. Whenever dealing with a constituent whose interests are potentially adverse, corporate counsel should explain that counsel represents the corporation and not the constituent.

6. Corporate counsel may represent constituents as well as the corporation if the conflict rules of Model Rule 1.7 are satisfied. Any conflict waiver must be given by an authorized representative of the corporation other than the one counsel is seeking leave to represent. Model Rule 1.13(e).

7. The possibility of a conflict increases if you represented some or all of the constituents in creating the corporation or drafted agreements among the constituents. So does the possibility of winding up on one or more witness lists.

8. Corporate counsel must be aware of special circumstances creating a duty to nonclient constituents.

9. Corporate counsel should observe corporate formalities and insist on compliance with corporate governance documents.

10. Corporate counsel should only take direction from “duly authorized” constituents and document their instructions.

Awareness of, and attention to, these considerations should significantly help corporate counsel to navigate the ethical minefields in closely held business disputes.

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