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Corporate Counsel And Duties Beyond The Client

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Representing closely-held entities can present a challenging array of ethical dilemmas for in-house or outside counsel, especially with regard to fiduciary duties and conflicts of interest. These challenges can be particularly onerous where in-house counsel wears two hats for the entity: lawyer and executive.

This article outlines some of the legal landmines counsel for the closely-held entity may face, and how corporate lawyers may insulate their business clients and themselves from claims by third parties.

Divided Loyalties

On the one hand, it is generally the case that a lawyer to a closely-held entity only owes a legal duty of care to the entity, not to individual shareholders or members of the entity. This is because a lawyer does not owe a duty to a third party that might conflict with a duty to her client. In rare cases, a legal duty to third parties may arise where there is an implied attorney client relationship or where the third party reasonably relies on the lawyer's advice and counsel.

Counsel should always make clear to shareholders and members that he or she represents the entity and not their interests. Assuming that is done, a lawyer to a closely-held entity is generally insulated from claims of legal malpractice by individual shareholders or members, unless those claims are brought as derivative actions on behalf of the entity itself.

On the other hand, when it comes to fiduciary duties, a lawyer's potential for liability may be broader. A lawyer's fiduciary duties, including the duty of loyalty and fairness, may extend to third parties, including the individual shareholders and members of a closely-held entity. A recent Massachusetts Supreme Judicial Court case, Baker v. Wilmer Cutler Pickering Hale and Dorr, addressed this issue.[1]

In Baker, the lawyers represented a closely-held limited liability company. The LLC's operating agreement gave substantial rights in managing the LLC to both the majority and minority members. When the company started having financial issues and the members reached an impasse, however, the majority put a plan into action to take over the company.

The majority members hired counsel for the LLC to assist in structuring a secret transaction to bypass the provisions of the LLC's operating agreement that protected the minority members. After the minority members were effectively stripped of their rights, they sued the majority members and the lawyers who represented the company.

The trial court dismissed the claims against the lawyers on the grounds that the minority members never relied on the advice of the lawyers and that the lawyers for the entity did not owe a fiduciary duty to the minority members, as it would conflict with the duties owed to its client, the LLC. The Supreme Judicial Court reversed. The court, relying on dicta from its nearly-30-year-old decision in Shaeffer v. Cohen[2], held that it could see the "logic" in imposing a fiduciary duty on counsel for the closely-held entity to protect the minority members' rights, and, therefore, the case should not have been dismissed at the pleading stage.

While Baker may be distinguishable on a number of grounds, including the grant of management rights to the LLC's minority shareholders in the operating agreement, it did leave open the question of what counsel should have done. An ethics article by Massachusetts Bar Counsel following Shaefer suggests that the result of Baker may have been different had the lawyers disclosed the transaction to the minority members.[3]

Certainly, where the majority of a closely-held entity seeks to take action to prejudice the minority interests, counsel to the entity should consider whether it can follow the instruction of the majority in such a transaction, whether it needs to disclose such action to the minority interests and whether it should advise the majority and minority interests to obtain separate counsel.

Conflicts of Interest

In limited circumstances, counsel to a closely-held entity may represent both the entity and one or more shareholders or members. Under Rule 1.7 of the Model Rules of Professional Conduct, such concurrent representation is allowed only if the interests of the entity and the shareholder or member are aligned, the lawyer can provide "competent and diligent" representation to both clients and each client gives "informed consent, confirmed in writing."

Similar considerations must be taken into account when a lawyer transitions from representing the closely-held entity to only representing a shareholder or member of the entity, or vice versa. Under Rule 1.9 of the Model Rules, a lawyer cannot represent a client in a matter adverse to a former client "in the same or a substantially related matter" in which that client's interests are "materially adverse to the interests of the former client", unless the lawyer again obtains informed, written consent of the former client.

The pitfalls in both of these situations happen, of course, when the conflict arises or already exists and could result in malpractice claims, ethics complaints or disqualification. In M'Guinness v. Johnson, the California Courts of Appeals took the rare step of reversing the denial of a motion to disqualify a law firm as a result of the law firm's concurrent conflict of interest representing a shareholder, Johnson, and the corporation, TLC, in a litigation in which they were directly adverse.[4]

Although the law firm in M'Guinness argued that it no longer represented TLC at the time it represented Johnson, the court noted that the firm had an ongoing attorney client relationship with TLC over a number of years, had actively represented TLC until a year prior to its representation of Johnson and had never sent a withdrawal or disengagement letter to TLC, and that other conduct of the law firm indicated that it continued to represent TLC after it had begun to represent Johnson. For these reasons, the court held that the law firm was engaged in an impermissible concurrent representation and had to be disqualified.

The lesson of M'Guinness is that a lawyer should be very cautious when entering into concurrent or subsequent representation of a closely-held entity and one or more shareholders or members. To lessen the risks, the lawyer should be very clear who he is representing in the engagement letter, and send a disengagement letter once the representation is over.

The lawyer must obtain informed, written consent if he is entering into a concurrent representation or seeks to represent a client in a matter adverse to the former client. The lawyer must then withdraw if an impermissible conflict of interest arises.

Wearing Two Hats

Problems for in-house counsel can arise when counsel to the closely-held entity also acts as an officer or director of the entity and participates in business decisions. While communications with counsel to the entity may be privileged if they concern legal advice or are in anticipation of litigation, general communications about the business are not protected.

Counsel also has to be aware of who is receiving the communications. If privileged communications are shared with others outside the management group or the board, they can be deemed waived. In-house counsel should always clearly identify communications that she seeks to keep confidential and privileged, and take steps to make sure those communications are not broadly distributed.

A further complicating factor arises when a director or manager sues a closely held entity and seeks privileged communications between the entity's counsel and the management group or board, as often happens in derivative actions. The law protects the rights of directors or managers of closely held entities to receive corporate records that other directors and officers receive, assuming the interests of the director or manager are aligned with the entity's interests.[5]

The law is also clear, however, that the lawyer's duty is to his client, the entity, which owns the privilege, and only the entity can waive it. Counsel to the closely held entity must be cautious with whom and when it shares the company's privileged communications.

In sum, corporate counsel will inevitably face ethical dilemmas when representing closely-held entities. The duties counsel owes to the shareholders and members will vary by circumstance and the terms of the agreements among the shareholders and members of the entity. Counsel must address such dilemmas with thoughtful consideration of his or her role in the entity, the rights of the shareholders and members and the controlling agreements.

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[1] Baker v. Wilmer Cutler Pickering Hale and Dorr, LLP, 91 Mass. App. Ct. 835, -- N.E.3d -- (2017).

[2] Shaefer v. Cohen, 405 Mass. 506, 541 N.E.2d 997 (1989).

[3] John W. Marshall, Assistant Bar Counsel, Closely Held Conflicts (July 2003), available at https://bbopublic.blob.core.windows.net/web/f/closely_held.pdf.

[4] M'Guinness v. Johnson, 243 Cal. App. 4th 602, 627, 196 Cal. Rptr. 3d 662, 680–81 (2015).

[5] Chambers v. Gold Medal Bakery Inc., 464 Mass. 383, 396, 983 N.E.2d 683, 693 (2013).
