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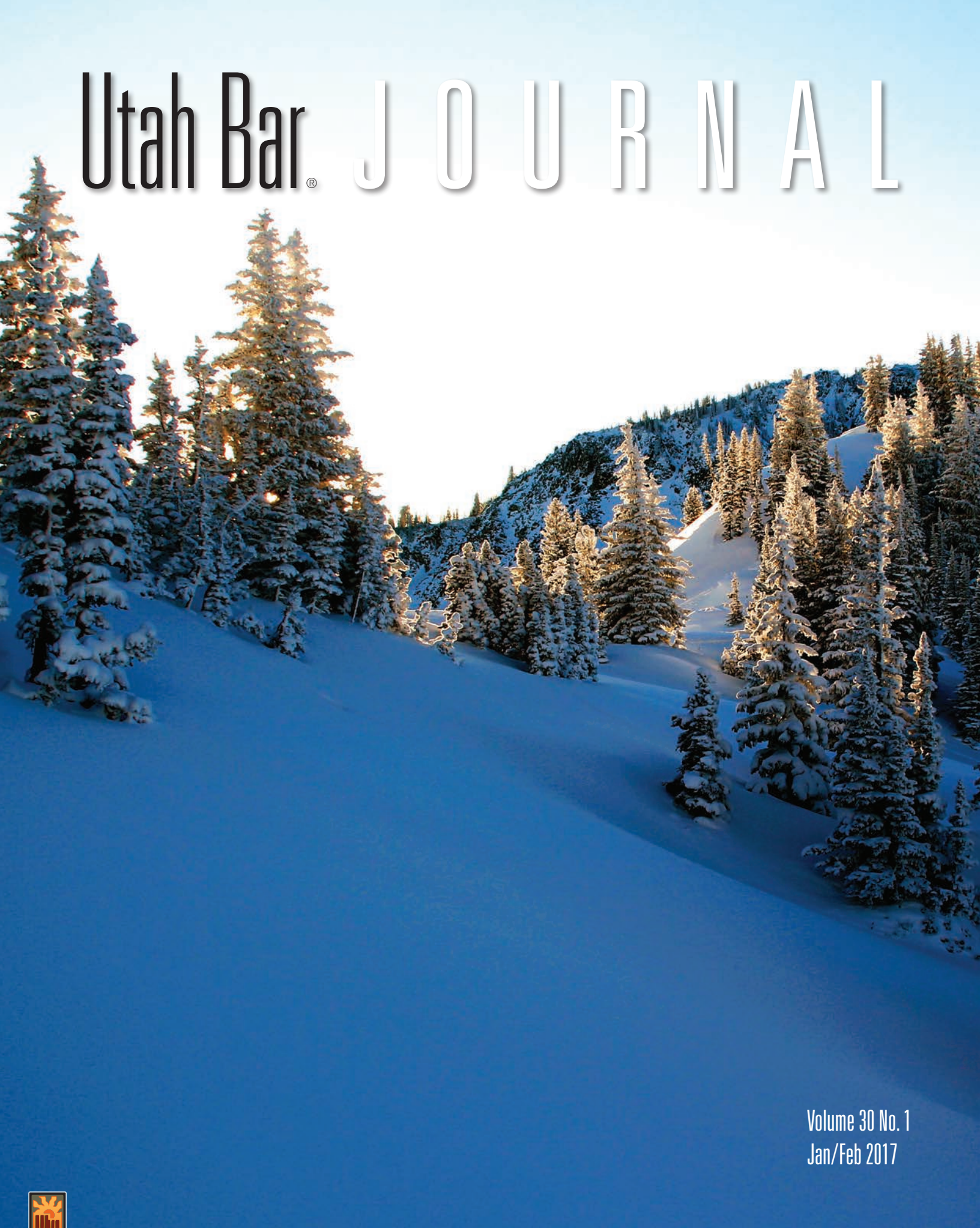

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Hold Me Close: Lawyers Beware, the Closely Held Company

by Eric Maxfield and Darren Reid

Utah's standard for forming an *implied* attorney-client relationship is nebulous from a loss prevention perspective, creating potential problems for even the most careful practitioner who clearly defines who the client is and the scope of such representation. *See Roderick v. Ricks*, 2002 UT 84, ¶ 40, 54 P.3d 1119 ("An attorney-client relationship exists when a person reasonably believes that the attorney represents the person's legal interests. In order for a person to 'reasonably believe' that an attorney represents the person, (1) the person must subjectively believe the attorney represents him or her and (2) this subjective belief must be reasonable under the circumstances." (internal citation and quotation marks omitted)). Though a person's belief must be reasonable under the circumstances of a particular case, this standard provides a pathway for malpractice claims against lawyers representing only a corporate client. This can be particularly tricky for transactional lawyers helping corporate clients navigate the varied interests of multiple shareholders. It is not uncommon for an officer, director, or shareholder of a company to later argue, "Hey, I thought you were my lawyer, too!"

ARGUMENTS SUPPORTING AN IMPLIED ATTORNEY-CLIENT RELATIONSHIP

The problem intensifies when lawyers represent closely held companies with relatively few shareholders or members. As most transactional lawyers are aware, the line between legal advice to the corporate client and legal advice to the person running the company can sometimes get blurry. Consequently, lawyers must be careful not to unwittingly expand the client relationship or the scope of representation beyond what was originally intended.

In recent legal malpractice cases, plaintiffs have argued that when a lawyer represents a closely held business, Utah courts should automatically impute an attorney-client relationship between the lawyer and the founder or majority shareholder of that closely held company regardless of what the engagement letter or other signed documents provide. The argument suggests that because the company is "virtually indistinguishable" from its founder or shareholder, the lawyer represents both the company and the founder/shareholder individually as a matter of law. *See, e.g., In re Brownstein*, 602 P.2d 655, 657 (Or. 1979) ("Where a small, closely held corporation is involved…the attorney in such a situation represents the corporate owners in their individual capacities as well as the corporation unless other arrangements are clearly made."); *In re Banks*, 584 P.2d 284, 290–91 (Or. 1978); *see also Detter v. Schreiber*, 610 N.W.2d 13, 17 (Neb. 2000) (holding that lawyer assisting closely held corporation acted on behalf of the corporation and both shareholders); *Matter of Nulle*, 620 P.2d 214, 217 (Ariz. 1980) (holding that attorney represented two principal owners of closely held company in their individual capacities while also serving as attorney for the company).

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In support of implying attorney-client relationships between company lawyers and the founders/shareholders of closely held companies, litigants have pointed to two Oregon cases, *Brownstein* and *Banks*, and suggested the Utah Supreme Court implicitly adopted this approach in *Margulies v. Upchurch*, 696 P.2d 1195 (Utah 1985). In *Margulies*, the court dropped a footnote citing *Banks*, noting "where the Oregon Supreme Court found that an attorney who was representing a closely held corporation was in fact representing both the corporation and its dominant shareholder because the interests of both were at stake." *Id.* at 1201 n.2.

We do not believe *Margulies* or current Utah law supports an argument that lawyers for closely held companies *per se* represent the company's founder or majority shareholder. Indeed, adopting such a *per se* standard would turn the legal representation of companies on its head and irrevocably change transactional practice in Utah.

Such a standard is contrary to the well-established rule that "[a] corporation exists apart from its shareholders, even where the corporation has but one shareholder." *Fassihi v. Sommers, Schwartz, Silver, Schwarts & Tyler, P.C.*, 309 N.W.2d 645, 648 (Mich. Ct. App. 1981). Even in a closely held company "the attorney's client is the corporation and not the shareholders." *Id.; see also Johnson v. Superior Court*, 45 Cal. Rptr. 2d 312, 321–22 (Cal. Ct. App. 1995) (holding that the lawyer for LLC owed no ethical duty to limited partners); ABA Formal Op. 91-361 (1991) ("Generally, a lawyer representing a partnership represents the entity rather than the individual partners."); *Margulies*, 696 P.2d at 1200 (reaffirming the well-established general rule "an attorney representing a corporation or similar entity owes allegiances to the entity rather than to its shareholders").

Utah law should recognize the corporate form and an attorney's fiduciary duties, when engaged by the company, should inure to the company only. *See* Utah R. Prof'l Conduct 1.13(a) ("A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."). Indeed, the corporate form is generally enforced to shield shareholders from company obligations, liabilities, taxes, penalties, and judgments. It should likewise operate to ensure directors, officers, and shareholders do not conflate the role of counsel hired to represent the company's interests.

In our view, *Margulies* does *not* hold that shareholders or members in a closely held or emerging business automatically have an attorney-client relationship with company counsel any time their individual interests may be directly involved in a transaction. *Margulies*, 696 P.2d at 1198. The court in *Margulies* was careful to limit its holding to the specific facts of the case before it:

> It should be noted that we do not find that an attorney automatically becomes counsel for limited partners when he or she undertakes representation of a limited partnership. Ethical Consideration 5-18 of the Utah Code of Professional Responsibility (1977) states that an attorney representing a corporation or similar entity owes allegiance to the entity rather than to its shareholders.... [T]herefore representation of a limited partnership does not of itself require allegiance to the interests of the limited partners.

Id. at 1200 (internal citation and quotation marks omitted).

Since *Margulies*, the Utah Supreme Court clarified that "direct involvement" with the individual interests of the partners or principals in an organization "is not a separate test, but only one factor to consider in determining whether the specific circumstances of the case demonstrate the individual [] partner's belief concerning representation is reasonable." *Kilpatrick v. Wiley*, 2001 UT 107, ¶ 49, 37 P.3d 1130. Thus, the standard for

forming an implied attorney-client relationship, as defined in *Roderick v. Ricks*, is necessarily a case-by-case inquiry.

Relying on the decades-old *Brownstein* and *Banks* decisions is misplaced for two other reasons. First, courts have rejected arguments asserting an automatic representation rule in the context of closely held corporations, distinguishing *Brownstein* and *Banks* as "extreme" outliers. *See, e.g., First Republic Bank v. Brand*, 2001 WL 1112972 at *4 n. 9 (51 Pa. D. & C.4th 2001) (characterizing *Brownstein* as an "extreme example" that "has been limited in focus in subsequent decisions"; "most courts…have analyzed the attorney-client relationship in closely held corporations based on the facts of the particular case"); *Agster v. Barmada*, 43 Pa. D.&C.4th 353, 369 (C.P. Allegheny 1999) (stating that there is "no legal justification" for an "absolute rule that in closely held corporations corporate counsel represents all shareholders"); *McCarthy v. John T. Henderson*, Inc., 587 A.2d 280, 283 (N.J. Super. 1991) (dismissing the *Brownstein* and *Banks* decisions as the "only two instances in which a court has disregarded the corporate form and determined that the principles of the corporation were indistinguishable from the corporation itself"); *In re Conduct of Kinsey*, 660 P.2d 660, 670 (Or. 1983) (distinguishing and narrowing *Brownstein*).

Second, closely held companies often are nothing like the exclusive, founder-dominated, family-run businesses described in *Banks* and *Brownstein*. In many instances, closely held or emerging businesses will have multiple investor, boards of directors, officers, and/or managers operating running the business, reinforcing a clear distinction between the corporate client and its authorized constituents.

We urge courts and practitioners to reject a proposed *per se* standard, which to date has neither been adopted nor clarified by Utah courts. When a company is solely owned or dominated by one person, we believe that adopting a *per se* rule imputing an attorney-client relationship between the lawyer and the sole owner would be troubling policy from a loss prevention perspective, especially when the lawyer and the sole owner have agreed upon an engagement where the company is the only client. A careful lawyer would be required to second-guess – or disclaim – too many interactions with his or her client's authorized constituent, rather than focusing on providing appropriate legal advice for the company in unfettered communication with the sole owner. We acknowledge there may be instances where an implied attorney-client relationship could (and even should) be formed, but such a relationship should be reasonable under the circumstances of a given case, instead of an initial presumption or automatic conclusion.

BEST PRACTICES WITH CLOSELY HELD COMPANIES AND THEIR CONSTITUENTS

Lawyers can and should protect themselves to avoid confusion with an authorized constituent of a closely held company, which may include founders, directors, officers, shareholders, members, or employees. This is true not just for transactional lawyers, but all lawyers who represent closely held companies. We believe the following practices will significantly reduce malpractice exposure and the likelihood that a founder or shareholder later claims that an implied attorney-client relationship also existed between the lawyer and the individual.

Avoiding "Stale" Engagement Letters

Consistent with Rule 1.5 of the Utah Rules of Professional Conduct, most lawyers formalize an engagement with a letter that specifies the corporate client and scope of representation. Problems arise when engagement letters gather dust in the file and the scope of representation evolves over time. For example, many initial engagement letters for corporate work identify the corporate client and set forth a broad scope of representation, such as "to provide general corporate advice" or "to assist in forming the company and related organizational documents," etc. Later, when a lawyer assists the corporate client in purchasing real estate or obtaining investment funds, such a generalized engagement letter may not adequately reflect the current scope of representation. When a new or significant client transaction is on the horizon, it is the perfect time to refresh the engagement letter, define the new scope of representation consistent with Rules 1.4 and 1.5, and, critically, remind all authorized company constituents – including founders or majority shareholders – that the representation is expressly limited to the company only.

Writing "I'm Not Your Lawyer" Letters/Emails

When a corporate transaction might touch on the personal interests of a founder or shareholder, a lawyer should remind the company's authorized constituents, in writing, that the lawyer represents the company only and not the owners, shareholders, members, directors, and/or officers. Many careful and well-intentioned practitioners may believe that a client's oral confirmation as to the lawyer's representation should suffice. But consider whether lay jurors, who often believe lawyers uniformly "document" all their dealings with clients, will accept the lawyer's testimony that the scope of the representation was discussed orally but never written down. Even a short email will be powerful evidence in a subsequent dispute regarding whom the lawyer actually represented in a transaction. It may also generate a contemporaneous

conversation with the authorized constituents to dispel any confusion about the lawyer's role and duties.

When a company transaction "goes bad," a malpractice plaintiff may later argue that, as a founder or significant shareholder, they were an "unrepresented person" in the transaction and that it directly involves their personal interests. Rule 4.3(a) of the Utah Rules of Professional Conduct states:

> When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct that misunderstanding. The lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonable possibility of being in conflict with the interests of the client.

Rule 1.13(f) of the Utah Rules of Professional Conduct has similar language: "In dealing with an organization's directors, officers, employees, members, shareholders, or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing."

A scenario where a founder, shareholder, or other authorized constituent misunderstands the lawyer's role is fraught with peril. Has a lawyer breached his or her fiduciary duties when the lawyer proceeds with a corporate transaction involving a constituent's personal interests without first clarifying the lawyer's role pursuant to Rule 4.3? We do not believe these rules apply in corporate transactions. In our view, the situation to which Rules 1.13(f) and 4.3(a) most often apply is one in which corporate counsel interviews company employees as part of an internal investigation of possible corporate wrongdoing. In such cases, the concern to which these rules are directed is that corporate lawyers may accidentally mislead employees into thinking that what they told the lawyer would be kept confidential as between them and not used against the employee or contrary to the employee's wishes. Thus, Rules 1.13(f) and 4.3(a) require the

lawyer to give employees in such cases what is informally called a "corporate *Miranda* warning." These rules should not be enforced against a transactional lawyer representing a company when that lawyer's role for the company is already clear to its constituents.

But regardless, if a lawyer has carefully drafted an engagement letter and directed appropriate legal advice to the company only, there should be no confusion among constituents, and Rules 1.13(f) or 4.3 should not be triggered. Given the relatively low bar for an implied attorney-client relationship, however, it is wise practice for a lawyer to reiterate prior to a transaction, in writing, that the only client is the company and the founder, shareholder, or other authorized constituent should secure counsel for their own personal interests. An "I'm Not Your Lawyer" letter or email should turn fertile ground for a claim of an implied attorney-client relationship into strong summary judgment material. Indeed, when a lawyer has communicated in writing, whether through an unambiguous engagement letter or an "I'm Not Your Lawyer" letter, whom the lawyer represents, courts should be hard pressed to allow such claims to proceed to trial.

Keeping Constituents Reasonably Informed.

Under Rule 1.4 of the Utah Rules of Professional Conduct, a lawyer shall keep his or her client "reasonably informed" and "explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." Rule 1.4 (a)(3), (5). While an authorized constituent is not the client when a lawyer represents the company only, the company, of course, acts through its authorized constituents and cannot make decisions unless the authorized constituent is reasonably informed. Thus, it is good practice to keep appropriate constituents apprised in the same manner described by Rule 1.4.

Ironically, plaintiffs in malpractice cases may point to routine communications between a lawyer and an authorized constituent as indicia establishing an implied attorney-client relationship between the lawyer and the constituent on a personal basis (as opposed to the company client). When the contours of the attorney-client relationship have been made abundantly clear, however, it is a difficult argument for would-be legal malpractice plaintiffs.

Likewise, lawyers must exercise careful judgment to determine under what occasions client constituents should be "in the loop" on transactional communications between the various interests participating in the transaction. Must a lawyer "copy" the constituent on every email chain with an investor's counsel? Or, to the contrary, has the lawyer instead fulfilled his or her duties by communicating with the authorized company constituent at regular intervals without the need for the constituent to view every single negotiated "back and forth"? While it is unnecessary – and sometimes inappropriate – to include authorized constituents in all email communications that further the legal objectives of the closely held company, a lawyer should be careful to observe the potential "optics" of leaving them off emails when they could easily be copied, or the relevant communication could be forwarded. Indeed, transactional lawyers should discuss and document with company clients their expectations for staying informed as to the progress and negotiation of a transaction, and should consciously exercise judgment under the circumstances on the level of detail to convey.

Including an "I'm Not Your Lawyer" Provision in the Deal Documents.

Many malpractice claims in the closely held business context involve a transaction and related deal documents. Along with executed engagement letters, and when appropriate, "I'm Not Your Lawyer" letters, we believe it is best practice to include an explicit provision in the executed documents that identifies the lawyer's client in the transaction and disclaims an attorney-client relationship with any other officers, directors, shareholders, members, employees, etc. Many transactional lawyers already implement this wise practice, but in at least one recent case, a malpractice plaintiff argued that such provisions are mere boilerplate buried in the deal documents, providing little in the way of notice to unsuspecting constituents. Though we believe Utah law requires the enforcement of executed terms of a written contract, it may nevertheless be helpful to have every signatory sign or initial their names next to the "I'm Not Your Lawyer" provision. While this is a "belt and suspenders" approach to clarifying the company counsel's role, it makes it very difficult for later complaining constituents to wiggle out of their express acknowledgement of the lawyer's role and duties.

CONCLUSION

By carefully defining the client and scope of representation during key stages of the representation and by understanding typical arguments that constituents later use to create an implied attorney-client relationship where none was intended, lawyers can avoid serious headaches down the road. Lawyers should carefully document his or her role with authorized constituents of closely held companies, which will make it difficult for malpractice claims to form in the "negative space" of routine interactions.