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CLOSELY HELD CONFLICTS

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In the December, 2001, article "Corporate Conflicts", the Bar Overseer wrote of the potential conflicts of interest that can arise in representing a corporate entity. (This and all other Bar Overseer columns can be found online at www.mass.gov/obcbbo). Toward the end of that article, a follow-up was promised on conflicts in connection with the formation and representation of closely held corporations. This is that article.

First, a definition-a "closely held" corporation is a corporation "typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation." Donahue v. Rodd Electrotype Co. of New England, Inc., 367 Mass. 578, 586 (1975). The important characteristic for the purposes of this article is that the management and ownership of a close corporation is in the hands of a few, often only two, individuals.

The Bar Overseer article of December, 2001, emphasized that under Mass. R. Prof. C. 1.13, counsel to a corporation does not automatically also represent the various corporate directors, officers and employees with whom the lawyer must communicate on behalf of the corporation. With a close corporation, although the same rule and principles apply, the fact that those corporate managers are also owners of the corporation can cause some unique and heightened concerns for counsel in avoiding conflicts of interest.

When the corporate managers with whom the lawyer deals also own a controlling interest in the corporation, the line between owner-managers and the corporate entity they own can become blurred. Over a period of time in a close working relationship, the lawyer may come to believe that the owner-manager's interests are synonymous with those of the corporation, as they will frequently be. For the same reasons, the owner-manager may come to believe that the lawyer represents his or her personal interests as well as those of the corporation. In either event, the lawyer's role can become problematic in the event that a dispute breaks out between the owner-manager and other shareholders over the management or control of the business.

In Schaeffer v. Cohen, Rosenthal, Price, Mirkin, Jennings & Berg, P.C., 405 Mass. 506 (1989), the Supreme Judicial Court dealt with conflicts problems that can arise from a dispute among shareholders of a close corporation. The plaintiff, Schaeffer, and her brother-in-law, Gross, were each 50% owners of a corporation. Although they both were officers and directors, Gross managed the business. Cohen and his firm were initially retained by Schaeffer and Gross to incorporate the business. Gross continued to use Cohen as corporate counsel.

At some point, Schaeffer became concerned about Gross's management of the business and retained her own counsel. From that point onward, Cohen represented the corporation and Gross in defending actions brought by Schaeffer, including a derivative action alleging excessive salary and diversion of assets and an action to dissolve the corporation. After those

cases were settled, Schaeffer sued Cohen for damages, alleging that Cohen had engaged in conflicts of interest by representing the business and Gross in the disputes with Schaeffer.

On appeal, the Court upheld the dismissal of Schaeffer's suit because her claims were not personal but derivative on behalf of the corporation and because she lost standing to press those claims when she sold her stock to Gross as part of the settlement of the prior derivative action. The Court also approved, however, the trial court's conclusion that Cohen had represented conflicting interests when he represented Gross and the corporation in the prior derivative action.

The Court also discussed fiduciary obligations in the Schaeffer decision. After noting that shareholders of a closely held corporation owe each other the same fiduciary duties owed to one another by partners in a partnership, the Court stated:

> Indeed, there is logic in the proposition that, even though counsel for a closely held corporation does not by virtue of that relationship alone have an attorney-client relationship with the individual shareholders, counsel nevertheless owes each shareholder a fiduciary duty. . . . [Citation omitted]. Just as an attorney for a partnership owes a fiduciary duty to each partner, it is fairly arguable that an attorney for a close corporation owes a fiduciary duty to the individual shareholders.

405 Mass. at 513. This fiduciary obligation adds another unique level of concerns in the representation of a closely held corporation.

In a decision dated August 19, 2002, in Applebaum v. Verndale Corporation et als., 2002 WL 1917262 (Mass. Super.), the superior court disqualified the defendant's corporate counsel from representing the corporate and individual defendants in the case in reliance on the above language from Schaeffer. The plaintiff was a minority shareholder of a closely held corporation suing for breach of fiduciary duty and wrongful termination of employment. Although the court noted that the plaintiff did not claim to be a client of corporate counsel, the court concluded that the corporate lawyer owed the plaintiff a fiduciary duty that would be compromised by counsel's representation of the defendants in the suit.

Similar reasoning informs the disciplinary case of Matter of Thurston, 13 Mass. Att'y Disc. R 776 (1997). The respondent represented a real estate development corporation that was equally owned by two individuals. Shortly after a dispute broke out between the two shareholders, one shareholder asked the respondent for assistance in obtaining control of the property of the corporation. The respondent prepared and recorded deeds transferring the corporation's real estate to that shareholder and did not inform the other shareholder of this transaction. In a decision adopted by a single justice of the Supreme Judicial Court, the Board of Bar Overseers concluded that the respondent engaged in a conflict of interest in representing the shareholder in obtaining the property while also representing the corporation. The Board also concluded that the respondent breached "a legal duty as counsel to the corporation to inform one shareholder of an imminent and grave breach of fiduciary duties by the other." Id. at 789 (citations omitted). The respondent was suspended for six months for his misconduct. See also Matter of Wise, 433 Mass. 80, 88-89 (2000) (six-month suspension for attorney in part for becoming "embroiled in an internal power struggle" (Id. at 88) over control of a non-profit corporation).

The fiduciary obligation owed to all shareholders of a close corporation augments the obligations of a corporate lawyer who discovers serious internal misconduct. Rule 1.13(b) requires the lawyer for any corporation to consider reporting the matter to the attention of senior management or the corporation's "highest authority". If, however, the corporation is closely held, the lawyer also has a fiduciary obligation to report the matter to all of the shareholders. This reporting requirement is consistent with corporate counsel's obligations to the corporation because the purpose is not to punish the wrongdoer or to protect the interests

of individual shareholders, but to protect the interests of the corporate client. See 1 Hazard & Hodes, The Law of Lawyering § 17.5, illustration 17.3, at 17-14 through 17-16 (3rd Ed., 2003 Supplement).

So what can a conscientious lawyer do to avoid conflicts pitfalls in representing closely held corporations? For starters, the lawyer needs to be aware and remain aware that the corporation is a separate entity entitled to independent representation. This remains true no matter how small the corporation is and no matter how much control the majority shareholder has. The lawyer needs to remember that the interests of the owner-manager and the corporation are not always synonymous.

Likewise, the shareholders of the corporation need to be aware and be reminded that the lawyer represents the corporation and not them individually. If a shareholder wants the lawyer to represent him or her individually as well, such representation should be undertaken cautiously under Rules 1.13(e) and 1.7. Given the Applebaum decision and the fiduciary obligations owed to all shareholders of a close corporation, corporate counsel should not represent any shareholder in any matter that could result in or become part of an intra-corporate dispute over management or control of the corporation.

Awareness and acknowledgement of the lawyer's role in representing a closely held corporation should begin at the beginning-when the lawyer first becomes involved with the business. If this happens prior to incorporation, the lawyer should meet with all who will be shareholders to discuss the representation issues. The lawyer should make it clear that he or she will represent the corporation and not any of the shareholders. This meeting may prompt the first pitfall because it may be that the shareholders will want or should have shareholder and employment agreements in place prior to incorporation. Because of the importance of such agreements in close corporations and the potential for differing interests then and down the road, corporate counsel should encourage the shareholders each to have their own counsel in the negotiation of these agreements.

Finally, as the Schaeffer, Applebaum and Thurston cases make clear, the obligations of counsel representing close corporations depend on the special obligations among shareholders of such corporations. It is therefore incumbent on lawyers to pay close attention to developing case law in both the corporate and ethics fields.

While these protective steps may seem burdensome, it is important to assure that the lawyer and all shareholders of a close corporation keep clear in their minds the limitations on the role of corporate counsel. If those limitations become blurred, an internal corporate fight can become side-tracked with disqualification issues, as in Applebaum, and in damage claims, as in Schaeffer. Protections taken early on will be for the benefit of all concerned in the long run.

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