SOLVING THE EVERYDAY PROBLEM OF CLIENT IDENTITY IN THE CONTEXT OF CLOSELY HELD BUSINESSES

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I. INTRODUCTION: AN EVERYDAY PROBLEM 182
II. THE CURRENT RULES AND SCHOLARLY THEORIES 187
A. *The Entity Theory* 187
1. *Model Rule 1.13: Organization as Client* 187
2. *Why the Entity Theory is Incomplete* 188
3. *The Potential Extension of Model Rule 1.13(g)* 192
B. *The Aggregate Theory* 192
1. *Case Law and Scholarly Commentary* 192
2. *Model Rule 1.7: Conflict of Interest: Current Clients* 195
3. *Why the Aggregate Theory Creates Impermissible Conflicts of Interest* 197
C. *Other Approaches Advanced By Commentators* 200
1. *Reasonable Expectations* 200
2. *Framework of Dealing* 202
III. A NEW PROPOSAL: THE INTERNAL-EXTERNAL DISTINCTION 203
A. *Internal Matters* 204
1. *Internal Matters Defined* 204
2. *Establishing the Internal Client* 206
a. *When to Establish the Internal Client* 206
b. *How to Establish the Internal Client* 207
c. *Clearly Aligned Owners* 208
d. *Considerations for the Default Rule* 209
B. *External Matters* 210
1. *External Matters Defined* 210
2. *Entity as External Client* 211
3. *Duly Authorized Constituents Revisited* 211
C. *When the Interests of the Internal and External Clients Conflict* 212
D. *Policy and Practical Considerations Furthered by the New Proposal* 213

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HeinOnline -- 56 Ala. L. Rev. 181 2004-2005

1. *Multiple Representation Promotes Efficiency and Economy* ... 213
2. *Bright-Line Rule Gives Definitive Guidance* ... 215
IV. THE PROPOSED RULE: REPRESENTATION OF CLOSELY HELD BUSINESSES ... 216
V. CONCLUSION: AN EVERYDAY PROBLEM—SOLVED ... 218

I. INTRODUCTION: AN EVERYDAY PROBLEM

Consider a seemingly simple dilemma that virtually all practicing lawyers face at some point in their careers and that many practitioners face daily. The lawyer receives an all-too-familiar visit from two friends who together ask the lawyer to form a legal entity for their new business.[1] (Assume, for the purposes of this hypothetical, that the business form chosen is a corporation.[2]) In this initial meeting, the friends ask the lawyer to prepare the necessary organizational documents. This task, which lawyers engage in daily,[3] sounds simple enough, and there would be near universal agreement that the lawyer may undertake this representation.[4] But numerous conflicts of interest are certain to arise between the friends, if not during formation then during the operation of the corporation,[5] and these are often ignored or deemed unimportant by the lawyer. Indeed, as this Article will show, even if the lawyer appreciates these conflicts, she has no—or conflicting—guidance in resolving them.

For example, consider some common questions that arise during formation. To issue stock to the friends, the lawyer must know whether they will be equal owners or majority-minority owners. If the latter, does the lawyer

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1. Although this hypothetical assumes only two friends for the sake of simplicity, its lessons are easily extrapolated to multiple individuals starting a business together.

2. Ethics rules regarding conflicts of interest apply equally to all business forms. *See infra* Part II.B.2. The substantive law of confidentiality and attorney-client privilege, however, may vary. *See infra* notes 73-74 and accompanying text.

3. According to the U.S. Small Business Administration, there were approximately 572,900 small businesses opened in 2003, and there were approximately 23.7 million total small businesses in operation in the United States in 2003. U. S. Small Business Administration, Frequently Asked Questions, *at* http://app1.sba.gov/faqs/faqindex.cfm?areaID=24 (questions 4 and 5) (last visited Oct. 10, 2004). In comparison, there are only about 12,000 public companies operating in the United States (based on the number of companies filing annual reports on Forms 10K and 10KS in 2003). Management's Reports on Internal Control Financial over Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33,8238, 68 Fed. Reg. 36,636 (June 5, 2003).

4. Professor Lawrence Mitchell, presenting a similar hypothetical, states that "[a]t this point, the [ethical rules] permit, and even encourage, the lawyer to comply with [the client's] request to prepare the papers." Lawrence E. Mitchell, *Professional Responsibility and the Close Corporation: Toward a Realistic Ethic*, 74 CORNELL L. REV. 466, 482 (1989).

5. *See* William H. Simon, *Whom (or What) Does the Organization's Lawyer Represent? An Anatomy of Intraclient Conflict*, 91 CAL. L. REV. 57, 59 (2003).

> The law tends to characterize . . . organizations as unitary "entities" or "legal persons" and to suggest the lawyers' duties to such clients are analogous to their duties to individual clients. In fact, however, these organizations consist of multiple individuals with potentially differing interests, and hence they are prone to internal conflicts that do not arise in individual representation.

Id.

HeinOnline -- 56 Ala. L. Rev. 182 2004-2005

have a duty to advise the minority shareholder that, without contractual protections, he could be outvoted on all matters?[6] Without legal guidance, an unsophisticated minority shareholder would not know that his appointments as an initial officer and director of the corporation are subject to the majority shareholder choosing not to remove him from these positions.[7]

The lawyer's dilemma, in its most-stripped-down form, is this: Who is the lawyer's client? Simply the corporation as an entity? Both shareholders? One shareholder to the exclusion of the other? Or some combination of the foregoing? Lawyers have faced potential civil liability and disciplinary actions for failing to appreciate the entity-owner distinction,[8] and clients are usually even more confused.

Assume the client is the corporation as an entity. This would provide no guidance for the lawyer when determining whether to advise the minority shareholder of the possible perils of this status. It would be impossible for the lawyer to know at the time of incorporation whether it would be better *for the corporation* if the majority shareholder could effectively eliminate the minority shareholder's management rights.[9] Maybe the majority share-

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6. *See, e.g.*, Cynthia S. Grandfield, Comment, *The Reasonable Expectations of Minority Shareholders in Closely Held Corporations: The Morality of Small Businesses*, 14 DEPAUL BUS. L.J. 381, 383 (2002).

> For example, in a three man corporation, if each shareholder owns a one-third interest and two shareholders join together against the other, the third shareholder will lose in every vote—two-thirds to one-third. . . . Oftentimes, minority shareholders inadequately plan for such an occurrence because they do not anticipate future disputes or oppression.

Id. A majority shareholder's power is not unlimited, however. The courts have developed certain doctrines prohibiting the oppression of minority shareholders. *See infra* note 12. However, the protections offered can vary widely from state to state. *See* Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099 (1999) (comparing Delaware, New York, and Massachusetts law). In addition, many shareholders of closely held businesses will not be able to afford the legal fees necessary to enforce these doctrines in formal legal proceedings, and therefore it is preferable to adopt contractual protections against oppressive treatment from the outset. A majority shareholder may think twice if certain actions would be a clear breach of contract, and breach of a specific contract provision may be easier to prove—if a legal dispute does ensue—than a breach of the general doctrine of minority oppression.

7. Even in an equal ownership situation, where it may appear that nothing the lawyer does in the organizational stages would benefit one shareholder over the other, this may not necessarily be the case. Although there appears to be less potential for conflicts between the shareholders in this situation, certain provisions in corporate articles of incorporation and bylaws can affect equal shareholders differently. For example, the lawyer may be called on to suggest the officer positions assigned to each shareholder. Each position ranks differently in the management hierarchy and carries a different set of responsibilities. Professor Mitchell also provides an enlightening example of how equal owners may be disparately affected by the form of entity chosen by counsel. *See* Mitchell, *supra* note 4, at 482-83.

8. *Compare* Granewich v. Harding, 985 P.2d 788, 790 (Ore. 1999) (holding that a lawyer can be civilly liable for acting in concert with close corporation majority shareholders who effect a "squeeze out" of a minority shareholder in breach of their fiduciary duties) *with* Skarbrevik v. Cohen, 282 Cal. Rptr. 627, 629 (Cal. Ct. App. 1991) (holding that a close corporation's minority shareholder can not recover against a lawyer when his interest is diluted by the majority shareholder because there is no attorney-client relationship established with the minority shareholder). *See also infra* notes 62-69 and accompanying text (discussing two Oregon cases in which disciplinary actions were brought against lawyers and an implied attorney-relationship between the lawyer and the individual shareholders was found).

9. Professor William Simon discusses the same concern in the context of a potential corporate takeover. Simon, *supra* note 5, at 77-78. In such a situation, the lawyer will not know whether current management or the challenger will be better for the corporation. *Id.*

holder is more business-savvy, or perhaps the majority shareholder will prove too impetuous in his decision-making and the minority shareholder's veto power on important decisions will keep him in check. In short, the lawyer will most likely be unable to predict which shareholder will be the better decision-maker at the outset. Moreover, even if the lawyer could hazard a guess, it is unadvisable to put the lawyer in the position of having to make subjective decisions that involve business, rather than legal, judgment.[10]

Assume the client is only the majority shareholder. If the lawyer advises the minority shareholder to prospectively guard against oppressive conduct, the majority shareholder may have a cause of action against the lawyer.[11] Now assume the client is only the minority shareholder. If the lawyer did not advise the minority shareholder of the dangers of this status,[12] the lawyer could be liable to the shareholder for inadequate representation. If both shareholders are deemed the lawyer's clients, the lawyer will face ethical conflicts of interest problems.[13]

To complicate matters, a lawyer forming a closely held corporation is usually asked to prepare a shareholders agreement to govern internal matters between the shareholders.[14] The shareholders agreement should provide, at the very least, a restriction on the transferability of shares.[15] Such a provision prevents one shareholder from selling his shares to a third party

10. *See infra* notes 128-29 and accompanying text.

11. Although the shareholders are not technically "adverse" at this stage, the lawyer should prompt them to think of such "what-ifs" when structuring their relationship. *See infra* notes 94-102 and accompanying text. Viewed in this light, advice beneficial to one shareholder and detrimental to another is equivalent to an asset purchase transaction where the buyer's lawyer warns the seller of the dangers in not taking collateral security for the buyer's future payment obligations. A buyer's lawyer would (rightfully) never provide this advice.

12. The doctrine of minority oppression gives minority shareholders some protection against majority oppression. Before this doctrine emerged (which allows minority shareholders to claim that the majority dealt with them unfairly or frustrated their reasonable expectations), majority shareholders could use their control position to treat minority shareholders as they pleased. Often, the majority would "squeeze out" the minority (i.e., deprive minority shareholders of employment, dividends, and return on capital) to force a sale of the minority shareholder's shares for a substantially discounted price. *See* Note, *Oppressed Shareholders in Close Corporations: A Market-Oriented Statutory Remedy*, 16 CARDOZO L. REV. 501, 508-09 (1994); *see generally* Robert C. Art, *Shareholder Rights and Remedies in Close Corporations: Oppression, Fiduciary Duties, and Reasonable Expectations*, 28 J. CORP. L. 371 (2003); Douglas K. Moll, *Shareholder Oppression v. Employment at Will in the Close Corporation: The Investment Model Solution*, 1999 U. ILL. L. REV. 517 (1999). For the opposing view—that the minority oppression doctrine creates significant costs for close corporations and allows minority shareholders to engage in opportunistic behavior—see Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 283-90 (1986).

13. *See infra* Part II.B.3.

14. In the limited liability company context, corporate governance matters and agreements between owners (members) would be addressed in an operating agreement (called a limited liability company agreement in some states, including Delaware). In the partnership context, they would be addressed in a partnership agreement (a partnership agreement, limited partnership agreement, or even limited liability limited partnership agreement, depending on the type of partnership).

15. Numerous other provisions can also be addressed in a shareholders agreement, including provisions for: establishing the value of cashed-out shares when available exit mechanisms are used; establishing voting rights in the corporation (i.e., which decisions require unanimity and which only require a majority); breaking deadlocks when two equal shareholders cannot agree on a course of action; and maintaining the status quo of minority shareholders.

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without first giving the remaining shareholder the right to buy them (commonly referred to as a "right of first refusal" provision).[16] This gives shareholders the right to choose with whom they do business.[17]

Often shareholders will instruct the lawyer to "prepare your standard shareholders agreement." The lawyer should respond that "there is no standard shareholders agreement" because each business and each set of shareholder relationships is unique. Moreover, almost every drafting choice the lawyer makes will favor one shareholder over the other. This is easy to see when considering the majority-minority ownership situation. For instance, shareholders agreements commonly divide decisions into those that can be made by a mere majority and those that require the unanimous approval of the shareholders. Lawyers representing majority shareholders prefer that no decisions require unanimous consent—that way, their clients ultimately make all decisions.[18] Conversely, lawyers representing minority shareholders would prefer that a broad range of decisions require unanimous consent, thus giving their clients more of a voice in the operation and affairs of the corporation.[19] It is difficult to see how the lawyer who represents only the corporation, or both shareholders, or who does not appreciate the subtleties of client identity, can adequately draft a shareholders agreement. Yet lawyers do it daily.

The foregoing discussion may lead the reader to conclude that these problematic drafting choices only present themselves in the majority-minority situation, and that representation of the nebulous "corporation," or even co-representation of the shareholders, is a harmless fiction in the equal ownership situation. Although client identity may be less of a concern in the equal ownership situation, important drafting choices benefiting one shareholder over another still exist.[20] How the lawyer drafts the corporation's

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16. A common alternative or supplement to the right of first refusal provision is the "buy-sell" provision, under which one shareholder sets a share price and, based on that price, the other shareholder must elect to either purchase the offering shareholder's shares or sell his shares to the offering shareholder. *See, e.g.*, Jason M. Hoberman, Note, *Practical Considerations for Drafting and Utilizing Deadlock Solutions for Non-Corporate Business Entities*, 2001 COLUM. BUS. L. REV. 231, 232-33.

17. This is a fundamental principle of partnership law. *See, e.g.*, Paula J. Dalley, *The Law of Partner Expulsions: Fiduciary Duty and Good Faith*, 21 CARDOZO L. REV. 181, 181 (1999) ("The law recognizes that, in view of the close relationship between partners, partners must be free to associate with anyone they choose."). Shareholders of closely held corporations are often treated by the law as partners in their relationships with each other. *See infra* note 37 and accompanying text.

18. The corporate codes of states such as Delaware only mandate a minimum number of shares necessary to approve any action submitted to a vote of the shareholders. *See* DEL. CODE ANN. tit. 8, § 216 (2001). In other words, without some contractual right giving a minority shareholder veto power, he can be outvoted on all matters submitted to a vote of the shareholders. *But see supra* note 12 (discussing the minority oppression doctrine).

19. For a negative view of unanimity agreements, see Easterbrook & Fischel, *supra* note 12, at 296.

> Unanimity agreements, which exist in many closely held corporations, create a risk of deadlock. A minority shareholder may . . . refuse to consent to corporate acts, paralyzing the firm. Although this right helps minority shareholders protect themselves against opportunistic behavior by the majority, it creates incentives for the minority to behave opportunistically toward the majority to extract disproportionate concessions.

Id.

20. For example, it initially appears that any right of first refusal provision will affect all sharehold-

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internal documents again depends on who is classified as the lawyer's client. The foregoing discussion focuses on potential conflicts during the corporation's initial stages, but lawyers will continue to encounter these ethically gray issues once the corporation is up and running.[21]

Part II of this Article explores the existing ethical rules applicable to lawyers representing closely held businesses. I argue that the majority approach taken by the ABA Model Rules of Professional Conduct (the "Model Rules")[22]—that the lawyer represents the entity itself and not its individual owners (sometimes referred to as the "entity" theory)—is incomplete because it does not guide the lawyer seeking to negotiate an agreement or resolve a dispute between the individual owners. (I often refer to such matters as "owner relationship issues.") Recognizing the impracticalities of the entity theory as applied to closely held businesses, some courts have held that the lawyer's clients are actually the entity *and* each of the entity's individual owners (sometimes referred to as the "aggregate" or "joint representation" theory). But as I will show, this solution is flawed because it puts the lawyer in a precarious situation when dealing with owner relationship issues. In short, each of the lawyer's actions inevitably favors one owner—and thus one client—over another, thereby often creating impermissible conflicts of interest that informed consent cannot cure.[23] Part II also examines other solutions advanced by commentators.

Part III proposes a new solution to this problem. It first distinguishes between "internal" and "external" matters that arise in representing closely held businesses. Internal matters involve the inner workings of the entity, and in particular owner relationship issues. External matters involve the entity's interactions with third parties, whether customers, suppliers, lenders or potential investors. I propose that the best way for a lawyer to provide complete representation to the entity, yet avoid conflicts of interest, is to permit the lawyer to represent one owner on internal matters and to repre-

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ers equally. This is not true, however, if the shareholders have significantly different financial situations. If the lawyer drafts the provision so that the shareholder exercising the right of first refusal must pay for the shares in cash within thirty days, the shareholder in the better financial position is favored—he is more likely to have the cash on hand to procure the buyout. On the other hand, a provision permitting the exercising shareholder to pay for the shares with ten percent cash down and the remainder in five equal annual installments would allow a shareholder in a weaker financial position to obtain financing, buy the shares, and prevent a sale to the third party. Hoberman, *supra* note 16, at 248-49. This is an example of a drafting choice, present even in the equal ownership situation, benefiting one shareholder over another.

21. For example, consider the potential admission of a new shareholder. Assume that one co-founder of the corporation believes that this new shareholder would supply the corporation with much-needed capital and the benefits of prior business experience. The other co-founder opposes the admission of a new shareholder, however, because he does not want his interest to be diluted, or he would prefer not to bring in an "outsider." Can the first co-founder admit the new shareholder despite the second co-founder's objection? The co-founder will certainly ask the lawyer this question. Whether the lawyer should provide this advice depends yet again on who the lawyer's client is.

22. MODEL RULES OF PROF'L CONDUCT (2004) [hereinafter MODEL RULES].

23. While the focus of this Article is on conflicts of interests, which implicate the lawyer's cardinal duty of loyalty, confidentiality and attorney-client privilege concerns are also important and will be discussed in notes 73-74 and 191-92 and accompanying text.

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sent the entity on external matters.[24] Lawyers must only withdraw from representation when the interests of these internal and external clients conflict (which I contend happens far less frequently than conflicts between individual owners). This approach provides clear guidance on client identity regardless of the complexity of the situation, and thus saves lawyers and clients from potentially perilous judgments as to the appropriateness of co-individual client representation. As a proposed codification of this approach, Part IV presents a new rule, specific to closely held businesses, to supplement the existing ethical rules.[25]

II. THE CURRENT RULES AND SCHOLARLY THEORIES

A. *The Entity Theory*

1. *Model Rule 1.13: Organization as Client*

The entity theory—that the lawyer represents the entity itself and not its individual constituents—is the most widely accepted theory of entity representation.[26] It is also the theory adopted by both the Model Rules and the Model Code. Model Rule 1.13(a), titled "Organization as Client," provides that "[a] lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."[27] Similarly, the Model Code provides:

> A lawyer employed or retained by a corporation or similar entity owes his allegiance to the entity and not to a stockholder, director, officer, employee, representative, or other person connected with the entity. In advising the entity, a lawyer should keep paramount

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24. While the Model Rules allow a lawyer to also represent an entity's constituents, traditional application is limited to the very different public corporation context. The prototypical example is a public corporation law firm that wishes to defend the corporation and its senior officers in a lawsuit brought by a third party. *See infra* Part II.A.3 for a full discussion.

25. Because the Model Rules have been adopted by far more states (thirty-eight plus the District of Columbia) than any other set of rules, they are the ethical rules primarily discussed in this Article. ABA, Links to State Ethical Rules Governing Lawyer Advertising, Solicitation and Marketing, *at* http://www.abanet.org/legalservices/clientdevelopment/adrules.html (last visited Oct. 10, 2004). The Model Code of Professional Conduct ("Model Code") is also discussed where relevant. MODEL CODE OF PROF'L RESPONSIBILITY (1981) [hereinafter Model Code]. Four states have adopted the Model Code, and nine have adopted unique rules. http://www.abanet.org/legalservices/clientdevelopment/adrules.html (last visited Oct. 10, 2004).

26. *See* Charles W. Wolfram, *Legal Ethics: Corporate-Family Conflicts*, 2 J. INST. STUD. LEGAL ETHICS 295, 309 (1999) ("No sustainable theory has been able to challenge the supremacy of the entity-representation concept."); *see also* Meehan v. Hopps, 301 P.2d 10, 14 (Cal. Dist. Ct. App. 1956) ("The attorney for a corporation represents it, its stockholders and its officers in their representative capacity. He in [no way] represents the officers personally."); Skarbrevik v. Cohen, 282 Cal. Rptr. 627, 635 (Cal. Ct. App. 1991).

27. MODEL RULES, *supra* note 22, at R. 1.13(a).

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> its interests and his professional judgment should not be influenced by the personal desires of any person or organization.[28]

The entity theory is based on two ideas: that an organization is a distinct legal entity; and that under the laws of agency, a lawyer, as agent of the entity-principal, owes her duties to the principal and not its other agents.[29]

2. *Why the Entity Theory is Incomplete*

Despite the use of the generic term "organization" in Model Rule 1.13(a), which encompasses all entity forms,[30] it has been suggested that Model Rule 1.13 was drafted with the traditional corporation in mind.[31] The traditional corporation—which conjures up images of Ford, Microsoft, and General Electric—has been described as "an economic organization in which: (1) management and shareholding are separable and separated functions; (2) shares are held by a number of persons; and (3) shares are freely transferrable and neither entry to nor exit from the firm is restricted."[32] Corporations whose stock is publicly traded fall into this category, as do private corporations that function more like public corporations than partnerships.

A closely held business is very different.[33] There is no precise definition of a closely held business, though they are often easily identifiable (think of the new corporation formed by the two friends in the introductory hypothetical). For purposes of this Article, I will adopt a general definition suggested by Professor Michael Dooley: a closely held business is a business whose "distinguishing characteristic . . . is that management and shareholding are *not* separated functions."[34] Other characteristics of closely held businesses include the issuance of private equity (stock or interests that are not publicly-traded) and the significant personal investment of both time and capital by shareholders.[35]

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28. MODEL CODE, *supra* note 25, at EC 5-18.

29. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 91-361 (1991) [hereinafter ABA Formal Op. No. 91-360] (discussing the representation of a partnership); GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING § 17.3 (3d ed. 2001) ("[O]fficers are co-agents *along with the lawyer* in terms of their relationship to the entity.").

30. MODEL RULES, *supra* note 22, at R. 1.13 cmt. 1 ("The duties defined in this Comment apply equally to unincorporated associations."); ABA Formal Op. No. 91-361, *supra* note 29 ("There is no logical reason to distinguish partnerships from corporations or other legal entities in determining the [organizational] client a lawyer represents."). Similarly, the Model Code uses the generic term "entity" and discusses lawyers retained by "a corporation or similar entity." MODEL CODE, *supra* note 25, at EC 5-18.

31. At least one commentator has suggested that it is "indisputably clear that the draftsmen of [Model Rule] 1.13 . . . relied exclusively on the traditional corporate model." Mitchell, *supra* note 4, at 469 n.13.

32. MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 1010 (1995).

33. *See* Easterbrook & Fischel, *supra* note 12, at 271 ("There is a fundamental difference between closely and publicly held corporations.").

34. DOOLEY, *supra* note 32, at 1011 (emphasis added).

35. *See, e.g.*, ROBERT CHARLES CLARK, CORPORATE LAW § 1.3 (1986) (describing close corporations as corporations with "only a small number (for example, fewer than thirty) of individual shareholders and whose shares are not traded on a recognized securities exchange or on the over-the-counter

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Closely held businesses can operate as corporations, partnerships, or limited liability companies. Several states allow closely held corporations, or "close corporations," to opt-in to special statutory treatment.[36] These statutory schemes treat close corporations more like partnerships or limited liability companies than like traditional corporations.[37]

Although Model Rule 1.13 may work well for traditional corporations, it has limited application to closely held business forms. There are two important differences between closely held businesses and traditional corporations that explain why applicability is limited:[38] the frequency with which owners and lawyers interact, and the nature of the representation that the lawyer is hired to provide.

Owners of closely held businesses have frequent interactions with lawyers either in their capacities as owners or managers of the entity.[39] One of them most likely hired the lawyer based on a pre-existing lawyer-client relationship, a friendship, or a referral.[40] These personal interactions and history give owners the impression—usually reasonable—that the lawyer represents them individually.[41] These owners view the entity not as a separate creature,

market"); Mitchell, *supra* note 4, at 477 ("The most significant characteristics . . . [of a close corporation are] the substantial investment by participants, the illiquidity of ownership interests, and the substantial identity of ownership and management.").

36. *See* ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 476 (7th ed. 2001) ("The call for special legislative treatment of closely held corporations has led to statutory developments [recognizing the problems of closely held corporations] in most states. These statutes permit closely held corporations to depart dramatically from the traditional statutory scheme of shareholders/directors/officers in specified circumstances."); Easterbrook & Fischel, *supra* note 12, at 283 ("[T]he much-heralded development of special close corporation statutes recognizes the utility of a set of presumptive rules tailored to closely held corporations.") (citation omitted).

37. *See, e.g.*, Crosby v. Beam, 548 N.E.2d 217, 220 (Ohio 1989) ("Close corporations bear a striking resemblance to a partnership. . . . Just like a partnership, the relationship between the shareholders must be one of trust, confidence and loyalty if the close corporation is to thrive."); Galbreath v. Scott, 433 So. 2d 454, 457 (Ala. 1983) (recognizing that a close corporation "acquires many of the attributes of a partnership or sole proprietorship and ceases to fit neatly into the classical corporate scheme"); DEL CODE ANN. tit. 8, § 354 (2001):

> No written agreement among stockholders of a close corporation . . . shall be invalid on the ground that it is an attempt . . . by the stockholders . . . to treat the corporation as if it were a partnership or to arrange relations among the stockholders or between the stockholders and the corporation in a manner that would be appropriate only among partners.

Id.; Mitchell, *supra* note 4, at 469 (observing a "general recognition that the shareholders of a close corporation are considered partners in their dealings with one another and that the corporation is an entity only with respect to the rest of the world"); Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083, 1087 (1992) ("[T]he LLC has much in common with a statutory close corporation . . . .").

38. *See* HAMILTON, *supra* note 36, at 476-79 (discussing the uniqueness of close corporations); *Galbreath*, 433 So. 2d at 457 (adopting "attitudes toward close corporations which . . . recognize a distinction between closely and widely held corporations").

39. Note, *An Expectations Approach to Client Identity*, 106 HARV. L. REV. 687, 691 (1993) [hereinafter *An Expectations Approach to Client Identity*] ("[T]he attorney for a close corporation deals with a constituent who is often a director, officer and/or shareholder . . . .").

40. *See infra* note 105 and accompanying text.

41. At least one well-known case, Skarbrevik v. Cohen, 282 Cal. Rptr. 627 (Cal. Ct. App. 1991), may have held that the lawyer only represented the entity, and not also the shareholder claiming personal representation, because the shareholder had no direct contact with the lawyer. *See* Simon, *supra* note 5, at 62-63.

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but merely as an extension of themselves. Indeed, the owners have often been operating their businesses as sole proprietorships or general partnerships and have incorporated simply for liability protection.[42] Therefore, any rule addressing representation of closely held businesses must adequately differentiate between the entity and its owners and provide guidance to lawyers when handling matters on behalf of each. Model Rule 1.13, which only addresses representation of the entity, is only half of the equation.[43]

On the other hand, a lawyer rarely interacts with the shareholders of a traditional corporation, who neither serve as directors nor officers of the corporation.[44] Therefore, it is highly unlikely that a traditional corporation's shareholders will believe that the lawyer represents them personally. Similarly, it is rare that the corporation's directors and officers believe that the lawyer represents them personally—most directors and officers of traditional corporations are experienced and understand that the lawyer's primary duty is to the corporation.[45] Also, constituents in traditional corporations are more accustomed to dealing with corporate lawyers and thus are more likely to understand their roles as agents of the corporation.

Second, lawyers for closely held businesses and lawyers for traditional corporations are usually hired to provide different services. Closely held business lawyers are typically hired to incorporate the business and guide its sometimes unsophisticated owners. These lawyers provide advice and draft agreements dealing with the owners' internal affairs before assisting the entity with its outside business, and regularly thereafter. It is this role that Model Rule 1.13 completely overlooks—that owners of closely held businesses seek advice from their lawyers on matters affecting them personally. As discussed above,[46] in the owners' minds, they and the entity are one and the same.

Conversely, lawyers for traditional corporations tend to focus primarily on assisting the corporation with its outside business. Although lawyers for traditional corporations may incorporate the business or prepare minutes from board meetings, significant internal matters such as owner relationship

42. Simon, *supra* note 5, at 67 (theorizing that shareholders in a close corporation "may think of incorporation primarily as a means of limiting liability or gaining tax advantage, and may not think of it as affecting internal relationships at all"); *see also* Mitchell, *supra* note 4, at 478-79 (observing that "counsel for the close corporation typically will have regular contact with . . . shareholders and may well have personal relationships with some or all of them"); *An Expectations Approach to Client Identity*, *supra* note 39, at 689 (arguing that in the close corporation context "[o]pportunities for such lawyer-constituent interaction lie at the heart of the client identity problem").

43. See *infra* Part II.A.3 for a discussion of the potential impact of Model Rule 1.13(g) on this omission.

44. An obvious exception is the large shareholder who demands a board seat in return for his investment.

45. If the lawyer senses a conflict between the corporation and an individual constituent, Model Rule 1.13(f) provides guidance. "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." MODEL RULES, *supra* note 22, at R. 1.13(f).

46. *See supra* note 42 and accompanying text.

HeinOnline -- 56 Ala. L. Rev. 190 2004-2005

issues do not typically present themselves to these lawyers.[47] For example, shareholder agreements are not used in traditional corporations because shares are freely transferable and held by a wide variety of shareholders whose identities can change daily.[48] Also, as mentioned before,[49] the owners and managers of traditional corporations are more familiar with the corporate lawyer's role, and thus would not be inclined to seek personal advantage or advice from the lawyer. Because of these important differences between closely held businesses and traditional corporations, each requires its own rule for guiding lawyers in their representation.

Even when the Model Rules were substantially revised per the American Bar Association's "Ethics 2000" project, the shortcomings of Model Rule 1.13 in the closely held business context were not addressed.[50] Admittedly, during business formation, there is no "entity" yet, and thus Model Rule 1.13 is not the appropriate place for discussion of co-representation of the would-be owners.[51] But, this does not explain its shortcomings in addressing owner relationship issues that occur beyond formation, which may even include drafting a shareholders agreement (if not done concurrently with formation). Under the current structure, closely held business lawyers must look beyond Model Rule 1.13 for guidance in addressing these issues.[52] Model Rule 1.7, entitled "Conflict of Interest: Current Clients," goes further than Model Rule 1.13 in identifying the lawyer's role as to individual owners of closely held businesses.[53] It is not designed for the unique problems presented; however, it is the general rule of concurrent representation.[54] This rule, and other efforts to rectify the problems with Model Rule 1.13, are discussed in Parts II.B and II.C below.

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47. This is especially true of firm lawyers. Most traditional corporations have in-house legal departments that handle internal matters for the corporation. Due to the added expense, firm lawyers are sometimes brought in only to handle significant business combinations or complex litigation.

48. *See* DOOLEY, *supra* note 32, at 1010.

49. *See supra* note 45 and accompanying text.

50. *See* Margaret Colgate Love, *The Revised ABA Model Rules of Professional Conduct: Summary of the Work of Ethics 2000*, 15 GEO. J. LEGAL ETHICS 441, 453 (2002) (no substantive changes in Model Rule 1.13).

51. *But see* Jesse v. Danforth, 485 N.W.2d 63, 67 (Wis. 1992) (retroactively applying entity representation concepts to a pre-incorporation group of individuals).

52. *See* Mitchell, *supra* note 4, at 470-71.

> Under the [Model Rules], counsel must look to the exception, Rule 1.7 (dealing with conflicts of interest[)], rather than the rule, Rule 1.13 (dealing with entity representation), to determine to whom she owes her professional obligations. The [Model Code] indicates even more forcefully that multiple representation in general is considered exceptional. Moreover, the [Model Code], like the [Model Rules], fails to guide counsel in the close corporation situation, but simply directs her to the rule governing multiple representation. The consequence is that the issue of client identification, notwithstanding its frequent occurrence is necessarily resolved by the lawyer on a case-by-case basis.

Id. (citations omitted).

53. MODEL RULES, *supra* note 22, at R. 1.7.

54. *Id.*

HeinOnline -- 56 Ala. L. Rev. 191 2004-2005

3. *The Potential Extension of Model Rule 1.13(g)*

An initial reading of Model Rule 1.13(g), which provides that "[a] lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7,"[55] might lead one to conclude that in fact there is no gap left by the rule.

Despite the rule's broad language, it has traditionally been used to allow a public corporation's regular law firm to represent a corporation and its senior officers in litigation brought by a third party, or to represent its senior officers in unrelated matters, such as estate planning.[56] The official comment to the rule, which provides that "a lawyer for an organization may also represent a principal officer or major shareholder,"[57] comports with this traditional interpretation.

In addition, this provision has only been interpreted to allow representation of an individual constituent whose interests do not conflict with those of the lawyer's principal client, the corporation.[58] The conflicts of relevance in the close corporation setting are usually not conflicts between the entity and an individual owner, but between the individual owners themselves. Finally, even if the rule's application could be extended to individual owner conflicts, the structure of Model Rule 1.13 clearly envisions individual representation as secondary to entity representation. In the closely held business context, however, it could be just as important—if not more important—than the external matters a lawyer handles for the entity.[59] Therefore, subsection (g) is not an adequate cure for Model Rule 1.13's omission.

B. *The Aggregate Theory*

1. *Case Law and Scholarly Commentary*

Courts and commentators have noted the unique relationships between lawyers and shareholders of closely held businesses, and that Model Rule 1.13 does not take this into account. Some have gone to the other extreme, finding that instead of representing no owners individually, the lawyer

55. The Model Code counterparts are EC 4-4, EC 5-16, and DR 5-105(B) & (C).

56. HAZARD & HODES, *supra* note 29, § 17.14.

57. MODEL RULES, *supra* note 22, at R. 1.13 cmt. 12.

58. *See, e.g.*, Scott L. Olson, *The Potential Liabilities Faced by In-House Counsel*, U. MIAMI BUS. L. REV. 1, 5 n.31 (1998) (interpreting New Model Rule 1.13(g) (formerly Model Rule 1.13(e)) as allowing dual representation of an individual constituent and the organization, "if consent is provided by either the shareholders or 'an appropriate official of the organization other than the individual who is represented'"); Sean J. Griffith, *Ethical Rules and Collective Action: An Economic Analysis of Legal Ethics*, 63 U. PITT. L. REV. 347, 372 n.85 (2002) (stating that New Model Rule 1.13(g) (formerly Model Rule 1.13(e)) "applies rule 1.7 to concurrent conflicts arising from the representation of different parts of an organization—e.g., a corporation and an officer or employee").

59. *See supra* Part II.A.2 and accompanying text (discussing the difference in the types of matters handled by close and public corporation lawyers).

HeinOnline -- 56 Ala. L. Rev. 192 2004-2005

represents *all* of the owners individually (in addition to the entity).[60] This approach is sometimes called the "aggregate theory" because the lawyer represents the aggregate of the entity and its constituents. It should be noted that the drafters of the Model Rules rejected the aggregate theory in favor of the entity theory.[61]

Two Oregon cases involving disciplinary action brought against a lawyer, *In re Banks*[62] and *In re Brownstein*,[63] are often cited as illustrations of the aggregate theory. In *Banks*, a lawyer prepared an employment agreement for a corporation's sole shareholder.[64] After the corporation underwent a change in control, the lawyer advised the new owners that the former owner had breached his employment agreement.[65] The court found that it was improper for the lawyer to represent the new owners adverse to the former owner because the former owner was essentially the corporation at the time the agreement was drafted.[66] The court understood the confusion over the lawyer's actions experienced by the former owner, who had hired the lawyer to protect his interests "both personal and corporate, which interests were substantially identical."[67]

Likewise, the lawyer in *Brownstein* was reprimanded for representing a third party with interests adverse to the shareholders of a close corporation he represented.[68] The court in *Brownstein*, citing *Banks*, held that there was a conflict because "the attorney in [the close corporation context] represents the corporate owners in their individual capacities as well as the corporation unless other arrangements are clearly made."[69] In both cases, the court's

60. *See, e.g.*, Opdyke v. Kent Liquor Mart, 181 A.2d 579, 583 (Del. 1962) (holding that "[t]he corporation [i]s simply a form for the carrying on of a joint venture . . . [and the lawyer] must be regarded as the attorney for [the] three joint adventurers"); Woods v. Superior Court, 197 Cal. Rptr. 185, 188 (Cal. Ct. App. 1983); *see generally* Ellen A. Pansky, *Between an Ethical Rock and a Hard Place: Balancing Duties to the Organizational Client and Its Constituents*, 37 S. TEX. L. REV. 1167, 1184-87 (1996) (discussing cases in which an implied attorney-client relationship was found in the close corporation setting).

61. ABA Formal Op. No. 91-361, *supra* note 29. Former Model Rule 2.2, however, seemed to at least implicitly adopt the aggregate theory. *Id.* A lawyer's role in the organization of a business was addressed in the comment to the Rule, which provided that a lawyer is an intermediary "in helping to organize a business in which two or more clients are entrepreneurs." *Id.* Model Rule 2.2 was replaced by the Ethics 2000 Commission with new Model Rule 2.4, and the above-quoted language was moved to the comments of revised Model Rule 1.7. *See* MODEL RULES, *supra* note 22, at R. 1.7 cmt. 28. At least one commentator had suggested that Model Rule 2.2 provided the applicable standard of conduct in determining the lawyer's professional responsibility when representing the closely held business. *See* Bryan J. Pechersky, Note, *Representing General Partnerships and Close Corporations: A Situational Analysis of Professional Responsibility*, 73 TEX. L. REV. 919, 938-39 (1995) (describing this standard as "paternalism").

62. 584 P.2d 284 (Or. 1978).

63. 602 P.2d 655 (Or. 1979).

64. *Banks*, 584 P.2d at 286.

65. *Id.* at 287.

66. *Id.* at 290 ("In such a situation . . . common sense dictates that the corporate entity should be ignored.").

67. *Id.* at 291.

68. *Brownstein*, 602 P.2d at 656.

69. *Id.* at 657.

HeinOnline -- 56 Ala. L. Rev. 193 2004-2005

rationale focused on the uniqueness of close corporations, and in particular on the expectations of the close corporation shareholders.

Commentators have also advocated the aggregate theory, often arguing that reasons of economy and efficiency justify multiple representation when representing closely held businesses.[70] For example, Professor Mitchell suggests that "[b]ecause counsel's conduct will . . . directly affect each of these shareholders, it should be recognized that counsel owes a duty to each of them."[71] Another commentator suggests that the aggregate theory "realistically balances and protects the interests of clients, the legal system, and the public."[72]

Under the aggregate theory, there are no confidentiality or attorney-client protections between co-clients, and one co-client may waive these protections for all co-clients.[73] Confidential information may also pass from one co-client to another via the laws of confidentiality applicable to organizations.[74]

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70. These justifications will be discussed in detail in Part III.D.1.

71. In an argument that is contrary to first impression, Professor Mitchell suggests that representing all of the owners does not present a conflict in the majority-minority situation, but does present a conflict if the owners have equal ownership interests. Mitchell, *supra* note 4, at 472. Professor Mitchell cites *Brownstein* as decided correctly: "*In re Brownstein* . . . directly confronts the issue and unequivocally answers (correctly, I think) the frequently asked (and as frequently unanswered) question of who the client is in the close corporation." *Id.* at 472 n.26. When a conflict arises in the unequal ownership situation, he argues, "counsel is obligated to advise the majority that it must deal fairly with the minority, and counsel may even be expected by the minority to represent their interests." *Id.* at 503. But, he argues that equal owners will have "equally valid claims," *id.* at 504, and "each of the equal sides will expect counsel to assist in obtaining the advantage sought by it." *Id.* Although I believe that Professor Mitchell reaches the correct conclusion in the equal ownership situation (that aggregate representation should not be permitted), I disagree with his conclusion that aggregate representation is acceptable in the majority-minority situation. Recall from the introductory hypothetical the ethical dilemma lawyers face if they attempt to navigate these murky waters. Moreover, simply advising the majority that it must deal fairly with the minority does not ensure that minority interests will be protected. So long as the majority's treatment of the minority cannot be deemed oppressive or a violation of the majority's fiduciary duties, which are high and vague standards, nothing prevents the majority owner from ignoring the lawyer's admonitions. Further, in practice, many lawyers may be hesitant to advise both the majority and minority for fear of damaging the existing relationship with the individual with which the lawyer has (or hopes to have) a long-lasting attorney-client relationship. Professor Mitchell's approach does not adequately address these issues.

72. Pechersky, *supra* note 61, at 936.

73. *See, e.g.*, Debra Lyn Bassett, *Three's A Crowd: A Proposal to Abolish Joint Representation*, 32 RUTGERS L.J. 387, 434-35 (2001).

74. An attorney's confidentiality obligations to a closely held business and its owners are difficult to determine due to the intertwined interests of entity and individual. The first question is: What is confidential or privileged as to third parties? An organization has the same right to confidentiality as any other client. But an organization's attorney-client privilege, which protects confidential communications between lawyer and client, can be waived by the organization's management. *See, e.g.*, Commodity Futures Trading Comm. v. Weintraub, 471 U.S. 343, 348-49 (1985); *In re* Silvio de Lindegg Ocean Devs. of Am., Inc., 27 B.R. 28, 28 (S.D. Fla. 1982) (holding that, in bankruptcy proceedings of a close corporation, a bankruptcy trustee can waive the corporation's attorney-client privilege but not an individual shareholder's personal privilege). For criticism of *In re Silvio*, see Neil E. Herman, Note, *Who Controls the Attorney-Client Privilege in Bankruptcy?*, 13 HOFSTRA L. REV. 549, 581-82 (1985). Even if the organization's constituents are not the lawyer's individual clients, the lawyer cannot reveal their confidences relating to the organization to third parties. *See* MODEL RULES, *supra* note 22, at R. 1.13 cmt. 2 ("When one of the constituents of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is protected by Rule 1.6.").

The second, and more interesting question, is what is confidential or privileged among the

HeinOnline -- 56 Ala. L. Rev. 194 2004-2005

2. *Model Rule 1.7: Conflict of Interest: Current Clients*

Model Rule 1.7 safeguards a lawyer's cardinal duties of zealous representation[75] and loyalty[76] to her clients by disallowing joint concurrent representation where it would create an improper conflict of interest.[77] Revised Model Rule 1.7(a) provides that a concurrent conflict exists if the representation of two clients will be "directly adverse" or if there is a "significant risk" that the representation of either client will be "materially limited."[78] Most conflicts are of the material limitation type,[79] including the typically

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individual owners. The general rule is that "confidential entity information in the lawyer's possession normally should *not* be communicated to a fellow employee whose responsibilities do not require that he know the information, because that individual is not a client." HAZARD & HODES, *supra* note 29, § 17.6. (This, of course, reflects the entity theory of representation.) Under partnership law, "information received by the lawyer while representing the partnership . . . normally may not be withheld from the individual partners." ABA Formal Op. 91-361, *supra* note 29. *Compare* McCain v. Phoenix Res., Inc., 230 Cal. Rptr. 25, 29 (Cal. Ct. App. 1986) (holding a lawyer may not withhold information from partners on the basis of attorney-client privilege) *with* Buford White Lumber Co. v. Octagon Properties, Ltd., 740 F. Supp. 1553, 1570 (W.D. Okla. 1989) (holding that an attorney has no duty to disclose to limited partners information learned from general partners). One scholar suggests that this rule should also apply to close corporations because, as in partnerships and other small groups of individuals, each group member should "have relevant information to maintain continued group identity and decisionmaking abilities." Russell G. Pearce, *Family Values and Legal Ethics: Competing Approaches to Conflicts in Representing Spouses*, 62 FORDHAM L. REV. 1253, 1309 (1994). This scholar also suggests that a corporate shareholder's fiduciary duty to act in the best interests of the entity may also compel him to disclose all relevant information to the other shareholders. *Id.* at 1309-10.

75. MODEL RULES, *supra* note 22, at R. 1.3 cmt. 1 ("A lawyer must . . . act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf."); MODEL CODE, *supra* note 25, at EC 7-1 ("The duty of a lawyer, both to his client and to the legal system, is to represent his client zealously within the bounds of the law . . . .").

76. The lawyer's duty of loyalty has been described as "the lawyer's ultimate responsibility to a client." Bassett, *supra* note 73, at 390. *See also* MODEL RULES, *supra* note 22, at R. 1.7 cmt. 1 ("Loyalty and independent judgment are essential elements in the lawyer's relationship to a client.").

77. *See also* MODEL CODE, *supra* note 25, at DR 5-105(A).

> A lawyer shall decline proffered employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, or if it would be likely to involve him in representing differing interests, except to the extent permitted under DR 5-105(C).

Id. MODEL CODE DR 5-105(B) is the same general concept in the context of continuing (rather than beginning) multiple representation.

> A lawyer shall not continue multiple employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by his representation of another client, or if it would be likely to involve him in representing differing interests, except to the extent permitted under DR 5-105(C).

Id. at (B). DR 5-105(C) is the exception referred to in both DR 5-105(A) and (B). This exception clarifies that multiple representation is reserved for the unique situation.

> In the situations covered by DR 5-105(A) and (B), a lawyer may represent multiple clients *if it is obvious* that he can adequately represent the interest of each and if each consents to the representation after *full disclosure of the possible effect* of such representation on the exercise of his independent professional judgment on behalf of each.

Id. at (C) (emphasis added).

78. The former version of Rule 1.7 treated these two concepts separately, creating confusion over whether one or both were required to find a concurrent conflict of interest. *See* Charles W. Wolfram, *Ethics 2000 and Conflicts of Interest: The More Things Change . . .*, 70 TENN. L. REV. 27, 30 (2002). The revised version clarifies that a conflict is created by a violation of either test, and also raises the standard required for a material limitation conflict from "may create" to "substantial risk." *Compare* MODEL RULES, *supra* note 22, at R. 1.7(a)(2) *with Id.* 1.7(b).

79. *See* Bassett, *supra* note 73, at 410.

friendly negotiations involved in the startup of a business.[80] (Although some could be deemed to put business owners in adverse positions.) If a concurrent conflict exists, the lawyer may only undertake the co-representation if both clients consent, if such consent is confirmed in writing,[81] and if "the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client."[82]

Revised Model Rule 1.7 echoes the Restatement view.[83] The Restatement's official illustrations help put into context when there is a substantial risk of a material limitation. Directly applicable to this discussion is an illustration where three individuals seek a lawyer's assistance in forming a partnership.[84] The partners will each contribute different things to the entity, but few other facts are given. According to the Restatement, the lawyer may assist in forming the partnership.[85]

There are several problems with this conclusion, however. First, the facts are extremely scant, and we have no way of knowing whether the lawyer has a preexisting relationship with one or more of the partners. Second, we have no way of knowing whether all of the partners are equally business-savvy or knowledgeable about what is entailed in forming a business. It is strange that this illustration summarily reaches the conclusion that co-representation is acceptable when the outcomes of the three previous illustrations—dealing with joint representation of a husband and wife in estate planning—vary depending on such facts.[86]

Finally, even if all is equal between the partners, the illustration defers the question of what the lawyer should do if a conflict develops. It is particularly troublesome that the conflict will likely be resolved under the partnership documents the lawyer drafts. So what the lawyer does now, when

80. MODEL RULES, *supra* note 22, at R. 1.7 cmt. 8.

> [A] lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer's ability to recommend or advocate all possible positions that each might take because of the lawyer's duty of loyalty to others. The conflict in effect forecloses alternatives that would otherwise be available to the client. The mere possibility of subsequent harm does not itself require disclosure and consent. The critical questions are the likelihood that a difference in interests will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.

Id.

81. The writing requirement is an addition of the Ethics 2000 Commission. *See id.* at R. 1.7(b)(4), R. 1.7(b)(4) cmt. 20.

82. *Id.* at R. 1.7(b)(1).

83. RESTATEMENT OF THE LAW THIRD, THE LAW GOVERNING LAWYERS § 130 (1998) [hereinafter, RESTATEMENT].

> Unless all affected clients consent to the representation under the limitations and conditions provided in § 122, a lawyer may not represent two or more clients in a matter not involving litigation if there is a substantial risk that the lawyer's representation of one or more of the clients would be materially and adversely affected by the lawyer's duties to one or more of the other clients.

Id.

84. *Id.* § 130 illus. 4.

85. *Id.*

86. *Id.* § 130 illus. 1-3.

HeinOnline -- 56 Ala. L. Rev. 196 2004-2005

the Restatement finds no conflict, can predetermine the outcome of any eventual conflict from which she must withdraw or be disqualified. This, and further problems with co-representation of individual owners, are the subject of the next section.

3. *Why the Aggregate Theory Creates Impermissible Conflicts of Interest*

Despite the apparent Restatement view, there is no clear consensus on whether joint representation of closely held business owners is ethically permissible or desirable. Two experienced business lawyers, posed with a scenario much like my introductory hypothetical, reached very different conclusions.[87] One lawyer felt that the practical advantages of joint representation outweighed the disadvantages.[88] The other "concluded that the present and potential differences are so large that separate representation is required."[89] I agree with the latter sentiment—that closely held businesses lawyers can seldom provide competent and diligent representation to each individual owner when joint representation is undertaken. Therefore, under Model Rule 1.7, co-representation should not be allowed.

First, informed consent to joint representation in this setting is difficult to achieve.[90] As Professor Simon explains, "[e]ven explicit consent given after considerable advice may be held insufficient if it later appears that an important contingency was not foreseen."[91] Even pretermitting the added difficulties in consenting to conflicts that have not yet materialized,[92] it seems highly unlikely that a lawyer can adequately explain the benefits and drawbacks of each decision she must make when engaging in a present task. Although these contingencies, such as the specifics of a buy-sell provision in a shareholders agreement,[93] may appear minor at the time, they can become extremely important later. Therefore, at least in practice, the informed consent requirement poses a problem to joint representation.

Second, the notion that business startups are "friendly" rather than contentious, and thus joint representation is acceptable,[94] becomes a fiction if

87. *See* GEOFFREY C. HAZARD, JR. ET AL., THE LAW OF ETHICS AND LAWYERING 682-83 (2d ed. 1994).

88. *Id.* at 683 (citing accentuation of agreement, efficiency, and economy reasons for allowing the joint representation).

89. *See id.* (pointing to the numerous unresolved, yet critical issues not readily apparent to clients); *see also* Mitchell, *supra* note 4, at 484 ("Each [of the Model Rules and Model Code] permits counsel to represent [two equal owners] if she can do so without compromising the representation of either. However, it is extremely difficult in my personal experience for counsel uncompromisingly to represent both . . . because their interests conflict.").

90. For the Model Rules position on informed consent, see MODEL RULES, *supra* note 22, at R. 1.0(e) cmt. 6. *See also* Wolfram, *supra* note 78, at 42-43.

91. Simon, *supra* note 5, at 67.

92. Revised Model Rule 1.7 allows advance consent under certain circumstances. MODEL RULES, *supra* note 22, at R. 1.7 cmt. 22.

93. *See supra* notes 14-20 and accompanying text.

94. *See* MODEL RULES, *supra* note 22, at R. 1.7 cmt. 28 (joint representation impermissible where relationship between co-clients is antagonistic); Pechersky, *supra* note 61, at 939 (the lawyer "must

HeinOnline -- 56 Ala. L. Rev. 197 2004-2005

the lawyer does her job properly. Reconsider the introductory hypothetical, which presents the situation with the least present conflict between owners. It is the lawyer's job to advise owners who are on friendly terms, and may even be family members, of the unpleasant contingencies that may lie ahead.[95] The lawyer should advise them that, no matter how unlikely it is that such contingencies will materialize, it is better to have mechanisms for handling such events in place from the outset.[96]

Stated differently, even if negotiations seem friendly at the organizational stage, the lawyer must cause the owners to imagine a time in the future when their relationship has become contentious.[97] This is a time when the conflict of interest rules would disallow multiple representation.[98] To envision what could happen if multiple representation were allowed at the organizational stage, consider two shareholders on friendly terms, but one in the majority and one in a minority position. The majority shareholder could instruct the lawyer as to the contents of the shareholders agreement, and the minority shareholder (without proper warning and because of her trust in the majority shareholder) may consent to these terms.[99] If the contentiousness of negotiations is truly the test, then the lawyer would rightfully draft the shareholders agreement to reflect the terms agreed to by the non-disputing shareholders.

But consider a time in the future when a dispute between the shareholders may arise. The minority shareholder has suddenly lost his trust in the majority shareholder and has become very concerned with his legal rights.[100] Imagine how the minority shareholder will react upon reviewing

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determine whether contentious negotiations are contemplated, for multiple representation is 'plainly impossible' in that situation").

95. *See* Bassett, *supra* note 73, at 419 ("Assuming that all of the actors share the same interests, the attorney may decide joint representation is appropriate. However, all too frequently some inconsistency in the clients' interests becomes apparent at a later date.").

96. Hoberman, *supra* note 16, at 242.

> Advance planning allows the principals to have an exit strategy that may prove more profitable for both parties than it would be had they waited for the deadlock before addressing exit procedures. Unfortunately, such advanced planning is not entirely simple. Principals, enthusiastic about engaging in a new venture, are forced to sit down and discuss the possibility of their relationship terminating. Therefore, this part of the negotiations must be handled very delicately . . . .

Id. This admittedly pessimistic view also undercuts another common rationale for joint representation in business formation—that it keeps the discussions "positive." *See* HAZARD ET AL., *supra* note 87, at 683.

97. Many commentators improperly focus only on the contentiousness of matters at the outset of representation without considering what may happen later. *See, e.g.*, Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583, 1608 (1994) ("Professional responsibility rules prohibit simultaneous representation of multiple clients only when the clients' interests are 'fundamentally antagonistic.' Then, even informed client consent is insufficient to waive the conflict. But the interests of companies and insureds can be and normally are harmonious *at the outset* of joint representations.") (emphasis added) (citations omitted).

98. *See* Pechersky, *supra* note 61, at 939.

99. For example, a majority shareholder may instruct the lawyer that all decisions made by the shareholders require only a majority vote. The minority shareholder, believing that he and his partner will always agree on what is best for the corporation, does not object. The minority shareholder has just lost his voice in the corporation's management.

100. *See* Easterbrook & Fischel, *supra* note 12, at 284.

HeinOnline -- 56 Ala. L. Rev. 198 2004-2005

the shareholders agreement and realizing that all of his rights have been bargained away! This is not meant to say that a minority shareholder is not entitled to, and subsequently bound by, the principles of freedom of contract.[101] Indeed, parties enter into unfavorable agreements everyday. But, what is troubling here is that the minority shareholder probably thought his rights were being safeguarded by the lawyer. Rights should only be bargained away knowingly. Given that a potential conflict between the owners could materialize at any time, joint representation of the owners is unadvisable at the organizational stage when relationships are friendly.[102]

Third, Model Rule 1.7 allows joint representation until a conflict arises, then mandates withdrawal.[103] While the wisdom of this structure is beyond the scope of this Article,[104] it has a serious drawback in the closely held business context. Unique to this context, a lawyer's work during business formation will likely dictate the result of a future conflict. In other words, the lawyer's work product either forms the basis for, or is an integral part of, the later dispute. Conversely, in civil litigation or criminal prosecutions, a conflict between two co-clients likely arises over events that took place before the lawyer was retained.

Finally, even though the above concerns are diminished if all owners are equally business-savvy and knowledgeable about what is entailed in forming and operating a business, this is rarely the case in practice. Even if this is the situation, a lawyer may have difficulty determining it. In addition, human nature must be accounted for. The lawyer likely has a stronger relationship with one owner, and that inevitably leads to favoritism. The closely held business lawyer is usually hired at the suggestion of an owner with whom the lawyer has a pre-existing relationship, either legal or otherwise.[105]

> The rule [of law] matters most frequently, though, when parties are ignorant of it until a dispute arises; then they are bound by whatever the standard term happens to be. Many commentators have argued that such ignorance is widespread and that the law of closely held corporations is defective because it fails to protect ignorant investors, particularly minority shareholders, who do not know enough to protect themselves by contract. The extent to which minority shareholders are ignorant of problems they might face and thus fail to protect themselves is impossible to tell.

Id. (citations omitted).

101. *See* Shannon Wells Stevenson, Note: *The Venture Capital Solution to the Problem of Close Corporation Shareholder Fiduciary Duties*, 51 DUKE L.J. 1139, 1145 (2001) (recognizing that freedom of contract can also benefit minority shareholders).

102. This comports with the general prohibition against representing buyers and sellers in certain transactions. *See* State v. Callahan, 652 P.2d 708, 711 (Kan. 1982); Ze'–ev Eiger and Brandy Rutan, Note, *Conflicts of Interest: Attorneys Representing Parties with Adverse Interests in the Same Commercial Transaction*, 14 GEO. J. LEGAL ETHICS 945 (2001); Bassett, *supra* note 73, at 398-99.

> [A]lthough historically it was common for an attorney to represent both parties in the transfer of a property interest, today such a practice is usually considered improper. . . . [A] few courts have prohibited joint representation in certain specific, recurring situations despite the clients' informed consent. These situations include . . . the representation of both buyer and seller in real property transfers.

Id. (citations omitted).

103. MODEL RULES, *supra* note 22, at R. 1.16.

104. *See generally* Bassett, *supra* note 73.

105. *See* Daniel M. Filler, *Lawyers in the Yellow Pages*, 14 L. & LITERATURE 169, 171 (2002) ("Those who had previously hired lawyers cited personal acquaintance and recommendations of family

HeinOnline -- 56 Ala. L. Rev. 199 2004-2005

The fact that this lawyer will want to maintain this relationship casts doubt on her ability to remain impartial.[106]

If there is no pre-existing relationship, the lawyer will quickly deduce during the course of representation which owner is "running the show."[107] This person will likely be the lawyer's primary contact, the ever-important draftsman of the lawyer's checks, and the victor in the event of an intracorporate dispute. Consequently, the lawyer may—intentionally or even subconsciously—give more time, attention and advice to this owner at the expense of the other owners, thereby exhibiting partiality.[108]

In sum, the lawyer will often be forced to make subtle choices favorable to one owner and detrimental to another whenever handling an owner relationship issue.[109] It is difficult to see how a lawyer can obtain the informed consent required to make these hard choices, or how the lawyer can make such choices without running afoul of the "competent and diligent" representation standard set forth in Model Rule 1.7.

C. Other Approaches Advanced By Commentators

1. Reasonable Expectations

One scholarly attempt to solve the client identity problem is drawn from case law and looks to the "reasonable expectations" of closely held business owners regarding personal representation.[110] Under this approach the judicial factfinder asks, "Could the constituent have reasonably expected that the attorney for the close corporation represented him individually?"[111] If answered in the affirmative, the court would find that the lawyer represented the constituent. If answered in the negative, the constituent would not be deemed the lawyer's client. According to one commentator, most cases are actually decided using this approach.[112]

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and friends as their preferred methods of attorney selection.").

106. *See* HAZARD ET AL., *supra* note 87, at 678 ("[W]hen a lawyer has a longstanding relationship with one party and a new relationship with the other, it may be unreasonable to believe that she can be impartial between them."); *see also* Mitchell, *supra* note 4, at 504-05 (suggesting that pre-existing relationships with constituents bias the lawyer and thus hurt the argument for multiple representation).

107. Mitchell, *supra* note 4, at 505 (suggesting that lawyers will tailor their advice to more sophisticated clients).

108. As Professor Mitchell correctly noted, "Even the seemingly menial task of drafting a set of corporate by-laws requires judgments, sometimes subtle and sometimes not, allocating control among the various parties. In such a situation the lawyer's human qualities may well lead to subtle favoritism of one constituent over another." *Id.* at 473-74.

109. *See* Easterbrook & Fischel, *supra* note 12, at 285.

> On the one hand, [drafters of organizational documents] must provide some protection to minority investors to ensure that they receive an adequate return on the minority shareholder's investment if the venture succeeds. On the other hand, they cannot give the minority too many rights, for the minority might exercise their rights in an opportunistic fashion to claim returns at the majority's expense.

Id.

110. *See An Expectations Approach to Client Identity*, *supra* note 39, at 691-704.

111. *Id.* at 688.

112. *Id.* at 700. At least one well known case in this area, Rosman v. Shapiro, 653 F. Supp. 1441

HeinOnline -- 56 Ala. L. Rev. 200 2004-2005

There are several touted benefits of this approach. First, like the aggregate theory, the approach is said to promote efficiency and cost-savings in that it allows for the representation of both the entity and one or more of its owners.[113] Second, the approach purportedly encourages an early determination of client identity by the lawyer and a correspondingly early disclosure of such identity to the owners.[114] Finally, as a standard, advocates claim that it is by definition more flexible and "substance-seeking" than a bright-line rule.[115] Each of these rationales, however, is inadequate in its support of this theory.

The efficiency and economy rationale fails here for the same reason that it fails to support the application of the aggregate theory—that is, reasons of efficiency and economy cannot justify the existence of an unwaivable conflict of interest.[116] There are situations when it is reasonable for multiple owners to believe that the lawyer represents them individually. However, this violates the conflicts of interest rules,[117] and thus cannot be the answer.

The second purported benefit of the reasonable expectations approach is that it encourages early client determination and disclosure. Although any rule should encourage this, the reasonable expectations approach only does so to the extent that it provides an unworkable default rule. It entices lawyers to specify their clients by employing a penalty default rule. I contend that a majoritarian default rule may be more appropriate.[118]

Finally, the increased flexibility of a reasonable expectation standard does not justify its use in place of a bright-line rule. Because of the necessity of a solution that can be easily understood and applied, a bright-line rule is more appropriate than a standard.[119] Any rule should have, as a primary focus, the reduction of confusion in this area of the law.[120] Everyday

(S.D.N.Y. 1987), supports this proposition. In *Rosman*, the court held that "where, as here, the corporation is a close corporation consisting of only two shareholders with equal interests in the corporation, it is indeed reasonable for each shareholder to believe that the corporate counsel is in effect his own individual attorney." *Id.* at 1445. Another famous case, Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C., 309 N.W.2d 645, 648-49 (Mich. Ct. App. 1981), could also be cited in support of the reasonable expectations theory. In *Fassihi*, the court held that although a lawyer and shareholder do not establish an attorney-client relationship, the lawyer may owe the shareholder fiduciary duties arising out of their confidential relationship. *Id.* Professor Simon suggests that the court reached this result because the lawyer did not clarify his role to the shareholder despite the shareholder's misunderstanding of that role. Simon, *supra* note 5, at 63 n.9.

113. *See An Expectations Approach to Client Identity*, *supra* note 39, at 701-02.

114. *Id.*

115. *Id.* at 688 n.11 (describing a substance-seeking approach as one that "attempts to discern the substance rather than the mere form of representation").

116. *See* Mitchell, *supra* note 4, at 484 ("Reasons of economy and efficiency suggest that, *where possible*, [joint] representation is desirable.") (emphasis added).

117. *See supra* Part II.B.3.

118. *See infra* Part III.A.2.d.

119. *See infra* Part III.D.2.

120. An examination of California case law illustrates the need for clarity. *See* James M. Fischer, *Representing Partnerships: Who Is/Are the Client(s)?*, 26 PAC. L.J. 961, 961-62 (1995) ("California courts have held that the lawyer who is employed by a partnership represents (1) the partnership, or alternatively (2) the partnership and the general partners, or alternatively (3) the partnership, the general partners *and* the limited partners. The decisions are difficult to reconcile.") (citations omitted).

HeinOnline -- 56 Ala. L. Rev. 201 2004-2005

lawyers must be able to apply the rule, and even more importantly, clients must be able to understand it.

2. *Framework of Dealing*

Professor William Simon focused on entity representation in a recent article.[121] After an excellent discussion and critique of the many existing theories, he proposed a new way of viewing the entity—as a "framework of dealing." Professor Simon suggested that the "duly authorized constituents" approach taken by Model Rule 1.13 is incomplete.[122] He believes that whether a person, body (e.g., board of directors), or decision is authorized in any given matter is often ambiguous, and thus cannot be properly addressed by a lawyer until she examines the merits of the particular matter.[123] If the lawyer cannot determine the merits of a dispute, the lawyer should remain neutral.[124]

I believe this theory can be viewed in one of two ways. First, it can be seen as embracing the entity theory, but attempting to solve a common problem that arises—the question of authorization. Second, it can be viewed more expansively as proposing a substantively new role for the lawyer as businessperson in addition to legal counselor. Supporting the second view, Professor Simon argues that the entity "has an interest in the fair treatment of its constituents,"[125] and that lawyers owe duties to those constituents who are correct in their positions on any given issue.[126] He concedes that "[s]ome will be disturbed by the notion that the lawyer has responsibility for determining the merits of an intracorporate dispute."[127]

This is indeed a troublesome proposition. The lawyer's expertise is not in making business decisions, and the Model Rules explicitly discourage this role for the lawyer.[128] Consider the consequences of requiring lawyers to make business decisions—in effect making them part of the entity's management (by facilitating the cause of the owner whose position the lawyer sees as more meritorious). If we begin down this road, we may subject lawyers to even greater potential confusion—and liability—than they now

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121. Simon, *supra* note 5, at 86-89.

122. *Id.* at 86-87.

123. *Id.* at 87.

124. *Id.* Simon notes:

> Of course, in many, perhaps even most, situations, the lawyer will not be able to determine reliably the substantive merits. In these circumstances, the Framework of Dealing approach favors neutrality. With respect to the conflict-of-interest issue, this means that the lawyer cannot speak for any of the disputing constituents.

Id.

125. *Id.* at 86.

126. *Id.* at 87 ("[T]he lawyer might resolve [a] conflict-of-interest issue by aligning herself with the constituent who had the more meritorious claim.").

127. *Id.* at 89.

128. The Model Rules provide that "[w]hen constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province." MODEL RULES, *supra* note 22, at R. 1.13 cmt. 3.

HeinOnline -- 56 Ala. L. Rev. 202 2004-2005

face.[129] The goal should be to clarify representation for both lawyers and clients, even if such a solution will sometimes sacrifice the optimal result for the sake of clarity.[130]

Further, assuming lawyers did try to become judges of these disputes, they would often have difficulty determining their merits, and thus could not advise on these matters.[131] Professor Simon concedes this problem.[132] This is especially true in the organizational stage, where the lawyer probably has limited familiarity with both the skills of the owners and the entity's new business plan. There have been no results generated by either owner for the new business at that time. Therefore, one owner's argument that a right of first refusal provision should be drafted his way may merits no more consideration than an opposing claim from the other owner.[133] Compounding the lack of operating history is the plethora of arguments for benefiting a majority owner or, conversely, protecting a minority owner no matter who they are. Thus, in the organizational context, the merits are simply too difficult for lawyers to judge. But this would mean a lawyer could never prepare organizational documents for an entity, which clearly cannot be an acceptable result.[134] The framework of dealing approach does not adequately solve the client identity problem in the closely held business context.

III. A NEW PROPOSAL: THE INTERNAL-EXTERNAL DISTINCTION

The preceding discussion reveals the deficiencies of the current rules and theories concerning representation of closely held businesses. In summary, the entity theory—under which the lawyer represents the entity only—guides the lawyer when representing the entity opposite third parties, but provides no guidance on how to resolve conflicts between the entity's owners. The aggregate theory, which claims that the lawyer represents the entity and all of its individual owners, too often creates impermissible conflicts of interest. The reasonable expectations approach is only useful in

129. *See* Bethany Smith, Note, *Sitting On vs. Sitting In On Your Client's Board of Directors*, 15 GEO. J. LEGAL ETHICS 597 (2002) (discussing the greater potential liability for the corporate lawyer who sits on his client's board of directors).

130. *See infra* Part III.D.2.

131. Simon, *supra* note 5, at 89 (noting the framework of dealing approach may not be useful "as a practical guide to professional responsibility decisions").

132. *Id.* ("Some will think [the lawyer] will so seldom be able to make such a judgment that the approach will require neutrality too often.").

133. I argue elsewhere that the lawyer usually has a pre-existing relationship with at least one owner. *See supra* note 105 and accompanying text. Although this may enable the lawyer to make an educated guess as to this owner's ability to run the new business, there would be no equally reliable means of determining the other owner's (or owners') skill and knowledge, and thus no means for a meaningful comparison.

134. See Simon, *supra* note 5, at 87. He argues that, in such a situation, the joint representation and the framework of dealing approaches will both require withdrawal from representation in certain circumstances, but for different reasons: "The joint-representation perspective requires withdrawal because the lawyer cannot adequately represent all individuals and cannot represent any of them individually without jeopardizing duties of confidentiality and loyalty to the others. The Framework of Dealing approach requires withdrawal because the client's interests cannot be determined." *Id.*

HeinOnline -- 56 Ala. L. Rev. 203 2004-2005

hindsight, and the framework of dealing approach improperly calls on lawyers to become the judges of business disputes.

My proposed solution first divides the world of the closely held business lawyer into "internal" and "external" matters.[135] In short, internal matters involve the inner workings of the entity and, in particular, the needs and concerns of the entity's owners. External matters relate to the entity's dealings with the outside world. This classification recognizes a key difference between closely held businesses and traditional corporations: because owners of closely held businesses often do not distinguish their interests from the entity's interests, internal matters take on significant importance in closely held businesses. Stated differently, unlike in traditional corporations, the closely held business lawyer is counselor to both the entity and its owners. Once the lawyer's world is divided to reflect these two distinct roles, she can establish her internal client—an owner[136]—and her external client—the corporation.[137] The lawyer is then ready to undertake representation generally free from conflict.[138]

A. Internal Matters

1. Internal Matters Defined

Internal matters are everything that happens "inside" the entity.[139] There are several categories of internal matters. The first, and the category that creates the conflicts of interest that my proposed approach seeks to eliminate, involves the business relationships between owners (what I have been

135. *See* Richard A. Epstein, *Contract and Trust in Corporate Law: The Case of Corporate Opportunity*, 21 DEL. J. CORP. L. 5, 7 (1996).

> Most of a corporation's affairs can be divided into two large categories: the first of these deals with the external relationships of the corporation to the rest of the world; and the second deals with the internal affairs of the corporation, i.e., the way in which the corporate participants—shareholders, directors, officers, and perhaps bondholders and contractual creditors—organize their cooperative venture among themselves . . . .

Id.

136. A related idea, that representation of one co-client against another in a later dispute should be permissible, has been suggested by Professor Richard Painter. Richard W. Painter, *Advance Waiver of Conflicts*, 13 GEO. J. LEGAL ETHICS 289, 323 (2000). ("Co-clients should . . . be permitted to agree ex-ante that their lawyer may subsequently represent one of the clients in the matter, or in another substantially related matter, even if an adverse interest among the clients later emerges.").

137. Ideally this is done via a retainer agreement from the outset of representation. Realizing that lawyers and clients will not always enter into such agreements, however, suggestions for a default rule are also provided. *See infra* Part III.A.2.d.

138. See *infra* Part III.C for the limited circumstances under which a lawyer must withdraw or face disqualification under my proposed theory.

139. *See* Pechersky, *supra* note 61, at 924 n.16 (defining a corporation's "internal affairs" as "matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders") (quoting Edgar v. MITE Corp., 457 U.S. 624, 645 (1982)); Dale A. Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, 66 U. COLO. L. REV. 881, 893 (1995) (suggesting that drafters of LLC statutes sought to increase "the flexibility and autonomy of firm participants in ordering, free from court restructuring, their firms' internal affairs through the firms' constitutional documents").

HeinOnline -- 56 Ala. L. Rev. 204 2004-2005

referring to as "owner relationship issues").[140] These are the owners' personal interests in the venture—each owner's expectations for the venture in relation to the others.[141] The ownership stakes and management positions of the owners are examples of this type of internal matter. Because many such items are addressed in a shareholders agreement, the lawyer represents her internal client during its preparation. As discussed earlier,[142] these matters present impermissible conflicts because they put owners in adverse, or at least potentially adverse, positions.

The second category of internal matters relates to the internal operations of the entity. These are the internal mechanisms by which the entity functions. For example, the preparation of corporate bylaws is an internal matter because bylaws divide decision-making duties among shareholders, directors, and officers. This document establishes who is authorized to act on behalf of the corporation on any given matter.[143]

The third category of internal matters is the catch all—if no third party has a direct interest in a matter, it is by default internal to the entity.[144] Determining whether a third party has a direct interest requires elaboration. Third parties may be indirectly affected by internal matters, but the owners or the entity will be the ones primarily affected. For example, all third parties who may potentially wish to buy an existing shareholder's stock have an indirect interest in how a right of first refusal provision is drafted.[145] The more difficult such a provision makes it for a remaining shareholder to exercise her right of first refusal, the better it is for the third party seeking to become a shareholder. But because these third parties have no control over how this provision is drafted, it is properly defined as an internal matter. (When an existing right of first refusal provision is triggered, however, the third party becomes an integral player in the transaction and thus the matter becomes external.)

The purpose of defining a matter as internal or external is to separate the two distinct roles that the closely held business lawyer plays. Once this has been accomplished, the lawyer can represent a separate "client" for each type of matter. Establishing the external client is simple—it is always the entity.[146] But, establishing the internal client, and ensuring that all of the

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140. *See, e.g.*, Pechersky, *supra* note 61, at 924 (discussing "representation solely concern[ing] the internal affairs of the individuals operating the business") (citation omitted).

141. The owners' relative interests can be implicated in choices concerning "organizational form[,] . . . capital structure, corporate finance, control mechanisms, [and] organic transactions." Mitchell, *supra* note 4, at 484.

142. *See supra* Part II.B.3.

143. *See infra* Part III.B.3.

144. There is significant overlap between these categories. For example, an employment agreement between a shareholder and the corporation qualifies as internal because it relates to the internal workings of the corporation—the corporation is employing a constituent to perform certain tasks. It is also internal simply because it is not external—it does not relate to a corporation's interaction with a third party.

145. *See supra* notes 15-17 and accompanying text.

146. *See infra* Part III.B.2.

owners understand the ramifications of this, is the biggest practical challenge in applying this theory.

2. *Establishing the Internal Client*

a. *When to Establish the Internal Client*

For many closely held business lawyers, representation begins at the beginning—with the formation of the entity. In the typical scenario, the lawyer will be approached by one or more individuals, who will correctly believe that incorporation is advisable to protect their personal assets from being used to satisfy business debts.[147] The individuals will discuss with the lawyer, among other things, the form of entity that will produce the most favorable tax result and the preparation of documents that will establish the terms of the business relationship between the individuals as owners. As discussed earlier,[148] it is at this early stage that conflicts between the owners are a concern, and it is because of these potential conflicts that the lawyer should specify the identity of her internal client at this stage.

Internal matters will arise predominantly in the organizational stages, but can also arise if the lawyer undertakes representation after the entity has commenced operations. For example, if the co-founders of the entity have a dispute over the future of the business and one or both want to examine their options for parting ways, they may approach the lawyer for strategic advice. If the lawyer has been representing the entity from the beginning, she will have already established which of the co-founders she represents (and, therefore, to whom the lawyer should provide the requested advice). If the lawyer undertook representation after the governing documents were adopted and operations had commenced, then perhaps the identity of the internal client has not yet been established (because no internal matters have yet arisen).[149]

Two possibilities present themselves for the lawyer's handling of this situation. First, if providing the requested advice involves merely determining the founders' rights under the entity's existing governing documents, then perhaps the lawyer can provide this advice without establishing an internal client. However, it may be argued (fairly, I think), that a lawyer's reading of these documents is different from a layperson's reading. Just as I am skeptical that a lawyer can act as a scrivener for the parties and document their agreement without encountering a conflict of interest, I seriously doubt that a lawyer can merely read and recite a legal document's contents.[150] Any such exercise involves the lawyer's skill and expertise in inter-

147. *See supra* note 42 and accompanying text.
148. *See supra* notes 94-102 and accompanying text.
149. In contrast, internal matters always arise during organization, and thus the internal client must be established at the outset of any representation undertaken at this stage.
150. *See* Mitchell, *supra* note 4, at 483 (suggesting that a lawyer acting as a "mere scrivener" is neither possible nor responsible).

HeinOnline -- 56 Ala. L. Rev. 206 2004-2005

preting such documents and devising a creative strategy based on a combination of discrete provisions.[151] My skepticism is supported by common sense—if the lawyer is merely to read and recite existing documents, why would the clients, who could do this themselves, pay a lawyer's fees for this task?

The more appropriate course of action would be for the lawyer to identify the internal client at this stage. Of course, doing so probably involves tipping off the other owner that the first owner's intentions have become adverse. It also likely aligns the lawyer with one owner at the expense of the lawyer's relationship with the other.[152] But regardless of these difficulties, it is still the advisable course of action because it avoids conflicts of interests and saves the lawyer from potential liability to an owner who had reasonable expectations of being represented.[153]

As is implicit in the above discussion, a lawyer may represent only the entity (i.e., not have an internal client) under limited circumstances if the lawyer was retained post-organization. It is very common for entities to hire lawyers for discrete purposes, such as for business combinations or litigation matters. The lawyer must only establish an internal client if an internal matter presents itself. It is important to reassert that every dispute among owners is not an internal matter. If the dispute concerns a decision relating to the entity's business and not the business relationship between the owners, it is purely an external matter and the lawyer takes her direction from the entity's duly authorized constituents.[154]

b. How to Establish the Internal Client

The identity of the internal client should be established in a retainer agreement signed by the lawyer and *all* of the entity's owners. An explicit agreement is not required to establish client identity (course of conduct can suffice), and the agreement does not have to be written[155] (unless to satisfy consent to a concurrent client conflict under Model Rule 1.7). But, because of the confusion over client identity in this area and its significant consequences, I submit that a detailed, written agreement clarifying representation is far better than relying on an oral agreement or course of conduct.[156]

The retainer agreement should be signed by all owners and should explain three things: (1) the internal-external distinction and how it will guide the lawyer's representation;[157] (2) which owner is the lawyer's internal cli-

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151. *See* George D. Gopen, *The State of Legal Writing: Res Ipsa Loquitur*, 86 MICH. L. REV. 333, 352 (1987) ("[T]he non-lawyer cannot interpret the law, or the lawyer's document.").
152. *But see infra* note 159.
153. *See supra* Part II.C.1.
154. *See infra* Part III.B.3.
155. *See* RESTATEMENT, *supra* note 83, § 14.
156. *See* Lawrence A. Dubin, *Client Beware: The Need for a Mandatory Written Fee Agreement Rule*, 51 OKLA. L. REV. 93 (1998) (advocating written retainer agreements, and in particular written fee arrangements).
157. This statement should be written in a way that laypersons with little experience dealing with

HeinOnline -- 56 Ala. L. Rev. 207 2004-2005

ent, and that the lawyer will provide advice on internal matters to that owner and draft internal documents per that owner's instructions; and (3) that the lawyer advises the non-represented owner (or owners) to seek separate counsel, particularly if the non-represented owner is in a minority ownership position.[158] The non-represented owner may or may not choose to seek separate counsel, but at least this owner will not be proceeding under the fiction that the organizational documents necessarily protect his interests.[159]

Often the non-represented owner will choose not to retain separate counsel, and the represented owner will instruct the lawyer to be "flexible" and "fair" when drafting shareholders' agreements and other internal documents.[160] Even in this situation, which is the same practical result provided by the aggregate theory (one lawyer being primarily responsible for all advice and drafting all documents), the conflict of interest problems have been satisfactorily resolved because the lawyer does not represent all of the owners.[161]

c. *Clearly Aligned Owners*

My proposed approach centers around avoiding conflicts of interest between individual owners. This usually means that only one owner can be the lawyer's internal client, or else potential conflicts are a concern.[162] But when two or more owners are "clearly aligned," these owners can all be the lawyer's internal clients and conflicts are not a concern. What constitutes clear alignment is a high standard. Simply that the interests of two owners are not presently in conflict is not sufficient,[163] and neither is the fact that

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lawyers can understand.

158. A brief statement warning of the general risks of being a minority owner should suffice. It is not the lawyer's job to advise the minority owner any further if this owner is not the lawyer's internal client.

159. This Article attempts to develop a solution for lawyers representing closely held businesses that reflects reality yet ensures that lawyers abide by their ethical duties. Part of reflecting reality is acknowledging that while certainly not "leaders" of the entities they represent, lawyers for small businesses are often more than legal counsel. They are also confidants and friends. *See* Mitchell, *supra* note 4, at 481 (stating a closely held business lawyer functions as "initiator, planner, and advisor to the close corporation regarding governance, finance, and the long-range planning of its operations"). Leadership theory attempts to determine which characteristic of a leader will maximize the good of the organization. It has been recognized that leaders who focus on their relationship with their subordinates, and therefore score high on "consideration" qualities, are the most effective leaders. *See* GEORGE F. WIELAND, ORGANIZATIONS, BEHAVIOR, DESIGN, AND CHANGE, 351 fig. 12-5 (1976). The most effective leaders produce the best results for the organization. *Id.* Thus, to the extent the closely held business lawyers can be viewed as leaders, facilitating a positive relationship with owners would help the entity achieve its goals. Specifying that the lawyer represents one owner, and not the others, could be said to polarize relations between the lawyer and the non-represented owners. But I submit that being upfront and avoiding confusion establishes the terms of the relationship and even respect for the lawyer, and lays the proper framework within which a positive relationship can develop.

160. *See* Oesterle, *supra* note 139, at 879 (opining that market constraints, such as the majority shareholder earning a bad reputation by mistreating the minority, will dictate a fairer course of conduct by the majority shareholder).

161. It would be difficult for a non-represented owner to have reasonable expectations of being represented individually if a lawyer complies with the steps I have outlined.

162. *See supra* Part II.B.3.

163. *See supra* notes 94-102 and accompanying text.

HeinOnline -- 56 Ala. L. Rev. 208 2004-2005

the owners currently have common business goals for the entity. Clearly aligned owners are either: (1) essentially the same person (and any distinction is form over substance) or (2) have a common identity (when compared to other owners). Both of these situations are explained below.

To explain what is meant by two owners being essentially the same person, consider a common estate planning technique: some of an individual's shares are held personally, and some are held by his family trust. The individual places shares in the trust's name as a means of wealth succession and to establish who will manage the business upon his death.[164] Technically these are two shareholders, but they are really the same interests (the individual shareholder is often the trustee of the family trust and makes decisions on its behalf).

To illustrate the second category of clearly aligned owners, imagine two families going into business together. They decide to form a corporation for purposes of their joint venture. Each family group's stock will be held by multiple members of the family. In this situation, because negotiations will primarily occur between the two families, as opposed to between members of the same family, the internal client can be one family group. The lawyer should ask one member of the family group to be the representative from that group for purposes of instructing the lawyer. Of course, it is still possible for conflicts to arise within the family group, and therefore the rationale for allowing joint representation of these clients is not as persuasive as in the first category.

d. Considerations for the Default Rule

One of the main tenets of my argument is that lawyers should identify their clients at the outset of representation. This avoids confusion, negates the reasonableness of owner expectations that do not reflect the lawyer's expectations, and allows for the recognition and proper handling of any conflicts of interest that may arise. But not all lawyers will do what they should. They may not prepare a retainer agreement, and even if they do, these agreements may not adequately explain the internal-external distinction or may be unclear in other respects.[165]

Recognizing these practical problems, a default rule for identifying the internal client may be desirable.[166] An obvious choice for the internal client is the majority owner, if there is one, as he speaks for the entity by virtue of this position.[167] Minority owners usually take a back seat to majority owners

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164. *See* Jay A. Soled, *Use of Judicial Doctrines in Resolving Transfer Tax Controversies*, 42 B.C. L. REV. 587, 604 (2001) ("When taxpayers attempt to transfer [business enterprise] wealth, they often have another agenda item in mind, namely business continuity.").

165. Although this would likely be attorney error, retainer agreements are general in nature and thus cannot adequately cover all scenarios that may arise.

166. *See* Fischer, *supra* note 120, at 980 (discussing "the problem of what the default rule should be when the parties have failed to address the issue" of client identity in a retainer agreement).

167. Such a rule is a "majoritarian" default rule in that it provides for what a majority of clients

HeinOnline -- 56 Ala. L. Rev. 209 2004-2005

in managing the business. Consequently, minority owners have fewer interactions with the entity's lawyer and thus less of an expectation that the lawyer represents them personally. In addition, because majority owners usually make decisions for the entity even prior to its formation, there is a good chance that the majority owner chose the lawyer based on a pre-existing relationship or referral.[168] Therefore, if there is a majority owner, and absent extenuating circumstances (explained below), a supportable default rule would be that the majority owner is the lawyer's internal client.[169]

If there is no majority owner (for example, three equal owners), then any default rule should look primarily to the extenuating circumstances. These include, in no particular order: which, if any, owner had a pre-existing relationship with the lawyer; which owner hired the lawyer; and whether the lawyer's conduct implied personal representation of any of the owners.[170] In my experience, the extenuating circumstances will usually strongly suggest that a particular owner is the lawyer's internal client.

B. External Matters

1. External Matters Defined

External matters relate to the entity's interactions with third parties—in other words, when the entity interacts with the outside world. When lawyers assist with external matters, they are helping the entity to facilitate its daily business. Drafting and negotiating manufacturing and supply agreements, acquisition agreements, and agreements to license software are examples of external matters. Representing an entity during fundraising is also an external matter. For example, a corporation may decide to create and sell preferred stock to investors. The lawyer could represent the corporation on all such matters, including drafting the prospectus and investor documents relating to the sale of the preferred stock.[171] Assisting an entity in litigation is also usually external.[172]

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would contract for in this position. *See* Painter, *supra* note 136, at 290-91. It could be argued that because there is such a great advantage for both lawyers and clients for *ex ante* determination of client identity, a "penalty" default rule (e.g., that the lawyer owes duties to all individual owners) is more appropriate. *See id.*

168. *See supra* note 105 and accompanying text.

169. *See* Fischer, *supra* note 120, at 987 ("[T]he presumption, if a presumption is needed, should be that the lawyer represents the constituents who speak for the entity.").

170. *See id.* at 963 (suggesting that "in the absence of a retainer expressly identifying the client(s), the lawyer's clients are determined by the relationship the lawyer has in fact with the putative clients and the reasonable expectations which arise out of that relationship").

171. In theory, the corporation may sell a majority of its stock and thus a controlling interest to outside investors (referred to as a "change of control"). In such a situation, the internal client would not change (unless of course that client was bought out by the outside investors), but now the investors would control the corporation and thus have the ultimate say in how the lawyer proceeds on external matters.

172. An obvious exception is when the litigation is between the entity and the internal client.

HeinOnline -- 56 Ala. L. Rev. 210 2004-2005

2. *Entity as External Client*

The entity is always the lawyer's external client. There is nothing novel about this—the entity is the lawyer's client under both the Model Rules and the aggregate theory. It is also a major reason business owners retain counsel—to represent the entity in the legal aspects of its business. The lawyer should make clear to all owners that the entity is the lawyer's external client, again preferably in writing, at the outset of representation.[173] Although it is conceivable that the would-be owners could employ the lawyer simply for internal matters, it will be uncommon for the business's main lawyer not to also represent the entity on some kind of external matter.

3. *Duly Authorized Constituents Revisited*

After specifying to all owners that the entity is the lawyer's external client, the lawyer must explain to the owners how she will receive instructions to act on behalf of the entity. We need look no further than Model Rule 1.13 to find the answer—lawyers should take their direction from the entity's "duly authorized constituents."[174] Usually a corporation's articles of incorporation, bylaws and other governing documents delineate its management structure.[175] Therefore, the lawyer need only refer to these documents (which she may or may not have drafted depending on when she undertook representation) to determine whose authorization she needs to proceed on a particular matter.[176] For example, for a merger of the corporation, a majority vote of the shareholders will most likely be required, whereas entering into a routine contract with a software provider can usually be done by the corporation's president acting alone.[177]

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173. *See infra* Part IV. For the suggestion that the board of directors, rather than the abstract "entity," should be the lawyer's client, see Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley § 307*, MICH. ST. L. REV. (forthcoming 2004).

174. *See* MODEL RULES, *supra* note 22, at R. 1.13. *But see* Simon, *supra* note 5, at 81-83 (noting it is sometimes difficult to determine proper authorities).

175. Although close corporation statutes in a majority of states permit close corporations to operate without boards of directors, the duties are simply vested in other individuals. *See* HAMILTON, *supra* note 36, at 476.

> The [close corporation] statutes of about 30 states permit the authority normally placed in the board of directors to be vested in other persons or organizations by an appropriate provision in the articles of incorporation (or in some instances for some types of provisions, in the bylaws). Many of these statutes also provide that if managerial authority is vested in persons or organizations other than the board of directors, those persons or organizations then have the duties, responsibilities, and liabilities of directors.

Id. Partnerships and limited liability companies will also have defined management structures. For example, general partners typically make decisions for limited partnerships, and members (the owners) and managers are vested with decision-making responsibilities in limited liability companies.

176. This view, the entity as its "authority structure," is one of three possible views of entity representation discussed by Professor Simon. For support and criticism of this and the other two views—entity as "control group" and entity as "framework of dealing"—see Simon, *supra* note 5, at 75-103. *See also supra* Part II.C.2 for further discussion of the framework of dealing view.

177. To further illustrate, the bylaws may give the president of a corporation the authority to execute contracts with third parties involving amounts under $5,000 without the approval of the board of directors. In this case, if the president instructs the lawyer to draft such a contract, the lawyer should proceed

HeinOnline -- 56 Ala. L. Rev. 211 2004-2005

If the governing documents do not specify the duly authorized representatives to instruct the lawyer, the lawyer should look to the default rules. These are the statutes and case law of the entity's state of incorporation, which specify in general terms the powers and duties of the entity's owners and managers vis-à-vis each other. These rules will also specify certain decisions that are traditionally within the provinces of the owners and managers.[178] Lawyers should be cognizant that some of these rules cannot be modified, and that they will control even if the entity's governing documents provide otherwise.[179]

C. *When the Interests of the Internal and External Clients Conflict*

Under my proposed approach, lawyers must only withdraw from representation or face disqualification when the interests of their internal and external clients conflict. Because internal and external matters are substantially different in nature and thus do not commonly overlap, these conflicts should be few and far between. But, they do occur.

The interests of internal and external clients will conflict mostly on internal matters. For example, preparing an employment agreement for the lawyer's internal client is an internal matter—it involves the internal operations of the entity.[180] Yet, this is a contract between the lawyer's internal and external clients, and their interests at least potentially conflict. To illustrate this conflict, imagine that the employment agreement prevents the employee from competing with the entity after his employment ends—a common provision.[181] This benefits the entity by enticing a key constituent to remain, but harms the owner by restricting his future employment options. A later dispute between the owner and the corporation over the interpretation of such a provision would likewise present a conflict of interest for the lawyer. Conversely, preparing an employment agreement for a non-represented owner, while still an internal matter, does not present a conflict. The lawyer represents only one client—the entity—in this matter.

Conflicts of interest can also arise on external matters. What if the lawyer's internal client disagrees with the other owners on whether the entity should purchase a piece of investment property? This is an external matter

with this task (which is an external matter) even if the president is not the lawyer's internal client.

178. *But see supra* note 175 (close corporation statutes allow some manipulation of traditional governance statutes).

179. *See, e.g.*, DEL CODE ANN. tit. 8, § 271 (2001) (stating that the sale of substantially all of a corporation's assets must be authorized "by a resolution adopted by the holders of a majority of the outstanding stock of the corporation"); Chapin v. Benwood Found., Inc., 402 A.2d 1205, 1210 (Del. Ch. 1979) ("[D]irectors of a Delaware corporation may not delegate to others those duties which lay at the heart of the management of the corporation.").

180. *See supra* note 143 and accompanying text. It is also internal because no third party has a direct interest in the matter. *See supra* notes 144-45 and accompanying text.

181. *See* Phillip J. Closius & Henry M. Schaffer, *Involuntary Nonservitude: The Current Judicial Enforcement of Employee Covenants Not to Compete—A Proposal for Reform*, 57 S. CAL. L. REV. 531, 532 (1984).

HeinOnline -- 56 Ala. L. Rev. 212 2004-2005

because it involves the entity's external business. If the internal client is not in the majority and thus does not speak for the entity, then the interests of the internal client and the entity conflict. The lawyer cannot assist with the matter unless both parties give informed consent to the co-representation.[182] Whether, and to what extent, the same problems with informed consent and compromising of a lawyer's duty of loyalty are involved in such waivers will be left for another day (although under my analysis the lawyer may well be advised to decline participation in such tasks).

D. Policy and Practical Considerations Furthered by the New Proposal

1. Multiple Representation Promotes Efficiency and Economy

Both the aggregate theory and my proposed rule allow multiple representation of closely held businesses. The main difference is that the aggregate theory proposes "true" multiple representation—one lawyer represents multiple clients on the same matter. My theory also allows for multiple respresentation, but in a different sense—multiple clients with related identities (an owner and the entity) are represented, but on *different matters* (internal and external matters). In this case, different is better—the benefits of true multiple representation are retained, without its problems. My theory is still a complete theory of firm representation.

Proponents of the aggregate theory argue that multiple representation is more efficient and economical than hiring multiple lawyers for the entity and its owners.[183] From a practical perspective, both of these arguments are persuasive. In my experience, in matters as routine and non-time intensive as business organization, one lawyer should take a leadership position. Not only is one lawyer more efficient at performing the tasks because she is the conduit for all information, but the owners, who are often short on available funds at start-up, prefer one lawyer to keep legal costs down.[184]

No reasons of efficiency or economy, however, can justify a violation of lawyers' ethical duties of zealous representation and loyalty to their clients.[185] The aggregate theory has been shown to cause such violations.[186] Furthermore, the aggregate theory forces a lawyer's withdrawal or disquali-

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182. If it is clear that the internal client has no legal basis to object to the majority owner's decision, this objection can be viewed as frivolous and the lawyer may elect to proceed with the matter. But because there will usually be some plausible grounds for the objection (and simply out of caution), the lawyer should be wary of this course of conduct.

183. *See* Mitchell, *supra* note 4, at 484 ("Reasons of economy and efficiency suggest that, where possible, [multiple] representation is desirable.").

184. *See* John S. Dzienkowski, *Lawyers as Intermediaries: The Representation of Multiple Clients in the Modern Legal Profession*, 1992 U. ILL. L. REV. 741, 747 (1992) ("Parties who seek to enter into a transaction or resolve a dispute often demand that one lawyer represent the interest of multiple clients for several reasons. In most cases, clients wish to minimize the cost of legal representation by engaging only one lawyer.").

185. *See supra* notes 75-76 and accompanying text.

186. *See supra* Part II.B.3.

HeinOnline -- 56 Ala. L. Rev. 213 2004-2005

fication whenever a dispute between owners arises.[187] Then, all efficiency and cost-savings justifications are turned on their heads, for the one lawyer who is familiar with the owners and their issues can no longer represent any of them.[188] So, unless there are no disputes involving owner relationship issues during an entity's existence—an unlikely scenario—the aggregate theory produces more situations requiring disqualification, and thus more expense for the owners, than another arrangement might.[189] Any proposed improvement in the ethical rules should allow for some form of multiple representation, and thus increased efficiency and economy for clients, while resulting in fewer disqualifications than the current rules require.

The internal-external distinction does just that. First, it does allow for multiple representation—both an owner (or a clearly aligned group of owners) and the entity itself are the lawyer's clients. The non-represented owners are urged to retain a lawyer to safeguard their interests, but are not required to. Thus, one lawyer will usually still be responsible for most of the work for the entity and its owners. Even if a non-represented owner chooses to retain separate counsel, the separate counsel will not be forced to duplicate the work of the entity's lawyer. This lawyer would most likely limit her representation to a review of the organizational documents and an analysis of areas where the rights of her client should be increased, or she might become involved if a specific dispute involving her client arises.

Internal clients may favor the internal-external rule because they do not automatically lose confidentiality and attorney-client privilege as between the other owners.[190] Of course, these theoretical benefits may be of limited practical use because relevant information relating to the business may find its way to the other owners through partnership and corporate law concepts.[191]

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187. *See* Bassett, *supra* note 73, at 435-36 ("[I]f the clients' interests diverge, the attorney is subject to disqualification and must withdraw—usually causing both financial and tactical hardship for the clients, and potentially resulting in a malpractice claim or disciplinary charges against the lawyer."); HAZARD & HODES, *supra* note 29, § 17.3 ("In the face of an irreconcilable conflict of interest under the group theory, the lawyer would no doubt be forced to cease representing *any* member of the group, including the entity itself.").

188. *See* Bassett, *supra* note 73, at 437 ("[T]he primary justification for joint representation from the clients' perspective—the cost savings—is overshadowed by the burden that will fall on the clients if the attorney is subsequently required to withdraw.").

189. Efficiency and expense are interrelated. New lawyers who must familiarize themselves with clients and their affairs must spend more time, and thus charge higher fees, than a client's existing lawyer would. *See id.* at 436-37 ("The lawyer's withdrawal requires each client to retain individual counsel, resulting in duplication of effort and expense for *both* clients. The original lawyer's work product usually cannot be delivered to substitute counsel . . . .") (citations omitted). Some lawyers may adjust the client's bill to "write-off" this time, but in my experience this is by no means the universal practice.

190. *See supra* notes 73-74 and accompanying text.

191. *See supra* note 75-76 and accompanying text.

HeinOnline -- 56 Ala. L. Rev. 214 2004-2005

2. *Bright-Line Rule Gives Definitive Guidance*

Whether a bright-line rule or a flexible standard is appropriate must generally be determined on an issue-by-issue basis.[192] The general argument is that bright-line rules are more appropriate when the need for predictability, uniformity, and stability outweigh the need for flexibility and consideration of individual circumstances.[193] Although bright-line rules may over-include or under-include,[194] they sometimes produce better results than subjective standards.[195]

Both closely held business lawyers and their clients may prefer the predictability of a bright-line rule as to client identity.[196] Lawyers must know the identities of their clients from the outset; otherwise they cannot represent them zealously or maintain their confidences. The existence of these duties is predicated upon the existence of an attorney-client relationship. The client also benefits from a bright-line rule because any unreasonable expectations of personal representation are removed at the outset.[197] Conversely, the use of a reasonable expectation standard requires an examination of all facts surrounding the representation *after they have transpired.* In other words, this approach fails to offer prospective guidance to a lawyer attempting to determine client identity.[198]

My proposed approach utilizes a bright-line rule to the extent possible. First, there will be no circumstances that change the fact that a closely held business lawyer has one internal client and one external client.[199] In other words, a judge would never be permitted to find that the entity was the law-

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192. For an in-depth discussion of rules and standards, see Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985).

193. *See id.* at 400. *Compare* Baltimore & Ohio R.R. v. Goodman, 275 U.S. 66, 69 (1927) (Justice Oliver Wendell Holmes holding that drivers approaching a railroad crossing "stop and look" before proceeding) *with* Pokora v. Wabash Ry., 292 U.S. 98, 100 (1934) (Justice Benjamin Cardozo, considering the same facts, delivered opinion establishing a standard whereby all circumstances must be considered).

194. *But see* Einer Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. CHI. L. REV. 1465, 1497 (1992) (at times "the greater error in applying [a] . . . standard means that the bright-line rule will result in less over- and under-deterrence").

195. Professor Robert Summers discusses the appropriateness of bright-line rules versus subjective standards in the context of legal formality. *See* Robert S. Summers, *The Place of Form in the Fundamentals of Law*, 14 RATIO JURIS 106, 119 (2001). He argues that a precise speed limit rule (e.g., 65 miles/hour) is more appropriate than a rule requiring drivers to "drive reasonably." The precise rule promotes highway safety and efficient traffic flow because its "simplicity, definiteness, and completeness generate more determinative guidance and thus clearer formal reasons for actions by drivers." *Id.*

196. *See* Fischer, *supra* note 120, at 985 ("Because the consequences of client misidentification [in the entity context] can be severe, both to the lawyer and the 'clients,' there is a temptation to prefer a 'rules' approach over case-by-case analysis.").

197. *Id.* at 962 ("It is hard to be an effective advocate when the identity of the client will be determined after the fact based on issues yet to be determined.").

198. *But see* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1943 (1998) ("Optimal Formulation of corporate law involves a tradeoff between predictability and flexibility. Reaching the best result in an individual case may come at the expense of providing the business community with sufficient guidance for future planning.").

199. *But see supra* text accompanying note 154 for the limited circumstances under which the lawyer may represent only the entity.

HeinOnline -- 56 Ala. L. Rev. 215 2004-2005

yer's only client, or that the lawyer represented all of the owners.[200] Second, the external client is always the entity.[201] Third, this approach views closely held business representation in a manner that reflects reality and thus can be understood by ordinary lawyers. This will make it easier for these lawyers to do what they should—specify their internal clients at the outset of representation.[202] This would, in effect, be a bright-line rule; if the lawyer names her internal client and all owners agree, no circumstances will change that. Finally, if the lawyer does not specify an internal client but there is a majority owner, a bright-line rule default rule could be that the majority owner is the internal client.[203] But, if the lawyer does not specify the internal client, and if there is no majority owner, then it becomes necessary to consider individual circumstances.[204] Unlike the general reasons for finding a majority owner to be the lawyer's internal client, a lack of commonality between individual cases would not support a bright-line rule where there is no majority owner.[205]

IV. THE PROPOSED RULE: REPRESENTATION OF CLOSELY HELD BUSINESSES

I suggest adding the following rule to the Model Rules to govern representation of closely held businesses. Similar rules should be added to the Model Code and any hybrid of the Model Rules or Model Code adopted by any state (revised to accord with the existing terminology).[206] This rule would not replace any of the existing rules, but would take precedence for representation of closely held businesses. The proposed Model Rule is as follows:

> REPRESENTATION OF CLOSELY HELD BUSINESSES
>
> When a lawyer undertakes representation of a "Closely Held Business," the lawyer shall represent no more than one owner, or one clearly aligned group of owners, and shall always represent the entity. A "Closely Held Business" is a corporation, partnership, lim-

200. *See* Bassett, *supra* note 73, at 457 (arguing that a bright-line prohibition on "traditional" joint representation is advisable because it "provides every client with an attorney who has a duty of loyalty only to that client; an attorney who is obligated to honor a duty of confidentiality only to that client . . . and an attorney who seeks the best solution as defined only by that client").

201. *See supra* Part III.B.2.

202. ABA Comm. on Ethics and Prof'l. Responsibility, Formal Op. 95-390 (1995) [hereinafter ABA Formal Op. No. 95-390] ("Clearly, the best solution to the problems that may arise by reason of clients' corporate affiliations is to have a clear understanding between lawyer and client, at the very start of the representation, as to which entity or entities in the corporate family are to be the lawyer's clients . . . .").

203. *See supra* notes 167-69 and accompanying text.

204. *See supra* note 170 and accompanying text.

205. *See* ABA Formal Op. No. 95-390, *supra* note 202 (looking to particular circumstances to determine whether a lawyer represents a corporate affiliate of her client).

206. *See supra* note 25.

HeinOnline -- 56 Ala. L. Rev. 216 2004-2005

ited liability company or other non-public entity with a small numbers of owners who are also the entity's management.

(a) For all "Internal Matters," the lawyer shall represent only one owner, or one clearly aligned group of owners. Internal Matters are those matters in which no party other than the owners or the entity has a direct interest. The lawyer shall specify to all owners the identity of this internal client: (1) at the outset of representation, if representation is undertaken before or during the organization of the entity; or (2) before beginning work on any Internal Matter, if representation is undertaken subsequent to the organization of the entity.

(b) For all "External Matters," the lawyer shall represent the entity acting through its duly authorized constituents. External Matters are those matters in which the entity interacts with third parties. The lawyer shall specify to all owners that the entity is the lawyer's external client at the outset of representation.

(c) If during the course of representation the lawyer is asked to work on any matter in which the interests of the internal client and external client actually conflict, the lawyer cannot represent either client in the matter. If such interests potentially conflict, the lawyer should typically refuse such representation out of an abundance of caution, but may in some circumstances represent both clients if such representation is permitted under Model Rule 1.7.

This rule recognizes the unique role played by closely held business lawyers; namely, that of counselor to the individual owners as well as to the entity. Part (a) addresses the lawyer's representation of individual owners. It provides that the lawyer may represent only one owner, or one clearly aligned group of owners. Otherwise, impermissible conflicts of interests will arise. Lawyers will usually have an internal client—the only exception is an established entity retaining a lawyer for a discrete task that does not present any internal matters. Part (b) provides that the lawyer represents the entity as well. Part (c) requires that a lawyer generally withdraw from representation when the interests of her two clients actually or potentially conflict.

Because of the fundamental importance of establishing an attorney-client relationship, the rule mandates that lawyers identify their clients at the outset of representation, with one exception. Lawyers violating this mandate could face disciplinary proceedings, not to mention potential civil liability for malpractice.[207] No default rule is provided. Such a rule would be contra-

207. *See* Fisher, *supra* note 120, at 987 ("The lawyer, not the client, should bear the burden of ensuring that no ambiguity or uncertainty exists with respect to who is and is not a client.").

dictory to the mandatory identification requirement. However, this Article provides suggestions for such a default rule to be employed as a last resort since a lawyer's ethical violation still begs the question of client identity.[208]

V. CONCLUSION: AN EVERYDAY PROBLEM—SOLVED

Representing organizations, and particularly closely held businesses, is as common as representing individuals for many lawyers. But, these lawyers often fail to appreciate the ethical concerns presented by organizational representation. There are well-established rules for representing traditional, public corporations. Unlike traditional corporations, however, the interests and identities of closely held businesses are often indistinguishable from those of their individual owners. Consequently, identifying the lawyer's client or clients is more difficult in this setting.

Lawyers who represent closely held businesses often overlook the subtle distinctions between representing the entity and its individual owners. They equate advice to an owner with advice to the entity. Only when the interests of the entity and the owner diverge will lawyers pay attention to the distinction. But often it is too late. The importance of proper client identification cannot be overstated: it determines to whom the lawyer owes duties, whose confidences the lawyer must keep, and perhaps most importantly, how to identify and properly handle conflicts of interest (which arise far more frequently than is generally thought).

This Article reveals what I believe to be the most significant shortcoming of the current ethical rules, court decisions, and scholarly debate regarding a lawyer's representation of closely held businesses: namely, that conflicts among individual owners are unavoidable at all stages. In order to properly address these conflicts, one—and only one—individual owner must be established as the lawyer's internal client. The entity is also a client—the lawyer's external client.

This is not to suggest that it is inappropriate for a lawyer to form an entity and draft its internal governing documents single-handedly; multiple lawyers handling this task would most likely be inefficient and cost-prohibitive for typical closely held business clients. My proposed solution allows for, and even encourages, multiple representation in this context. But multiple representation is proposed only after dividing the lawyer's world into internal and external matters and establishing internal and external clients. Once the lawyer's world is so divided, those not represented will not have expectations that the lawyer is protecting their interests and can seek separate counsel if they so desire, and the lawyer's duties can be fulfilled free from conflict.

208. *See supra* Part III.A.2.d.

HeinOnline -- 56 Ala. L. Rev. 218 2004-2005