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Bankruptcy Ruling Reminds Corp. Counsel To Mind Rule 1.13

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Under the Model Rules of Professional Conduct 1.13(a), "A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents." The ethics issues arise, however, when the individuals running the organization seek to take steps that benefit themselves and not necessarily the entity. While the rules make clear that the lawyer for the organization must act in the best interest of the organization, from whom does the lawyer obtain direction when a conflict arises between the organization and the "duly authorized constituents" tasked with running it?

A recent decision of the U.S. Bankruptcy Court for the District of Massachusetts in the adversary proceeding Cruickshank v. Dixon,[1] in which the court denied a motion to dismiss claims asserted against a law firm and two of its lawyers, is the latest in a series of cases that analyzed conflicts of interests arising in cases where the controlling equity holders seek legal advice in taking actions against the interest of the corporations. These cases emphasize the need for business attorneys to closely examine actual and potential conflicts of interest before and during transactions, especially when representing a closely held entity.

The case, brought by the trustee of the Chapter 7 debtor, Blast Fitness Group LLC, or BFG, alleged that the law firm defendants, among other things, committed malpractice, breach of fiduciary duty and unfair and deceptive practices by taking direction from BFG's sole manager and member, Harold Dixon, to the detriment and harm of BFG, including its other members. The law firm defendants moved to dismiss on statute of limitations grounds and that it was not a conflict to represent both the entity and its controlling equity holder.

The court disagreed, holding that, notwithstanding that one of the transactions in question had closed more than three years prior, the statute of limitations against the law firm defendants could be tolled because the complaint stated a claim for fraudulent concealment. Specifically, the complaint alleged sufficient facts that the law firm defendants owed and violated fiduciary duties to BFG by, for example, knowingly assisting Dixon in purchasing real estate with BFG assets without transferring any ownership to BFG. As such, the statute of limitations on BFG's claims against the law firm did not start to run until the disinterested members of BFG had actual knowledge that they had been harmed. The court, citing the adverse domination doctrine, held that Dixon's knowledge of his own wrongdoing could not be imputed to BFG and therefore, the statute of limitations for BFG's claims were tolled while it was under the control of Dixon.

The court also held that, despite the fact that it is common for attorneys to simultaneously represent a company and its controlling equity holder, the complaint set forth sufficient facts that the law firm defendants could not do so in this situation because they knew that Dixon was self-dealing and not acting for the benefit of BFG. In other words, assuming the facts in the complaint were true, the law firm defendants engaged in an impermissible, unwaivable conflict of interest, which caused harm to BFG.

The problems with conflicts arising in transactions was also highlighted in a 2017 Appeals Court decision, Baker v. Wilmer Cutler Pickering Hale & Dorr LLP,[2] which reversed the dismissal of claims brought by minority members of an entity against the entity's lawyers, who had allegedly, at the direction of the majority members, assisted in stripping the minority of their rights and equity in the company. The court, pointing to provisions in the company's operating agreement that gave specific rights to the minority members to participate in management, held that in certain circumstances, counsel to an entity will owe duties not only to the entity, but also to the minority members, notwithstanding the potential for conflicting duties. In the 2016 case of Bryan Corp. v. Abrano,[3] the Supreme Judicial Court affirmed the disqualification of a law firm from representing minority shareholders because the law firm had failed to withdraw from also representing the company at a time when there was a conflict or at least a potential for conflict between the shareholders and the company.

It must be kept in mind that decisions in Cruickshank and Baker were in the context of a motion to dismiss, where the court was required to accept the facts of the complaints as true. The real facts, once vetted through discovery, could demonstrate that the lawyers ultimately complied with their duties to the organizations. Assuming the facts are true, however, and with the benefit of hindsight, what could the lawyers have done differently? We must again turn to the Rules of Professional Conduct.

Rule 1.13 states that if the lawyer knows that an "officer, employee or other person associated with the organization" is acting in a way that violates a legal obligation to the entity or a violation of law and will likely result in substantial injury to the organization, the lawyer shall refer the matter to the "higher authority in the organization," which is usually a board of directors or similar governing body, but could also be independent directors of the organization. Moreover, when the organization will be taking an action that is adverse to an officer, director, employee or equity holder, counsel should make clear that he only represents the entity and urge that individual to seek independent counsel. Finally, Rule 1.7 urges lawyers who are going to represent both an organization and an officer, director, or majority equity holder in a matter should obtain informed consent to the dual representation and that, in the event that a conflict arises, the lawyer may have to withdraw from representing one or both of his clients.

Lastly, it is important for counsel to understand the management and control hierarchy of the business he or she is representing. Attorneys must always be wary of where their duties lie and when a conflict might arise; they cannot merely rely on the direction of the controlling equity holder. Attorneys may also avoid the serious consequences of conflicts between clients by well-crafted engagement letters, disengagement letters and by seeking guidance on their duties when the potential for conflict exists.

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[1] Cruickshank v. Dixon (In re Blast Fitness Grp.), Nos. 16-10236-MSH, 18-01011, 2019 Bankr. LEXIS 41 (Bankr. D. Mass. Jan. 8, 2019).

[2] Baker v. Wilmer Cutler Pickering Hale & Dorr LLP, 91 Mass. App. Ct. 835, 81 N.E.3d 782 (2017).

[3] Bryan Corp. v. Abrano, 474 Mass. 504, 52 N.E.3d 95 (2016).