

Resolving Conflicts In A Closely-Held Business

BY MARY C. DALY

This is the second installment of a two-part article.

Last month's column explored how the entity theory of representation can trigger especially knotty ethical dilemmas for a lawyer who represents a closely-held or family business. This column looks at specific questions relating to confidentiality of client information and conflicts of interest in these settings. A subsequent column will discuss malpractice and liability issues.

Questions relating to confidentiality frequently arise when a lawyer discovers wrongdoing by one principal of a business, and the principal rejects the lawyer's advice to reveal the conduct to the other partners or shareholders whose interests are adversely affected. Disciplinary Rule 4-101 of the Lawyer's Code of Professional Responsibility (Code) is, of course, the touchstone for all discussions of a lawyer's duty to preserve a client's confidences or secrets. Under DR 4-101, disclosure is always permissive, never mandatory. (There is a mandatory disclosure provision in DR 7-102(b) in cases involving fraud by the client, but the exception for information constituting a confidence or secret effectively eviscerates the exception).

DR 4-101 *permits* a lawyer to make disclosure of a client's confidences or secrets to a third party in a limited set of circumstances. For the purposes of this article, the most pertinent circumstances are: to prevent the client's commission of a future crime, to defend the lawyer from accusations of wrongdoing, and to enable the lawyer to make a "noisy" withdrawal. Unless the lawyer can invoke one of the exceptions, disclosure is generally forbidden. In responding to inquiries from lawyers faced with a principal's wrongdoing, bar association ethics committees have drawn a sharp line between disclosures to a third party and disclosures to the business's other principals. The formal logic of these opinions is not always clear. Without challenging the general applicability of the entity theory to closely-held and family businesses, the opinions conclude that in most circumstances involving related business principals, the lawyer is free to disclose the wrongdoing, unless the confiding principal reasonably believed that the communication was confidential.

Primary Allegiance Owed To Partnership

In Opinion 1994-10, the Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York responded to a lawyer who had represented the sole general partner of a partnership in connection with partnership business and unrelated matters. The lawyer had also served as counsel to the limited partnership. The partnership's accountant informed the lawyer that the general partner had been using the partnership's money to run a related business without the partnership's knowledge or approval. In addition, the partnership's general manager had complained to the lawyer about the general partner's "erratic behavior." Citing DR 5-109 (Organization as Client) and EC 5-18, the Committee concluded that the lawyer owed her primary allegiance to the partnership not to the general partner.

Accord, Association of the Bar of the City of New York, Formal Op. 1986-2 (1986) (permitting disclosure of a general partner's acts that would adversely affect the partnership interests of the limited partners, although the acts were neither criminal nor fraudulent).

The Committee noted that under normal circumstances the lawyer could appropriately disclose the wrongdoing to the governing body of the partnership. However, where, as here, the governing body (*i.e.*, the general partner) was implicated in the wrongdoing, the lawyer could make disclosure to the limited partners. The Committee carefully noted that disclosure to third-parties was prohibited. Finally, the Committee closed by suggesting that the "differing interests" provision in DR 5-105 might require the lawyer to withdraw from the representation of the partnership, the general partner, and any limited partner in matters relating to the partnership, especially any matter relating to the general partner's wrongdoing.

Unresolved Issues

While Opinion 1994-10 and its predecessor, Opinion 1986-2, provide practical guidance to a lawyer who learns of a principal's wrongdoing, they leave several issues unresolved. Both opinions stressed that the lawyer involved represented both the general and limited partners. They did not consider what disclosure a lawyer may make if the lawyer represents only the general partner. The entity theory suggests that the lawyer may nonetheless reveal the wrongdoing to the limited partners even if they are not clients. *See, generally* Op. 1994-10, *supra*; ABA Committee on Professional Responsibility and Ethics, Formal Op. 91-361 (1991).

The question whether disclosure is ethically permissible cannot be fully resolved, however, without determining if the principal who has admitted the wrongdoing has a reasonable expectation that the lawyer will not reveal the confided information. The facts in Opinion 855 of the New York State Bar Association Committee on Professional Ethics illustrate just how easily such an expectation can arise in the context of representing a closely-held or family business. A and B retained the inquiring lawyer to represent them in connection with their 2-person partnership. B subsequently advised the lawyer that B was breaching the partnership agreement, but he preceded that acknowledgment with the statement that he wanted to tell the lawyer something "in confidence." The Committee examined the law of agency, the ABA Model Rule 2.2 dealing with the lawyer's role as intermediary between clients, and the general distinction between a confidence and a secret in the Code. It then candidly admitted that it had found "indications in both directions" on the question of the propriety of disclosure in the circumstances. Ultimately, it concluded that in the absence of implicit or explicit consent to disclosure of the communications of one partner to another, the lawyer could not reveal B's wrongdoing. B's "in confidence" prefatory comment clearly indicated the absence of such consent.

The practical lesson to be learned from this Opinion is relatively straightforward. The principals in a closely-held or family business should have an agreement controlling communications by any one principal to the business's lawyer with respect to matters relating to their jointly owned entity. The agreement should cover whether the lawyer is required to respect the confidences of one principal in his dealings with the other principal(s). The ideal place to memorialize the understanding is, of course, in the retainer agreement. It is also advisable to state in the retainer agreement whether the lawyer is currently representing any of the principals in other matters or anticipates doing so in the future. *See*, Formal Op. 91-361, *supra*. Additional guidance can also be found in various commentaries to ABA Model Rule 2.2.

Rule 2.2 deals specifically with a lawyer's ethical obligations in acting as an intermediary, representing two or more clients with potentially conflicting interests. Many of the suggestions for successfully navigating the shoals of a common representation under Rule 2.2 apply with equal force to the representation of multiple clients under DR 5-105.

Additional issues are created when a lawyer has a long-standing relationship with one client and then assumes the representation of that client and another individual in connection with a common enterprise. See, *Allegaert v. Perot*, 565 F.2d 246 (2d Cir. 1977). Ignoring the complex interplay arising from the representation of individual clients and their associated entities can trigger liability for malpractice or breach of fiduciary duty. See, *Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C.*, 107 Mich.App. 509, 309 N.W.2d 645 (1981).

Entity Lawyer Free To Sue Individual Principal

Generally speaking, in the absence of a clearly established attorney-client relationship between a lawyer for a closely-held or family business and an individual principal of the business, the lawyer is free to represent the business or its other principals in an action against that individual. See e.g., *Omansky v. 64 N. Moore Associates*, 269 A.D.2d 336, 703 N.Y.S.2d 471 (1st Dept. 2000); *Kushner v. Herman*, 215 A.D.2d 633, 628 N.Y.S.2d 123 (2d Dept. 1995).

In applying DR 5-108, dealing with conflicts between former and present clients, the courts ask whether there is a substantial relationship between the matters involved in the prior and new representations or whether the lawyer received confidential information in the prior representation that would benefit the closely-held or family business in the new representation. Consider the following: Company A is owned by five shareholders. It retained Law Firm to represent it in a trademark infringement action that ultimately settled. Three years later, four of the shareholders seek to retain Law Firm to sue the fifth shareholder for breach of contract. If no substantial relationship exists between the subject matters of the two cases and Law Firm does not possess any confidential information concerning the fifth shareholder that would assist the potential plaintiffs in the proposed litigation, Law Firm may accept the representation. Compare, *Spano v. Tawfik*, 271 A.D.2d 522, 705 N.Y.S.2d 659 (2d Dept. 2000) with *Fleet v. Pulsar Construction Co.*, 143 A.D.2d 187, 531 N.Y.S.2d 635 (2d Dept. 1988).

Finally, it should be noted that other provisions in the Code than DR 5-105 and 5-108 may come into play and prompt a court to order disqualification. The lawyer-witness rule in DR 5-102 is one such provision. See, *Wensley and Partners, L.L.C. v. Polimini*, 292 A.D.2d 311, 692 N.Y.S.2d 85 (2d Dept. 1999). Another is DR 5-101, which addresses conflicts of interest between a lawyer and a client. If a lawyer has a financial interest in the opposing party or is named a party a court may order the lawyer's disqualification. E.g., *Guiliano v. Carlisle*, 211 A.D.2d 757, 621 N.Y.S.2d 685 (2d Dept. 1995); *Home Mortgage Corp. v. Saxon Equities Corp.*, 241 A.D.2d 511, 661 N.Y.S.2d 27 (2d Dept. 1997).

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