Closely Held: Ethical Issues that Arise in Small-Business Disputes

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February 13, 2020

This paper discusses ethical issues that arise in disputes involving closely held companies. The paper focuses on two key topics: (1) conflicts of interest and (2) the attorney-client privilege. It also discusses instances in which these issues can arise in the context of derivative litigation.

I. Conflicts of Interest and Corporate Clients

A. Who Is the Client?

The question of client identity has far-reaching implications. In the context of closely held corporations, client identification is not always straightforward. The issue that comes up most frequently is whether the lawyer for a close corporation also represents the corporation's shareholders.

Rule 1.13(a) of the North Carolina Revised Rules of Professional Conduct provides that "[a] lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents." N.C. R. Prof'l Conduct 1.13(a). In other words, the organization—not its constituents (i.e., its shareholders, members, directors, officers, or employees)—is the client.

The Rules of Professional Conduct require lawyers to make clear to a corporation's constituents that the corporation, not its constituents, is the client whose interests the lawyer must protect:

> 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.

N.C. R. Prof'l Conduct 1.13(f).

Of course, these rules do not prevent a lawyer from intentionally representing both the corporation and its constituents. To be sure, Rule 1.13(g) makes clear that a corporation's lawyer can also represent the corporation's directors, officers, or shareholders, as long as the dual representation is permitted by Rule 1.7's conflict-of-interest rules. N.C. R. Prof'l Conduct 1.13(g). Rule 1.7

allows dual representation if all parties consent, the lawyer reasonably believes that the interests of the parties will not be adversely affected, and the representation does not require the use of clients' confidential information. *See id.* R. 1.7(b).

If challenged, the question whether a corporation's lawyer also represents a constituent is a question of fact. *See Kingsdown, Inc. v. Hinshaw*, No. 14 CVS 1701, 2015 WL 1406311, at *6 (N.C. Bus. Ct. Mar. 25, 2015) ("Determining the reasonableness of a constituent's belief that he was personally represented by the organization's attorney is particularly difficult and fact-intensive in the context of a closely-held corporation." (quoting *Classic Coffee Concepts, Inc. v. Anderson*, No. 06 CVS 2941, 2006 WL 3476598, at *7 (N.C. Bus. Ct. Dec. 1, 2006))).

1. The ethical duty of confidentiality

Client identification is also important in ensuring compliance with lawyers' ethical obligation to protect client information.

Under Rule 1.6(a) of the Rules of Professional Conduct, a lawyer must obtain a client's informed consent before a lawyer reveals the client's confidential information:

> A lawyer shall not reveal information acquired during the professional relationship with a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b) [laying out certain exceptions, such as the crime-fraud exception].

N.C. R. Prof'l Conduct 1.6(a). The duty of confidentiality requires lawyers to make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client. *Id.*

This obligation is broader than both the attorney-client privilege and the work-product doctrine. As the comments to Rule 1.6(a) explain,

> The attorney-client privilege and work-product doctrine apply in judicial and other proceedings in which a lawyer may be called as a witness or otherwise required to produce evidence concerning a client. The rule of client-lawyer confidentiality applies in situations other than those where evidence is sought from the lawyer through compulsion of law.

Id. cmt. 3.

2. Duties to minority shareholders

Lawyers who represent closely held corporations face another dilemma that can affect their duties to the client: even if the lawyer identifies her client as only the corporation, the lawyer might still owe a derivative duty to the corporation's minority shareholders. This duty is based not on the attorney-client relationship, but on the controlling shareholders' duty not to oppress minority shareholders. *See Raymond James Capital Partners, L.P. v. Hayes*, 248 N.C. App. 574, 580, 789 S.E.2d 695, 701 (2016) (noting that a controlling shareholder owes a fiduciary duty to minority shareholders).

The following examples from the *Restatement (Third) of the Law Governing Lawyers* illustrate this dilemma:

- Lawyer represents Client, a closely held corporation, and not any constituent of Client. Under law applicable to the corporation, a majority shareholder owes a fiduciary duty of fair dealing to a minority shareholder in a transaction caused by action of a board of directors whose members have been designated by the majority stockholder. The law provides that the duty is breached if the action detrimentally and substantially affects the value of the minority shareholder's stock. Majority Shareholder has asked the board of directors of Client, consisting of Majority Shareholder's designees, to adopt a plan for buying back stock of the majority's shareholders in Client. A minority shareholder has protested the plan as unfair to the minority shareholder. *Lawyer may advise the board about the position taken by the minority shareholder, but is not obliged to advise against or otherwise seek to prevent action that is consistent with the board's duty to Client*.

- The same facts as in Illustration 2, except that Lawyer has reason to know that the plan violates applicable corporate law and will likely be successfully challenged by minority shareholders in a suit against Client and that Client will likely incur substantial expense as a result. *Lawyer owes a duty to Client to take action to protect Client, such as by advising Client's board about the risks of adopting the plan*.

Restatement (Third) of the Law Governing Lawyers § 96 cmt. g, illus. 2 & 3 (2000) (emphasis added).

Ultimately, whether the lawyer for a closely held corporation owes a duty to the corporation's minority shareholders is a question of fact. *See, e.g.*, *Baker v.*

Wilmer Cutler Pickering Hale & Dorr LLP, 91 Mass. App. Ct. 835, 845 (2017) ("In the context of these allegations, we can see the 'logic' in imposing a fiduciary duty on counsel for this closely held company to protect minority rights.").

B. Derivative Litigation

The problems surrounding client identification with closely held corporations is amplified in derivative litigation—that is, a lawsuit brought by one or more shareholders to enforce a claim that belongs to the corporation.

In a derivative action, the corporation itself is a necessary party to the lawsuit—typically as a nominal defendant. *Swenson v. Thibaut*, 39 N.C. App. 77, 98, 250 S.E.2d 279, 293 (1978). But because a derivative action is brought on behalf of the corporation and for the corporation's benefit, the corporation's interests are not necessarily adverse to the plaintiffs' interests. *Id.* at 98–99, 250 S.E.2d at 293.

1. Distinguishing between direct and derivative claims

Lawsuits brought by shareholders against a corporation generally fall into three categories: (1) derivative, (2) direct (or individual), and (3) class actions. The type of claim depends on whose right is being enforced.

- If the right belongs to the corporation, the action is derivative.
- If the right belongs to the shareholder, the action is direct (or individual).
- If the right belongs to numerous shareholders and is being asserted on behalf of the class, if it is a class action.

See Russell M. Robinson, II, *Robinson on North Carolina Corporation Law* § 17.02, at 17-3 (7th ed. 2019); *see also Norman v. Nash Johnson & Sons' Farms, Inc.*, 140 N.C. App. 390, 395, 537 S.E.2d 248, 253 (2000) (distinguishing between direct and derivative claims).

In the context of closely held corporations, the line between corporate and individual rights can be especially blurry.

Generally, a corporation's shareholders cannot pursue direct claims for wrongs or injuries to the corporation. *Barger v. McCoy Hillard & Parks*, 346 N.C. 650, 658, 488 S.E.2d 215, 219 (1997). In some instances, however, wrongful conduct can give rise to both direct and derivative claims. This is known as the *Barger* rule (or the *Barger* exceptions). Under *Barger*, two exceptions allow a shareholder to assert both direct and derivative claims: (1) the special-duty exception, and (2) the

special-injury exception. *Id.*; *Green v. Freeman*, 367 N.C. 136, 142, 749 S.E.2d 262, 268 (2013).

- The special-duty exception applies if "a special duty, such as a contractual duty, [exists] between the wrongdoer and the shareholder." *Barger*, 346 N.C. at 658, 488 S.E.2d at 219. "[T]he duty must be one that the alleged wrongdoer owed directly to the shareholder as an individual." *Id.* at 659, 488 S.E.2d at 220.

- The special-injury exception applies if "the shareholder suffered an injury separate and distinct from that suffered by other shareholders [or the corporation]." *Barger*, 346 N.C. at 658, 488 S.E.2d at 219. The injury must be "separate and distinct from the injury sustained by the other shareholders or the corporation itself." *Id.* at 659, 488 S.E.2d at 220.

In some instances, courts have allowed minority shareholders in closely held corporations to assert derivative claims in a direct action against majority shareholders. *See Norman*, 140 N.C. App. at 405, 537 S.E.2d at 259. *But see Gaskin v. J.S. Procter Co.*, 196 N.C. App. 447, 452, 675 S.E.2d 115, 118 (2009) (explaining that the *Barger* exceptions apply the same to closely held corporations as to non-closely held corporations).

2. Representation in derivative litigation

The question whether the lawyer for a closely held corporation can also represent the corporation's shareholders is a common issue in derivative litigation.

While there are no North Carolina decisions that directly address this question, comments to the North Carolina Revised Rules of Professional Conduct provide guidance:

> The question can arise whether counsel for the organization may defend [a derivative] action. The proposition that the organization is the lawyer's client does not alone resolve the issue. Most derivative actions are a normal incident of an organization's affairs, to be defended by the organization's lawyer like any other suit. However, if the claim involves serious charges of wrongdoing by those in control of the organization, a conflict may arise between the lawyer's duty to the organization and the lawyer's relationship with the board. In those circumstances, Rule 1.7 governs who should represent the directors and the organization.

N.C. R. Prof'l Conduct 1.13 cmt. 14.

The leading treatise on North Carolina corporation law observes that a corporation's lawyer "might be allowed to represent both the corporation as nominal defendant and the directors and officers as real defendants in the initial response to and investigation of a derivative claim, and perhaps even in filing a motion to dismiss what appears to be a baseless claim." Robinson, *supra*, § 17.05[3], at 17-24. The author notes, however, that separate counsel for the individual defendants and independent counsel for the corporation "will probably be required if the motion to dismiss is denied and the derivative action becomes a litigated contest." *Id.* *Cf.* *Restatement (Third) of the Law Governing Lawyers* § 131 cmt. g ("Even with informed consent of all affected clients, the lawyer for the organization ordinarily may not represent an individual defendant as well.").

II. Corporate Clients and the Attorney-Client Privilege

Like with conflicts of interest, closely held entities present difficult questions about which communications are privileged.

A. Basics of the Attorney-Client Privilege

Under North Carolina law, the attorney-client privilege protects communications from disclosure if:

1. the relation of attorney and client existed at the time the communication was made,

2. the communication was made in confidence,

3. the communication relates to a matter about which the attorney is being professionally consulted,

4. the communication was made in the course of giving or seeking legal advice for a proper purpose although litigation need not be contemplated[,] and

5. the client has not waived the privilege.

Friday Invs., LLC v. Bally Total Fitness of the Mid-Atl., Inc., 370 N.C. 235, 240, 805 S.E.2d 664, 669 (2017) (quoting *State v. Murvin*, 304 N.C. 523, 531, 284 S.E.2d 289, 294 (1981)). "If any one of these five elements is not present in any portion of an attorney-client communication, that portion of the communication is not privileged." *Id.* (quoting *Brown v. Am. Partners Fed. Credit Union*, 183 N.C. App. 529, 534, 645 S.E.2d 117, 121 (2007)).

B. Corporate Clients

Applying the attorney-client privilege in the corporate context "presents special problems." *Technetics Grp. Daytona, Inc. v. N2 Biomedical, LLC*, No. 17 CVS 22738, 2018 WL 5892737, at *3 (N.C. Bus. Ct. Nov. 8, 2018) (quoting *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 348 (1985)).

The attorney-client privilege attaches to the corporation, not to the corporation's constituents. *See* N.C. R. Prof'l Conduct 1.13(a). Likewise, the decision to waive privilege belongs to the corporation, not to its constituents. But "[a]s an artificial entity, a corporation can act only through its agents." *Technetics Grp.*, 2018 WL 5892737, at *3; *accord Woodson v. Rowland*, 329 N.C. 330, 344, 407 S.E.2d 222, 231 (1991). Thus, to obtain legal advice, a corporation must communicate with its lawyers through individuals authorized to act on the corporation's behalf. *Technetics Grp.*, 2018 WL 5892737, at *3.

The more complicated issue is identifying the constituents covered by the attorney-client privilege. Under federal law, the attorney-client privilege applies to communications with corporate employees. *Upjohn Co. v. United States*, 449 U.S. 383, 394 (1981) (holding that the attorney-client privilege applies to communications made by corporate employees to counsel at the direction of corporate superiors when the communications concern matters within the scope of the employees' corporate duties, and the employees are aware that they are being questioned for the purpose of the corporation obtaining legal advice).

North Carolina courts have not adopted the *Upjohn* test or defined the scope of the attorney-client privilege for corporations. *See Brown*, 183 N.C. App. at 536, 645 S.E.2d at 123 (noting that North Carolina's "appellate courts have not yet decided what test should apply as to the corporate attorney-client privilege").

In *Brown*, the court of appeals noted that "the mere fact that an employee is the company's 'agent' in some respects does not necessarily require that a communication involving that employee be found privileged." *Id.* at 536, 645 S.E.2d at 122. The court, however, did not define a test to govern the scope of the attorney-client privilege, nor did it opine on how far the privilege extends to intracorporate communications.

As noted above, lawyers should be mindful of their obligation under Rule 1.13(f) and should not assume that the attorney-client privilege covers their communications with all constituents of a corporation.

C. The Attorney-Client Privilege in Derivative Actions

Derivative actions can trigger complex questions about the attorney-client privilege.

Some jurisdictions apply the *Garner* or "fiduciary exception" rule, which allows shareholders in derivative actions to pierce the attorney-client privilege on a showing of good cause. *See Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970). The *Garner* rule allows shareholders to obtain the files of the corporation's lawyer relating to conduct leading up to the derivative claim. *Id.* at 1103–04; *see also In re Int'l Sys. & Controls Corp. Sec. Litig.*, 693 F.2d 1235, 1239–40 (5th Cir. 1982) (applying the rule to the attorney-client privilege but not to work product).

The North Carolina Business Corporation Act rejects the *Garner* rule in derivative actions. The statute provides that "no shareholder shall be entitled to obtain or have access to any communication within the scope of the corporation's attorney-client privilege that could not be obtained by or would not be accessible to a party in an action other than on behalf of the corporation." N.C. Gen. Stat. § 55-7-49 (2019); *see also id.* § 57D-8-07 (providing the same rule for derivative actions involving LLCs).

While North Carolina's statute applies only to derivative claims, it leaves open the possibility that a fiduciary exception could apply to a shareholder's direct claims. *See, e.g.*, *Tatum v. R.J. Reynolds Tobacco Co.*, 247 F.R.D. 488, 493–96 (M.D.N.C. 2008) (recognizing a fiduciary-duty exception to the attorney-client privilege in an employee's action against a corporate ERISA administrator and allowing access to communications about amending the plan but not about the defense of the action).