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PROFESSIONAL RESPONSIBILITY AND THE CLOSE CORPORATION: TOWARD A REALISTIC ETHIC

Lawrence E. Mitchell†

“The varied Protean-like forms which the term ‘corporation’ conceals illustrate the consequences which ensue when the metaphor obscures reality, when words intended as an aid to understanding become a substitute for it, when connotations start a chain reaction of new meanings.”*

One striking aspect of both the Code of Professional Responsibility¹ (CPR) and the Model Rules of Professional Conduct² (MRPC) is their self-contained quality. In particular, they fail to relate concepts of counsel’s professional responsibility to the substantive law governing client behavior.³ This is probably because ethics, as a body of regulation concerned with the conduct of lawyers, historically has been treated as being on a wholly different plane from the

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* Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONTEMP. PROBS., 435, 438 (1953). See also Kramer, *Foreword*, 18 LAW & CONTEMP. PROBS. 433, 434 (1953) (“The result is that businessmen *and their counsel*, whose legitimate needs find expression and satisfaction in the close corporation, are often compelled to operate in clouds of legal doubts and uncertainties and with realities masked by corporate fictions necessitated by awkward legislation and judicial decisions.”) (emphasis added).

¹ ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY (1979).

² ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT (1984). Because different jurisdictions have adopted the CPR and the MRPC to varying degrees, I will, for convenience, refer to them together as the “Codes” where the distinctions between them do not affect my analysis.

³ Cf. Patterson, *An Inquiry into the Nature of Legal Ethics: The Relevance and Role of the Client*, 1 GEO. J.L. ETHICS 43, 44 (1987) (“It is striking that both courts and lawyers perceive codes of legal ethics as enjoying a special status separate from, and independent of, the general law.”). Patterson makes this point in the slightly different context of the consideration of professional ethics as an integral part of the “general law.”

It should be noted, however, that some of the more blatant defalcations of counsel constituting ethical violations derive directly from substantive law (e.g., embezzlement). H. DRINKER, *LEGAL ETHICS* 22, 23 (1953). Cf. 1 G. HAZARD & W. HODES, *THE LAW OF LAWYERING: A HANDBOOK ON THE MODEL RULES OF PROFESSIONAL CONDUCT XXX* (Supp. 1986) (“the governing norms are the applicable code, ‘other’ law [chiefly common law], and moral obligation.”).

substantive law with which lawyers deal.⁴ The fact that the Codes have tended to build upon or derive from one another has compounded this problem by perpetuating this failing.⁵

In fact, substantive law, and changes therein, may radically affect the way lawyers approach their responsibilities and deal with their clients.⁶ The failure of the Codes to appreciate this reality is particularly acute in determining the professional responsibility of counsel to the shareholders, directors, and officers of close corporations.⁷

⁴ Patterson, *supra* note 3, at 48. See also 1 G. HAZARD & W. HODES, *supra* note 3, at XXIX-XXXI. But cf. Kutak, *Model Rules of Professional Conduct: Ethical Standards for the '80s and Beyond*, 67 A.B.A. J. 1116, 1118 (1981) ("The standards proposed by the commission are based on an analysis of intracorporate relationships and internal corporate decision-making structures, as these are defined by corporation and agency law."). As will be shown, in the case of the ethical response to the problems of corporate counsel, significant distinctions in the substantive law governing close corporations were largely unaddressed by the draftsmen of the MRPC, which accepted as its model the traditional structure of the public issue corporation. See E. REICH, *THE LEGISLATIVE HISTORY OF THE MODEL RULES OF PROFESSIONAL CONDUCT: THEIR DEVELOPMENT IN THE ABA HOUSE OF DELEGATES* 89, 90 (1987). But see ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT, Legal Background, at 147 (1984) [hereinafter *Legal Background*] (recognizing with respect to Rule 1.13 that counsel to a close corporation has been held to represent the shareholders "[w]hen a close corporation is indistinguishable from its owners.")

Substantive law appears only to have been considered relevant in accepting the entity theory of corporate organization, *id.*, a theory which lacks relevance in the close corporation. Mitchell, *Close Corporations Reconsidered*, 63 TULANE L. REV. 1143 (1989). The failure to take account of the substantive law of close corporations is particularly disturbing in light of the proportionally greater number of close corporations to public corporations in the United States. See M. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* § 5.1, at 38 (1976) (discussing data establishing that of the approximately 1,740,000 active corporations in the United States in 1969-70, "[o]nly a very few . . . were publicly held"). For a similar statistical analysis see A. CONARD, *CORPORATIONS IN PERSPECTIVE* 118, 119 (1976); H. HENN & J. ALEXANDER, *LAWS OF CORPORATIONS* § 257 (3d ed. 1983).

I suspect the failure of the MRPC fully to address the unique problems of close corporations results partly from an institutional bias of the ABA Commission on Evaluation of Professional Standards which drafted it. Of the eight practitioners serving on that Commission who were listed in the 1983 Edition of Martindale-Hubbell, six were members of firms with more than 50 lawyers. It is a fair guess that these firms deal primarily with public corporations or with close corporations the shareholders of which have sufficient wealth to afford independent representation.

⁵ Cf. H. DRINKER, *supra* note 3, at 23-26 (summarizing the history of the development of the MRPC.).

⁶ Indeed, as will be discussed, in the case of the close corporation it affects the way lawyers *identify* their clients. Cf. G. HAZARD, *ETHICS IN THE PRACTICE OF LAW* 54, 55 (1978).

⁷ A close corporation, for purposes of this Article, is a corporation in which the shareholders have taken advantage of one or more statutory provisions or judicial decisions which permit them to disengage the corporate machinery, wholly or partially, from the traditional three-tiered statutory model of shareholders, directors, and officers. It should be stressed that this Article focuses exclusively on close corporations in which most, if not all, of the shareholders are managers, rather than those close corporations in which non-management shareholders exist. See M. EISENBERG, *supra* note 4, at 12 (suggesting that some shareholders may not wish to participate in management). The

There has been a significant re-evaluation and recasting of the laws governing close corporations during the last forty years.⁸ The

analysis, as developed, does not turn on this distinction. A discussion of cases dealing with judicial responses to the client identification problem in close corporations appears *infra* in Parts II and III. Although very few reported cases have been found, and most of these deal with disqualification of counsel in litigation, it appears that the courts have not developed a consistent approach. See *DeLaMaria v. Powell*, Goldstein, Frazer & Murphy, 612 F. Supp. 1507 (N.D. Ga. 1985); *Bobbitt v. Victorian House, Inc.*, 545 F. Supp. 1124 (N.D. Ill. 1982); *Wayland v. Shore Lobster & Shrimp Corp.*, 537 F. Supp. 1220 (S.D.N.Y. 1982); *In re Nulle*, 127 Ariz. 299, 620 P.2d 214 (1980); *Woods v. Superior Court*, 149 Cal. App. 3d 931, 197 Cal. Rptr. 185 (1983); *Meehan v. Hopps*, 144 Cal. App. 2d 284, 301 P.2d 10 (1956); *Torres v. Divis*, 144 Ill. App. 3d 958, 494 N.E.2d 1227 (1986); *Mullaney, Wells & Co. v. Savage*, 78 Ill. 2d 534, 402 N.E.2d 574 (1980); *Lowder v. All Star Mills, Inc.*, 309 N.C. 695, 309 S.E.2d 193 (1983); *Terre du Lac Property Owners' Ass'n v. Shrum*, 661 S.W.2d 45 (Mo. Ct. App. 1983); *In re Jans*, 295 Or. 289, 666 P.2d 830 (1983); *In re Kinsey*, 294 Or. 544, 660 P.2d 660 (1983); *In re Brownstein*, 288 Or. 83, 602 P.2d 655 (1979); *In re Banks*, 283 Or. 459, 584 P.2d 284 (1978). The lack of consistent treatment in these cases is a result of judicial resolution on an *ad hoc* basis. This Article attempts to remedy that situation.

⁸ See, e.g., *Comolli v. Comolli*, 241 Ga. 471, 246 S.E.2d 278 (1978); *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); *Cressy v. Shannon Continental Corp.*, 177 Ind. App. 224, 378 N.E.2d 941 (1978); *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 353 N.E.2d 657 (1966); *Smith v. Atlantic Properties, Inc.*, 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981); *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); 68th St. Apts., Inc. v. Lauricella, 142 N.J. Super. 546, 362 A.2d 78 (1976); *Meiselman v. Meiselman*, 309 N.C. 279, 307 S.E.2d 551 (1983).

See also M. EISENBERG, *supra* note 4, at 9-10 n.2; F. O'NEAL & R. THOMPSON, O'NEAL'S CLOSE CORPORATIONS (3d ed. 1988); Chittur, *Resolving Close Corporation Conflicts: A Fresh Approach*, 10 HARV. J.L. & PUB. POL'Y 129 (1987); Haynsworth, *Competent Counseling of Small Business Clients*, 13 U.C. DAVIS L. REV. 401 (1980); Hetherington, *Special Characteristics, Problems and Needs of the Close Corporation*, 1969 U. ILL. L.F. I [hereinafter Hetherington, *Special Characteristics*]; Israels, *The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778 (1952); O'Neal, *Introduction to Symposium: Rights of Minority Shareholders*, 22 WAKE FOREST L. REV. 1 (1987) *Statutory Needs of Close Corporations—An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?*, 10 J. CORP. L. 849 (1985) [hereinafter *Statutory Needs of Close Corporations*]; *Symposium: The Close Corporation*, 18 LAW & CONTEMP. PROBS. 433 (1953). But see *Zidell v. Zidell, Inc.*, 277 Or. 423, 560 P.2d 1091 (1977) (court refuses to benefit minority at expense of majority in dispute over corporate repurchase of shares in the absence of a corporate policy regarding repurchases or an agreement protecting minority.).

The court in *Meiselman* correctly summarized the prevailing view:

We note at the outset that the enterprises with which we are dealing are close corporations, not publicly held corporations. This distinction is crucial because the two types of corporations are functionally quite different. Indeed, the commentators all appear to agree that "[c]lose corporations are often little more than incorporated partnerships."

309 N.C. at 288, 307 S.E.2d at 557 (citing Comment, *Oppression as a Statutory Ground for Corporate Dissolution*, 1965 DUKE L.J. 128, 138). Close corporations embrace the traditional characteristics of corporations in the conduct of their business and in their dealings with third parties, and behave as partnerships insofar as the intra-corporate relationships among their shareholders, directors, and officers are concerned. Economists, as well as legal scholars, have recognized significant behavioral differences between close and public corporations. See, e.g., A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6-7 (1932); Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 303, 305-07 (1983). See also Mitchell, *supra* note 4 (evaluating the validity of the different legal treatment of close corporations).

most significant result has been the 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.⁹ Certainly that is the objective of the participants.¹⁰ Consequently, application of the entity theory, with its underlying concepts of corporate democracy, is ill-suited to the economic and human behavior of these shareholders and to their expectations.¹¹ These constituents think of themselves as partners and behave accordingly. Yet with respect to third parties, and the conduct of their business, they are a corporation like any other.¹²

Both the CPR and the MRPC fail to take account of this organizational hybrid. Their guidance to corporate counsel is still based upon the model of the large, publicly held corporation,¹³ and thus directs counsel that his duties and loyalties are to the entity.¹⁴

⁹ See, e.g., *Meiselman v. Meiselman*, 309 N.C. 279, 307 S.E.2d 551 (1983); Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9, 27 (1987) [hereinafter Hetherington, *Defining the Scope*] ("Now that it is clear under both statutes and case law that participants in close corporations can alter the standard hierarchial management structure of stock corporations, the earlier view—holding that joint venture arrangements could not survive the formation of the corporation—should be rejected, as it has been in more recent cases."). *But see id.* at 27, n.54; *Boss v. Boss*, 98 R.I. 146, 200 A.2d 231 (1964); *Johns v. Caldwell*, 601 S.W.2d 37 (Tenn. 1980).

¹⁰ *Israels, The Close Corporation and the Law*, 33 CORNELL L.Q. 488, 491 (1948).

¹¹ See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 353 N.E.2d 657 (1977); *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); *Lowder v. All Star Mills, Inc.*, 309 N.C. 695, 309 S.E.2d 193 (1983); Chitaur, *supra* note 8, at 130 (entity theory not useful to, or accepted by, shareholders of close corporations); H. HENN & J. ALEXANDER, *supra* note 4, § 258; O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873 (1978). It should be noted that close corporations which are not operated internally as partnerships may exist (although it is unlikely there are many).

¹² The close corporation, however, by its very nature, may be more subject to veil-piercing and to disregard of the corporate fiction than publicly held corporations. See W. CARY & M. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 80-103 (5th ed. 1980).

¹³ Kutak, *supra* note 4, at 1118, makes indisputably clear that the draftsmen of MRPC Rule 1.13 (dealing with entity representation) relied exclusively on the traditional corporate model. The Rule itself makes this equally clear. See *infra* note 14. See also S. FITZGIBBON, *PROFESSIONAL ETHICS, ORGANIZING CORPORATIONS* 8 (1982) (In the MRPC, "[t]he 'fiction' of the corporate personality is taken seriously . . ."); E. REICH, *THE LEGISLATIVE HISTORY OF THE MODEL RULES*, *supra* note 4, at 4. Cf. Ehrlich, *Common Issues of Professional Responsibility*, 1 GEO. J.L. ETHICS 3, 10-11 (1987) ("The Kutak Commission grappled with the problems of lawyers in representing organizational clients and took several steps beyond the prior code, which was totally silent on the matter. Yet many issues regarding the ethical responsibilities of organization attorneys remain.").

¹⁴ EC 5-18 of the CPR 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 its interests and his

While the MRPC has gone some way toward recognizing that an organization may be legally viewed as an aggregate of individuals rather than an entity and toward establishing a rule to cover that situation,¹⁵ it fails to take account of statutes and decisions dealing with close corporations which, with increasing frequency, reject the entity theory with respect to the relationship among close corporations' shareholders.¹⁶ Under the MRPC, counsel must look to the exception, Rule 1.7 (dealing with conflicts of interest,¹⁷ rather than

professional judgment should not be influenced by the personal desires of any person or organization. Occasionally a lawyer for an entity is requested by a stockholder, director, officer, employee, representative, or other person connected with the entity to represent him in an individual capacity; in such cases the lawyer may serve the individual only if the lawyer is convinced that differing interests are not present.

Rule 1.13 of the MRPC provides in relevant part:

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

....

(e) 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 [dealing with conflict of interest]. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

¹⁵ *Legal Background, supra* note 4, at 147 ("An unincorporated association, limited partnership, joint venture or similar organization often is considered under *other law* . . . to be an aggregate of individuals rather than an entity. . . . [If so] . . . the lawyer has a client-lawyer relationship with each member individually, and the obligations of the lawyer are determined by the rules governing multiple representation."). See also Brown & Dauer, *Professional Responsibility in Nonadversarial Lawyering: A Review of the Model Rules*, 1982 AM. B. FOUND. RES. J. 519. Nonetheless, close corporations are not treated by "other law" as "aggregates of individuals." The Comments to Rule 1.13 suggest that it will be exceptional for a close corporation to be treated in law as an aggregate of individuals rather than an entity. Thus, it was apparently believed that Rule 1.7, *see infra* note 17, would be sufficient guidance for close corporations in which one or more shareholders desire to be represented by corporate counsel.

¹⁶ DEL. CODE ANN. tit. 8, §§ 341-56 (1974); MD. CORPS. & ASS'NS CODE ANN. §§ 4-101 to 4-603 (1985); S.C. CODE ANN. § 33-8-10 to 33-18-500 (Law. Co-op Supp. 1988); *see also* Wilkes v. Springside Nursing Home, Inc., 370 Mass. 578, 328 N.E.2d 505 (1975).

¹⁷ Rule 1.7 of the MRPC provides in relevant part:

(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

- (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and
- (2) each client consents after consultation.

(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

- (1) the lawyer reasonably believes the representation will not be adversely affected; and
- (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

the rule, Rule 1.13 (dealing with entity representation), to determine to whom she owes her professional obligations. The CPR indicates even more forcefully that multiple representation in general is considered exceptional.¹⁸ Moreover, the CPR, like the MRPC, fails to guide counsel in the close corporation situation, but simply directs her to the rule governing multiple representation.¹⁹ The consequence is that the issue of client identification, notwithstanding its frequent occurrence²⁰ is necessarily resolved by the lawyer on a case-by-case basis.

Counsel to the close corporation is thus left without any meaningful ethical guidance in determining the constituents to whom she owes a duty, and in determining the scope of that duty.²¹ The Codes purport to tell her who her client is, but their failure to account for the impact of the substantive law on this problem renders their dictates meaningless. Based on the traditional adversary model of the lawyer's role,²² the Codes allow counsel to represent

¹⁸ DR 5-105 of the CPR states:

(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, except to the extent permitted under DR 5-105(C).

(B) 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, except to the extent permitted under DR 5-105(C).

(C) 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.

See also Comment to DR 5-105(C) of the CPR.

¹⁹ See EC 5-15 of the CPR (lawyer "should resolve all doubts against the propriety of . . . [multiple] representation").

²⁰ Cf. Haynsworth, *supra* note 8, at 452 (representation of multiple clients is one of "[t]he two most frequent problems encountered by lawyers representing small businesses. . .").

²¹ See *supra* notes 14-18; *Developments in the Law: Conflicts of Interest in the Legal Profession*, 94 HARV. L. REV. 1244, 1335 (1981) [hereinafter *Developments in the Law*] (EC 5-18 "is simple and unhelpful in equal measure. It begs the central question: What are the entity's interests?"); Pierce, *The Code of Professional Responsibility in the Corporate World: An Abdication of Professional Self-Regulation*, 6 U. MICH. J.L. REF. 350, 358-62 (1973) (addressing the simplistic nature of the entity theory in ethics analysis). Cf. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 259 (1967) ("By and large the legal-historical developments and the economic functions of these two systems are quite different, and meaningful legal or economic analysis must begin by recognizing this fact."); O'Neal & Thompson, *Vulnerability of Professional-Client Privilege in Shareholder Litigation*, 31 BUS. LAW. 1775, 1783 (1976) (analysis of attorney-client privilege in shareholder litigation concluding that the duty of corporate counsel ultimately is to protect interests of shareholders.); Van Dusen, *Who is Counsel's Corporate Client*, 31 BUS. LAW. 474, 475 (1975) (stating that in some situations consideration of the "entity's" interests requires consideration of the interest of its shareholders).

²² Some consideration has been given by the MRPC to different roles. The CPR

multiple parties when the lawyer's duties of undivided care and attention and undivided loyalty will not be compromised.²³ This approach presents a much less significant problem in the case of the public corporation, for the MRPC (and to a lesser degree the CPR) is predicated explicitly upon the entity theory of the corporation,²⁴ a theory which retains vitality in the public context. Modern law, however, has largely stripped the close corporation of its entity mask with respect to intracorporate relations,²⁵ so that counsel to a close corporation will no longer have an entity interposed between her and the ultimate owners of the business. Because counsel's conduct will thus directly affect each of these shareholders, it should be recognized that counsel owes a duty to each of them.²⁶ The behavior of these shareholders toward one another will be regulated by their fiduciary duties,²⁷ a legal concept which clients can evaluate

hardly deals with the issue. Brown & Dauer, *supra* note 15, at 520 ("Nonadversarial lawyering is barely mentioned in the Code; the professional and ethical dilemmas unique to the nonlitigating counselor are scarcely admitted to—both, reflections of the fact that this part of the underlying model is scarcely there."); *cf.* Pierce, *supra* note 21, at 350 (CPR leaves role of corporate lawyer largely unaddressed).

²³ Postema, *Moral Responsibility in Professional Ethics*, in *ETHICS AND THE LEGAL PROFESSION* 158 (M. Davis & F. Elliston eds. 1986) (implicit in the CPR is the unsustainable implication that a lawyer can separate his professional personality from his "other" personality).

²⁴ And to that extent has considered substantive law. See Kutak, *supra* note 4 and sources listed *supra* note 21.

²⁵ See 68th Street Apts., Inc. v. Lauricella, 142 N.J. Super. 546, 557-58, 362 A.2d 75, 85 (1976); *cf.* Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 *LAW & CONTEMP. PROBS.* 435, 438 (1953).

²⁶ This Article assumes for the reasons discussed in Part II that the shareholders will also be directors and officers of the corporation, and does not separately address the duties of non-shareholder directors and officers to shareholders and other constituents of the corporation. *Cf., e.g.*, 68th Street Apts., Inc. v. Lauricella, 142 N.J. Super. 546, 557, 362 A.2d 78, 84 (1976) ("It would . . . be vain to attempt to distinguish acts done as shareholders from those done as directors . . ." where ownership and control were unified.).

In re Brownstein, 288 Or. 83, 602 P.2d 655 (1979), discussed *infra* note 148, 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. Unlike the other cited cases, *Brownstein* holds that the "client" consists of the shareholders as well as the corporation. However, it fails to guide counsel in determining whether or when separate representation of each shareholder, or group of shareholders, is appropriate. *But see* Felty v. Hartweg, 169 Ill. App. 3d 406, 119 Ill. Dec. 799, 523 N.E.2d 555 (1988) (rejecting the proposition that counsel to a close corporation owes a duty to minority shareholders in their capacity as such); *Torres v. Divis*, 144 Ill. App. 3d 958, 964, 494 N.E.2d 1227, 1231 (App. Ct. 1986) ("It would be unwise to impose on an attorney, retained by only one of several incorporators for the purpose of organizing a corporation, a duty to act on behalf of all of the incorporators in the absence of an agreement that he do so."). Moreover, *Brownstein* has been modified, as discussed *infra* note 148, and the scope of its dictum is not clear.

²⁷ This duty is clearly owed only in the relationship of a controlling interest to a non-controlling interest. *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); *Smith v. Atlantic Properties, Inc.*, 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981); *Hetherington*,

only upon advice from counsel.²⁸ Since each shareholder will seek to maximize his own welfare,²⁹ sole counsel to a close corporation and its shareholders will always, to a greater or lesser extent, be compromised in duties of care and loyalty.³⁰ Even the seemingly menial task of drafting a set of corporate by-laws requires judg-

Defining the Scope, *supra* note 9; *cf.* S. FITZGIBBON, *supra* note 13, at 12 (in partnership situation, fiduciary duty mediates between the parties); Chittur, *supra* note 8, at 170 (oppression of non-controlling shareholders should be defined by reference to (i) reasonable expectations of the shareholders and (ii) fiduciary duties). *But see* Zimmerman v. Bogoff, 524 N.E.2d 849 (Mass. 1988) (one 50% shareholder held to be able to bring action for breach of fiduciary duty against other 50% shareholder).

The fiduciary duty of controlling shareholders toward minority shareholders is derived directly from the fiduciary duty of directors and officers to shareholders and indirectly from the law of trusts. H. HENN & J. ALEXANDER, *supra* note 4, § 240. In the close corporation context, this duty has been likened to that of partners to one another. Helms v. Duckworth, 249 F.2d 482, 486 (D.C. Cir. 1957); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); Wilkes v. Springside Nursing Home, 370 Mass. 842, 353 N.E.2d 657 (1976); Donahue v. Rodd Electrotyping Co., 367 Mass. 578, 328 N.E.2d 505 (1975).

²⁸ *Cf.* Wasserstrom, *Lawyers as Professionals: Some Moral Issues*, in ETHICS AND THE LEGAL PROFESSION 114, 125 (M. Davis & F. Elliston eds. 1986) (clients not capable of resolving legal issues without guidance of counsel).

The fiduciary duty itself essentially is a duty of good faith and fair dealing. Perhaps the most famous description of this duty (which the reader familiar with corporate law will forgive me for repeating) is then Judge Cardozo's famous dictum in Meinhard v. Salmon, 249 N.Y. 458, 463, 64, 164 N.E. 545, 546 (1926) which illustrates the proposition in the text, that such duty cannot be evaluated without the assistance of counsel:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

Id. at 463-64, 164 N.E. at 546.

Professor Hetherington has observed that the standard of conduct of shareholders to one another clearly is not self-executing. Hetherington, *Defining the Scope*, *supra* note 9, at 12-13 ("Despite the all-embracing tone of judicial rhetoric in fiduciary duty cases, the results make it clear that these pronouncements . . . are not to be taken literally.") *See also infra* note 98.

²⁹ *See infra* note 59.

³⁰ G. HAZARD, *supra* note 6, at 78-79, is worth quoting at length:

Clients do not have a conflict of interest simply because their interests diverge or because an intense legal dispute could arise between them People have conflicts of interest only if, in addition to having divergent interests, one or both wish to pursue them beyond a certain degree of aggression. Whether they wish to do so inevitably depends on circumstances. *It also depends on the legal advice they may get, which turns the question into a circle.* (emphasis added)

This last sentence is a fascinating observation in the context of this discussion. Leaving aside for a moment the questions of (i) whether an inchoate conflict of interest is in fact a conflict of interest, and (ii) what that "certain degree of aggression" is which turns an inchoate conflict of interest into an actual conflict of interest, this sentence suggests that such conflicts can be created (or at least made tangible) by counsel competently advising a client of the full extent of his rights or the boundaries of his duties. This observation highlights the need for guidelines which permit counsel to fulfill her duty without creating conflicts for herself and her clients in the process. *See* Wasserstrom, *supra* note 28. *Cf.* Brown &

ments, sometimes subtle and sometimes not, allocating control among the various parties.³¹ In such a situation the lawyer's human qualities may well lead to subtle favoritism of one constituent over another.³²

This does not necessarily suggest that a lawyer should never undertake the representation of a close corporation where the shareholders are not represented individually.³³ There may be perfectly good reasons for such representation and circumstances in which it is appropriate.³⁴ Further, although empirical evidence is scarce,³⁵ it is likely that this practice is common. The problem left unresolved by the Codes is when such representation should not be undertaken short of circumstances in which tangible conflicts ex-

Dauer, *supra* note 15, at 532 ("In preventive lawyering the facts are mostly in the future . . .").

For the proposition that an inchoate conflict of interest is nonetheless a real conflict, see F. O'NEAL & R. THOMPSON, *supra* note 8, § 2.02, at 2 ("Participants in close corporations almost always have conflicting interests . . . There are few "neutral" decisions . . ."); Aronson, *Conflict of Interest*, 52 WASH. L. REV. 807 (1977).

³¹ Cf. S. FITZGIBBON, *supra* note 13, at 11 (charter and by-laws direct counsel how to act for corporate constituents).

³² Aronson, *supra* note 30, at 826; Pierce, *supra* note 21, at 369. Cf. Fried, *The Lawyer as Friend: The Moral Foundations of the Lawyer-Client Relation*, 85 YALE L.J. 1060 (1976) (asserting that such favoritism is morally defensible and even necessary).

³³ Cf. Hazard, *Triangular Lawyer Relationships: An Exploratory Analysis*, 1 GEO. J.L. ETHICS 15, 38 (1987) ("In a triangular relationship in the normal state, the interests of the nonlawyer participants are not adverse; both, therefore, may be considered to be clients."). *But see* Haynsworth, *supra* note 8, at 457-67, 472 (suggesting that the "wise" lawyer will not undertake such representation "if there is any substantial likelihood that [a conflict of interest] might arise"). *Contra* S. FITZGIBBON, *supra* note 13, at 12 (arguing that where the various participants have chosen to bind together their fate, and opt for the common good, there should be no requirement of separate representation, due to the extra expense involved, unless separate lawyers are specifically needed or sought). *See also infra* notes 34-38 and accompanying text for arguments disputing both these views.

³⁴ Efficiency and economy argue in favor of multiple representation. *See* S. FITZGIBBON, *supra* note 13, at 12; Haynsworth, *supra* note 8, at 461; Hazard, *supra* note 6, at 74; Kipnis, *Conflict of Interest and Conflict of Obligation*, in ETHICS AND THE LEGAL PROFESSION 283, 286 (M. Davis & F. Elliston eds. 1986). The fact that multiple counsel may inject greater adversity into negotiation argues further in favor of representation by one lawyer. S. FITZGIBBON, *supra* note 13, at 12 ("the introduction of opposing counsel would likely give the whole matter an adversarial cast. . ."); Haynsworth, *supra* note 8, at 461 (presence of multiple counsel may increase the adversarial nature of negotiations); Kipnis, *supra*, at 258 (to same effect); G. HAZARD, *supra* note 6, at 73 (where no real conflict of interest exists, added expense and distress caused by retention of separate counsel suggests use of joint representation); Hetherington, *Special Characteristics*, *supra* note 8, at 16-17 (" . . . the lawyer who decides to play Cassandra and to recommend arrangements to handle possible future difficulties . . . may introduce dissension. . .").

³⁵ *But see* J. CARLIN, *LAWYERS' ETHICS* (1966); *Statutory Needs of Close Corporations*, *supra* note 8 (empirically examining the most useful and effective methods of providing special legal treatment for close corporations).

ist.³⁶ The question, then, is whether there is a way of categorizing close corporations which will enable us to develop guidelines to help counsel determine at the outset of her representation whether separate representation for each constituent (or constituent group) is required.

A review of the facts of the reported cases and of the commentaries suggests a partial answer to this question. The cases and literature suggest that close corporations come to be organized in a variety of predictable ways, with classes of predictable participants.³⁷ By identifying the ways in which close corporations typically are formed, it is possible to identify situations which, from the beginning, are more likely to involve inherent conflicts that may put counsel in an untenable position (or, if she later withdraws, put the shareholders in an untenable position).³⁸ This process may in turn lead to the development of a series of ethics rules which will assist counsel in determining at the outset whether to undertake representation of a close corporation (and therefore its shareholders) or whether to suggest that all or certain of the shareholders seek separate representation. Therefore, this Article will first examine some of the characteristics of close corporations which make their counsel particularly vulnerable to conflicts of interest. It will then establish (based on reported cases and, in part, on my own practical experience) a typology of close corporations by examining the various ways in which these corporations come into being. After examining the typology in the context of facts found in reported cases, I will discuss the lawyer's conflicting roles in each situation, and determine whether they are so inconsistent with her proper role and the parties' expectations that they always should be avoided. This Article then concludes with a proposed rule of ethics which will guide counsel, when undertaking the representation of a close corporation, in determining the identity of the client and for whom independent representation is required. Such a rule may provide

³⁶ And thus where the CPR (DR 5-105) and MRPC (Rule 1.7) clearly would prohibit such representation.

³⁷ See *infra* Part II.

³⁸ Cf. Brown & Brown, *What Counsels the Counselor? The Code of Professional Responsibility's Ethical Considerations—A Preventive Law Analysis*, 10 VAL. U. L. REV. 453, 469 (1976) ("The withdrawal of an advisor may have just as deleterious an effect upon the client as the withdrawal of a litigator. Yet neither advisor nor advocate is asked to weigh the potential harm of withdrawing against the benefits of accepting employment."); Note, *Unchanging Rules in Changing Times: The Canons of Ethics and Intra-Firm Conflicts of Interests*, 73 YALE L.J. 1058, 1067 (1964) (disqualification of counsel may result in loss to client of aid of long standing counsel); *Cannon v. U.S. Acoustics Corp.*, 398 F. Supp. 209, 220 (N.D. Ill. 1975) (noting hardship imposed on parties having to retain independent counsel during course of litigation), *aff'd in part, rev'd in part*, 532 F.2d 1118 (7th Cir. 1976).

meaningful guidance to counsel and provide a basis for consistency in her decision making.

I

THE SPECIAL PROBLEM OF THE CLOSE CORPORATION

A. Structural and Human Conflicts

Judges, legislators and scholars increasingly are in substantial agreement that the close corporation is a unique legal creature, different from its publicly held cousin in certain essential respects.³⁹ Yet there is a lack of agreement on what precisely a close corporation is. Various factors have been used in defining such corporations including, either singly or in combination, (1) a small number of shareholders,⁴⁰ (2) restrictions on share transferability,⁴¹ (3) a disregard of corporate formalities,⁴² (4) the substantial personal interaction of participants,⁴³ (5) a lack of significant trading of securities,⁴⁴ (6) an election to be treated as a close corporation,⁴⁵ (7) a

³⁹ See *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957); *Comolli v. Comolli*, 241 Ga. 471, 246 S.E.2d 278 (1978); *Galler v. Galler*, 32 Ill.2d 16, 203 N.E.2d 577 (1964); *Cressy v. Shannon Continental Corp.*, 177 Ind. App. 224, 378 N.E.2d 941 (1978); *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 353 N.E.2d 657 (1976); *Donahue v. Rodd Electrottype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); *Smith v. Atlantic Properties, Inc.*, 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981); *Meiselman v. Meiselman*, 309 N.C. 279, 307 S.E.2d 551 (1983); *68th Street Apts., Inc. v. Lauricella*, 142 N.J. Super. 546, 362 A.2d 78 (1976); A. BERLE & G. MEANS, *supra* note 8. *But see* CLARK, *CORPORATE LAW* 24-30 (1986); F. O'NEAL & R. THOMPSON, *supra* note 8; Chittur, *supra* note 8; Fama & Jensen, *supra* note 8; Hetherington, *Special Characteristics*, *supra* note 8; Hetherington & Dodley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977); Manne, *supra* note 21; O'Neal, *supra* note 8; *Statutory Needs of Close Corporations*, *supra* note 8; *Symposium: The Close Corporation*, *supra* note 8; Hetherington, *Defining the Scope*, *supra* note 9, at 27 n.54 (suggesting that a few states continue to apply traditional corporate doctrine to the relationship among shareholders in close corporations). *See also* *Boss v. Boss*, 98 R.I. 146, 200 A.2d 231 (1964) (same in Rhode Island); *Johns v. Caldwell*, 601 S.W.2d 37 (Tenn. 1980) (rejecting special treatment of close corporations in Tennessee).

⁴⁰ *Donahue v. Rodd Electrottype Co.*, 367 Mass. 578, 582, 328 N.E.2d 505, 511 (1975); *Darvin v. Belmont Indus., Inc.*, 40 Mich. App. 672, 677, 199 N.W.2d 542, 544 (1972); *Sundberg v. Lampert Lumber Co.*, 390 N.W.2d 352, 356 (Minn. Ct. App. 1986); CAL. CORP. CODE § 158(a) (West 1977); DEL. CODE ANN. tit. 8, § 342 (1967).

⁴¹ CAL. CORP. CODE § 421 (West 1977); DEL. CODE ANN. tit. 8, § 342 (1974); ILL. ANN. STAT. ch. 32, para. 1203 (Smith-Hurd 1970); N.C. GEN. STAT. §§ 55-73(b) (1982).

⁴² *Compton v. Paul K. Harding Realty Co.*, 6 Ill. App. 3d 488, 285 N.E.2d 574 (1972); *Somers v. AAA Temporary Serv., Inc.*, 5 Ill. App. 3d 931, 284 N.E.2d 462 (1972); *Roos v. Aloï*, 127 Misc. 2d 864, 487 N.Y.S.2d 637 (Sup. Ct. 1985); CAL. CORP. CODE § 300(e) (West 1977).

⁴³ *Donahue v. Rodd Electrottype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); F. O'NEAL & R. THOMPSON, *supra* note 8, § 1.02.

⁴⁴ *Brooks v. Willcuts*, 78 F.2d 270, 273 (8th Cir. 1935); *Wasserman v. Rosengarden*, 84 Ill. App. 3d 713, 406 N.E.2d 131 (1980); DEL. CODE ANN. tit. 8, § 354 (1967); N.Y. BUS. CORP. LAW § 620(c) (McKinney 1986); N.C. GEN. STAT. § 55-73 (1982).

⁴⁵ CAL. CORP. CODE § 158 (West 1977); ILL. ANN. STAT. ch. 32, para. 1204 (Smith-Hurd 1970); MD. CORPS. & ASS'NS CODE ANN. § 4-201 (1985).

substantial identity of ownership and management,⁴⁶ (8) proportionately substantial wealth invested by each shareholder in the corporation,⁴⁷ and (9) the illiquidity of ownership interests.⁴⁸

The most significant characteristics for the purposes of this Article are the last three, the substantial investment by participants, the illiquidity of ownership interests,⁴⁹ and the substantial identity of ownership and management. These characteristics make the nature of shareholder relations in close corporations different from that in their public counterpart⁵⁰—in the public corporation, dissatisfied shareholders can withdraw from the enterprise with relative ease.⁵¹ In the public corporation, counsel to the entity may find herself embroiled in the conflicts between the board of directors and management, or between management and shareholders, or some combination of these. The conflicts with which she deals are between or among different constituent groups with reasonably well defined legal rights and responsibilities with respect to one another.⁵² When conflicts arise among the constituents of close cor-

⁴⁶ F. O'NEAL & R. THOMPSON, *supra* note 8, § 1.07, at 24-25. See also *Zion v. Kurtz*, 50 N.Y.2d 92, 405 N.E.2d 681, 428 N.Y.S.2d 199 (1980) (applying Delaware law); CAL. CORP. CODE § 300(b) (West 1977); DEL. CODE ANN. tit. 8, § 351 (1967); ILL. ANN. STAT. ch. 32, para. 1212 (Smith-Hurd 1970); N.Y. BUS. CORP. LAW § 620(b) (McKinney 1986).

⁴⁷ F. O'NEAL & R. THOMPSON, *supra* note 8, § 1.08, at 31-32.

⁴⁸ *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975). See F. O'NEAL & R. THOMPSON, *supra* note 8, § 1.07, at 24-28 (for a listing of additional characteristics and for the proposition that some of the characteristics may fade over time); Shapiro, *The Statutory Close Corporation: A Critique and a Corporate Planning Alternative*, 36 MD. L. REV. 289 (1976) (listing statutorily required characteristics of close corporations).

⁴⁹ H. HENN & J. ALEXANDER, *supra* note 4, § 257; cf. Hetherington & Dooley, *supra* note 39, at 6 (the problem of exploitation of minority shareholders by the majority in close corporations is "uniquely related to illiquidity . . ."); Hetherington, *Special Characteristics*, *supra* note 8, at 11. This characteristic always results from a lack of a market for the securities of a close corporation and may also result from transfer restrictions in the corporation's charter and/or by-laws or as provided in shareholders' agreements.

Although close corporation literature generally deals with oppression of minority interests by the majority, the reverse can also occur. For the proposition that control of a close corporation is not necessarily congruent with control of a majority of voting shares, see *Smith v. Atlantic Properties, Inc.*, 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981); cf. *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975).

⁵⁰ And thus, too, the ethical problems of counsel. Cf. Shapiro, *supra* note 48, at 291 ("Close corporation statutes tend to reflect an inadequate grasp of the critical role played by the personalities and private motivations in any 'small' business.").

⁵¹ Hetherington, *Special Characteristics*, *supra* note 8, at 20 ("The position of minority interests in close corporations is unique. Participants in partnerships . . . are not . . . stranded by the law if they are excluded by their associates from full participation in the enterprise."); *id.* at 21 (the liquidity of public corporation stock serves as a safety valve for dissatisfied minority shareholders); *Comolli v. Comolli*, 241 Ga. 471, 246 S.E.2d 278 (1978) (repurchase by close corporation of its stock to cement control by majority "depreciated" interest of minority). See also *supra* note 39 and accompanying text.

⁵² The rights of shareholders, directors, and officers of the public corporation are established by state corporation statutes which were drafted with these entities in mind.

porations, however, the lawyer representing the entity typically will be trapped between individual shareholders or groups of shareholders, of whom the most that can be said is that they owe one another a fiduciary duty.⁵³ These people generally are also the managers and directors of the enterprise.⁵⁴ As a result, counsel for the close

Manne, *supra* note 21, at 276 n.26. Under this model the business and affairs of the corporation are "managed by or under the direction of" the Board of Directors, *see, e.g.*, DEL. CODE ANN. tit. 8 § 141 (1967), with certain limited rights of approval granted to the shareholders. The law has developed largely in response to the problems of the separation of ownership and control presented by this model. W. CARY & M. EISENBERG, *supra* note 12, at 208-19. In contrast, the laws governing close corporations permit infringement on corporation statutes. *E.g.*, *Galler v. Galler*, 32 Ill.2d 16, 203 N.E.2d 577 (1964). Statutes have also permitted close corporations to achieve some of the characteristics of partnerships. *See supra* notes 39-48 and accompanying text. Thus, in terms of legal characteristics, the close corporation more nearly resembles a partnership than a public corporation complying with the statutory model. Israels, *supra* note 10, at 491-92.

Consistent with the statutory model, when conflicts among constituents arise in the public corporation the MRPC seems to conclude that counsel has satisfied her ethical obligations by good faith compliance with the directives of the Board of Directors. *See Kutak, supra* note 4, at 1118; *see also* S. FITZGIBBON, *supra* note 13, at 11 (charter and by-laws direct lawyers as to how to act for corporate constituents).

The fundamental device for governance of intracorporate relations in the close corporation is the principle of fiduciary duty. On the scope of fiduciary duties and the persons possessing them in close corporations, *see* Hetherington, *Defining the Scope, supra* note 9. Professor Hetherington comments: "With respect to the benefits and risks which the parties intend to share, fiduciary obligations between shareholders are enforcement devices for implementing the intent of the parties." *Id.* at 19; *see also* M. EISENBERG, *supra* note 4, at 17; O'Neal, *supra* note 11. Professor Hetherington further notes that the expectations of shareholders are "remarkably uniform," and that fiduciary duties may be well suited for enforcing those expectations. Hetherington, *Defining the Scope, supra* note 9, at 21. Finally, he argues that the limits to controlling shareholders' fiduciary duties (as well as those of directors and officers) have been created by balancing interests among participants in corporations and are consistent with the interests and expectations of investors. *See id.* at 22-23.

Whether this is a change in his analysis since 1969, *see infra* note 53, or whether developments in the case law such as *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975), *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 353 N.E.2d 657 (1976), and *Smith v. Atlantic Properties, Inc.*, 12 Mass. App. Ct. 201, 422 N.E.2d 798 (App. Ct. 1981), have changed his mind, Professor Hetherington's arguments for the utility (and improvement) of the fiduciary doctrine are useful. The utility of the fiduciary principle in governing intra-shareholder relations forms an essential part of my argument in Part III of this article.

⁵³ Hetherington, *Defining the Scope, supra* note 9, *passim*. With respect to the efficacy of fiduciary principles in protecting minority shareholders of close corporations, Professor Hetherington has observed:

The legality of the majority's conduct is tested first against specific statutory criteria [which I have observed is largely inapplicable, or at least highly permissive, in the close corporation context], and second against the common law principle that in the exercise of its managerial prerogatives the controlling group may not be motivated primarily by its own partisan interests, but must seek to maximize the interests of all concerned. The complexity of business situations and the plurality of motives drastically limit the effectiveness of the latter principle.

Hetherington, *Special Characteristics, supra* at 28. *But see supra* note 52.

⁵⁴ Israels, *supra* note 10, at 491.

corporation typically will have regular contact with these shareholders and may well have personal relationships with some or all of them, each of whom is likely to have a significant financial stake in the enterprise. Counsel to the close corporation may often find it difficult to determine who speaks for this "entity" the Codes insist she represents.⁵⁵ She will particularly be stymied in making this determination when the distribution of ownership is relatively equal, for under such circumstances each shareholder will legitimately expect that the corporation will fulfill his individual interests.⁵⁶

Another problem in identifying who speaks for the corporation lies in determining that person's real interest; in other words, whether such person is speaking in the corporation's best interests or his own.⁵⁷ In the public corporation model, once the lawyer has identified the appropriate speaker, she is entitled to assume that such person is motivated by the best interests of the entity.⁵⁸ In the case of the close corporation, however, counsel is more likely to find individual participants attempting to realize their personal goals through the enterprise. Those goals may be inconsistent with the best interests of the enterprise as a whole.⁵⁹ This point is intensified

⁵⁵ See cases cited *supra* note 7, all of which deal with this difficulty; *Developments in the Law, supra* note 21, at 1335. At least in the public corporation model, counsel is protected by the MRPC when she relies in good faith on directives of the board. Kutak, *supra* note 4.

⁵⁶ Of course the legitimacy and reasonableness of these expectations may depend upon the existence of mechanisms such as voting agreements or super-majority voting provisions which give each shareholder a right to veto significant actions. See, e.g., *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957); *Smith v. Atlantic Properties, Inc.*, 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981). Nevertheless, the shareholders might reasonably expect that such a veto right will not be abused.

⁵⁷ *Smith v. Atlantic Properties, Inc.*, 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981), left open the question of whether a shareholder in a close corporation is required to act in the corporation's best interests, assuming no breach of a fiduciary duty of the other shareholders. There the court modified the balancing test established in *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 353 N.E.2d 657 (1976) (breach of fiduciary duty must be measured against a reasonable business purpose asserted by the controlling shareholder and whether there exists a less damaging means of accomplishing that purpose) to take account of the competing business interests of each shareholder. In so doing, the court implicitly recognized that in a close corporation, the "corporation" has no best interests; rather, the only relevant interests are those of the individual shareholders. See also *infra* note 59.

⁵⁸ The MRPC takes this approach. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13 comment (1984); Kutak, *supra* note 4; *Developments in the Law, supra* note 21, at 1336, 1337.

⁵⁹ See *supra* note 55. Cf. *Torres v. Divis*, 144 Ill. App. 3d 958, 494 N.E.2d 1227 (1986) ("The interests of the incorporators of a closely held business are not always the same, and they are often adverse. Each incorporator may seek to maximize his personal return and to minimize his personal contributions."); KLEIN & COFFEE, BUSINESS ORGANIZATION AND FINANCE 40 (2d ed. 1986) (each investor seeks to maximize his wealth); Chittur, *supra* note 8; Hetherington, *Defining the Scope, supra* note 9, at 39 ("Equity investors are assumed to be rational wealth maximizers. . .").

by the fact that the shareholders in a close corporation are likely to be its directors and officers as well,⁶⁰ and thus have the power to direct its affairs. The close corporation assumes singular importance to each of its shareholders as a vehicle for individual wealth maximization and each shareholder will tend to see the enterprise as existing to fulfill his individual needs.⁶¹ This, together with the confining illiquidity of close corporation securities, throws the significance of client identification into high relief because dissatisfied shareholders may be unable to withdraw from the enterprise and will have to protect their investments within its structure.⁶²

Thus the character of the conflict problems posed by the close corporation differs, from the model envisioned by the Codes in at least two significant dimensions: (i) on the structural level, because the *inter se* relationship among the parties disregards the traditional corporate model (and lacks the safety feature of liquidity possessed by partnerships and public corporations),⁶³ and (ii) on the human level, because the best interests of the "corporation" are, in reality, the best interests of each of the shareholders rather than the best interests of the entity.⁶⁴ While this difference should not affect

⁶⁰ See *supra* note 11.

⁶¹ But see S. FITZGIBBON, *supra* note 13, at 11.

⁶² A reasonably close analogy to the problem of identifying the corporation's interest arises in the context of shareholder derivative suits against directors or controlling shareholders. As one court put it: "Simply stated, in a derivative suit a minority shareholder places himself in the shoes of the corporation to enforce a corporate right, and the interests of the plaintiff-shareholder and the corporate defendant become merged." *In re Kinsey*, 294 Or. 544, 555, 660 P.2d 660, 666 (1983). Cf. *Cannon v. U.S. Acoustics Corp.*, 398 F. Supp. 209, 213 (N.D. Ill. 1975) (corporation in derivative suit, although nominally a defendant, is in fact a plaintiff), *aff'd in part, rev'd in part*, 532 F.2d 1118 (7th Cir. 1976); *Lewis v. Shaeffer Stores Co.*, 218 F. Supp. 238 (S.D.N.Y. 1963); *Schwartz v. Gutermen*, 109 Misc. 2d 1004, 441 N.Y.S.2d 597 (Sup. Ct. 1981) (applying same rule in context of limited partnership). In *Kinsey*, the court reviewed the cases dealing with "the defendants in a derivative action," 294 Or. at 556, 660 P.2d at 667, and concluded that, while there was a split of authority, that split was one "in time" and that recent cases established the impropriety of such representation. *Id.* at 557-58, 660 P.2d at 667-68. The court concluded that such representation was improper "unless the claim [asserted in such derivative actions] is patently sham or patently frivolous." *Id.* at 559, 660 P.2d at 669. Cf. *Goldstein v. Lees*, 46 Cal. App. 3d 614, 120 Cal. Rptr. 253 (1975) (holding that counsel to a corporation could not take sides in a contest for corporate control).

Similarly, in a close corporation, where ownership and control merges so that the shareholders have become the corporation, counsel should be prohibited from taking sides in a conflict among the shareholders. See *infra* note 98. This does not, however, address the question of whether counsel should represent such a corporation before conflict actually appears. Cf. *Kinsey*, 294 Or. at 553-54, 660 P.2d at 665 (no ethical violations when counsel undertook representation of corporation and controlling shareholders where initially no clear conflict existed).

⁶³ See *supra* notes 39-52. The liquidity of partnerships inheres in their free dissolvability. But this freedom may be limited by agreement, thus creating a problem similar to that found with respect to close corporations.

⁶⁴ See generally F. O'NEAL & R. THOMPSON, *supra* note 8. Of course, whether the "entity" has its own best interests is a matter of dispute even in the public corporation

counsel to the close corporation with respect to the corporation's conduct of its business, that is, in its quotidian relationships with third parties,⁶⁵ it will necessarily affect her ability to function as an initiator, planner and advisor to the close corporation regarding governance, finance, and the long-range planning of its operations.⁶⁶

B. The Role of Counsel

Before examining a proposed typology of close corporations and how the conflicts previously described may pose ethical problems in each type, it is worth taking a moment to examine how the lawyer's concept of her role, and clients' expectations, magnify the conflicts problem in the context of a close corporation.⁶⁷ As has been noted, the CPR pays very little attention to the corporate lawyer, proceeding as it does on the basis of the traditional advocacy model.⁶⁸ The MRPC makes some attempt to recognize the lawyer's counseling role,⁶⁹ but still fails to integrate fully the planning role of corporate counsel. The role of counsel in a nonadversarial setting is quite different from that in the traditional litigation model.⁷⁰ A brief example will suffice to illustrate this role in the close corporation context.⁷¹

context. See *supra* note 62 (with respect to derivative actions). However, the dispute in that context revolves around constituent groups (i.e., shareholders, directors, and officers) rather than individual constituents, and the courts make some effort to deal with the potential conflicts on a group level. See, e.g., *In re Kinsey*, 294 Or. 544, 660 P.2d 660 (1983).

⁶⁵ Cf. *Developments in the Law, supra* note 21, at 1346 (courts will rarely find breaches of fiduciary duties arising from ordinary business decisions but are more likely to find such breaches in disputes over control in which "[t]he corporate attorney may be invited to play a central role.").

⁶⁶ This is because long-range planning may well be inseparable from the financial goals of the corporation's shareholders. For example, a shareholder nearing retirement age who, pursuant to an agreement among shareholders, must be "bought out" upon retirement, will want to achieve significant short term improvement in those financial measures upon which the repurchase price is based. However, increasing book value may have very different consequences for the enterprise than increasing earnings. And increasing short-term earnings may have very different consequences than increasing earnings over a longer term. The next section discusses the importance and appropriateness of corporate counsel's functions in this context.

⁶⁷ In this regard, the conflicts problems in a close corporation tend to differ in magnitude, rather than in type, from those in the public corporation. See generally MODEL CODE OF PROFESSIONAL RESPONSIBILITY Canon 5, EC 5-18 (1980).

⁶⁸ Brown & Dauer, *supra* note 15, at 520; Pierce, *supra* note 19, at 356.

⁶⁹ MODEL RULES OF PROFESSIONAL CONDUCT Rules 2.1 and 2.2 (1984); Brown & Dauer, *supra* note 15.

⁷⁰ Brown & Brown, *supra* note 38, at 453-54. See Brown & Dauer, *supra* note 15; Redlich, *Should a Lawyer Cross the Murky Divide?*, 31 BUS. LAW. 478 (1975).

⁷¹ The role of the lawyer contemplated here should make self-evident the reason I do not treat Rule 2.2 of the MRPC ("lawyer as intermediary") as an adequate rule of representation for these purposes.

Two individuals (John and Sue) have decided to conduct a business together and approach counsel with their plan.⁷² Sue says to counsel:

John and I want to form a corporation in which we will have equal control. Each of us will invest equally, and expect to draw equal salaries and share equally in the profits. John will be Vice President and I will be President. Please prepare the papers.

At this point, the Codes permit, and even encourage, the lawyer to comply with Sue's request to prepare the papers.⁷³ Yet it is both irresponsible and inconsistent with the clients' expectations for the lawyer simply to comply with this mandate. The clients have approached a professional with a plan implicitly predicated upon legal conclusions.⁷⁴ It is both the lawyer's role and the clients' expectation that counsel will discuss with them the facts underlying those conclusions, and re-examine those conclusions based upon the facts adduced.⁷⁵ For example, it may turn out that John has investments in a number of enterprises and really does not want to devote full time to the business. In that case, Sue might wish to rethink their agreement about equal salaries. Another possibility is that both parties expect substantial losses to be generated by the business in its early years. John, whose passive income from other sources is equally substantial, might prefer a "subchapter S" corporation.⁷⁶ But if the corporation is structured that way, his total economic benefit from an equal sharing arrangement will be greater than Sue's.⁷⁷ It might be to Sue's advantage to organize the business as a partner-

⁷² It is rare (and has never occurred in my experience) for clients to approach a lawyer with either a complete plan of organization or a naked series of facts. See Brown & Brown, *supra* note 36, at 458. Typically they will want to organize a business and have had some, albeit incomplete, discussions among themselves as to the form the organization will take, their relative roles in its operations, and their investments in it. Often they will present the results of their discussions to the lawyer in a conclusory form. See Braucher, Darrell, Herwitz & Malone, *Business Planning and Professional Responsibility*, PRAC. LAW. 17 (Jan. 1962) [hereinafter Braucher] for a hypothetical situation highlighting many of the same problems. Ethical guidance in this situation is not significantly clearer today than it was in 1962.

⁷³ Brown & Brown, *supra* note 38; Brown & Dauer, *supra* note 15, at 521-22.

⁷⁴ Cf. Wasserstrom, *supra* note 26, at 125 (clients unable to make decisions without advice of counsel).

⁷⁵ Redlich, *supra* note 68, at 479. But see Brown & Dauer, *supra* note 15, at 521-23 (MRPC discourages initiation by counsel).

⁷⁶ Fundamentally, a "subchapter S" corporation is a corporation which is treated as a partnership for tax purposes. Each shareholder is individually taxed on her *pro rata* share of the corporation's profits and the corporation as an entity is not so taxed. I.R.C. §§ 1361-1379 (1987).

For a good discussion of "S" corporations and the requirements for election to become one, see F. O'NEAL & R. THOMPSON, *supra* note 8, § 2.06, at 30-34.

⁷⁷ John will have passive income against which to set off his losses from the corporation. Sue will not have such income and, therefore, will be unable to use those losses. I.R.C. § 496 (1987).

ship. But if it is so organized, John will be facing greater risk of personal liability since Sue has relatively few personal assets (beyond those invested in the enterprise).⁷⁸ John may want to be able to liquidate his interest in the corporation if a better investment opportunity arises. But Sue will be uncomfortable with the risk that his buyer (Sue's new "partner") may be undesirable to her.

This colloquy could continue virtually *ad infinitum*.⁷⁹ The problems are clear: To the extent that the lawyer acts as a mere scrivener (if such a thing is possible or responsible)⁸⁰ and carries out the parties' request, there will be no conflict in her sole representation of the corporation because she is not favoring either participant's interests over those of the other.⁸¹ But once she begins to explore the facts, her role becomes that of an initiator, a planner, and an advisor. She will be an initiator in that she will suggest economic, legal, and practical considerations and possible courses of action which have not been considered or fully appreciated by the parties. She will be a planner in that she will lay out the organizational model and assist in establishing the allocation of rights and responsibilities between the parties. And she will be an advisor in that she will counsel each of the parties with respect to the course of action which is likely to be most profitable to each of them based upon their individual circumstances and desires.⁸²

She will do all of these things, that is, if she does what she is trained to do and what the clients expect of her. For the lawyer is an expert. She is an expert not only in her knowledge of the law but also because, in the course of applying that knowledge in her practice and as a result of her experience, she will have counseled many clients in similar circumstances. She will have knowledge and judgment developed as a result of having been in the same situation many times. Yet to John and Sue the situation that brings them to

⁷⁸ Of course the parties are liable personally for the obligations of the partnership. U.P.A. § 15 (1969).

⁷⁹ See Haynsworth, *supra* note 8, at 459 (listing of additional considerations).

⁸⁰ See *Beal v. Mars Larsen Ranch Corp.*, 99 Idaho 662, 586 P.2d 1378 (1978) and *Blevin v. Mayfield*, 189 Cal. App. 2d 649, 11 Cal. Rptr. 882 (Ct. App. 1961) for the proposition that a lawyer may act as a mere scrivener in drafting real estate contracts for both buyer and seller. The court in *In re Jans*, 295 Or. 289, 666 P.2d 830 (1983) distinguished both these cases in the close corporation context. I wish to note that I do not believe that *Beal* and *Blevin* stand for the broad propositions described in *Jans*. The facts in at least the *Blevin* case indicate that counsel was jointly representing the parties in circumstances in which it was appropriate. The *Beal* case, I believe, was, on this point, wrongly decided. Aronson, *supra* note 30, at 826, suggests that it may be possible for a lawyer to function solely as a scrivener. I disagree based on the reasoning presented in the text.

⁸¹ Except perhaps to the extent she knows that the proposed form will be more advantageous to one of the participants and remains silent.

⁸² Brown & Dauer, *supra* note 15, at 521-22; Redlich, *supra* note 70, at 479.

the lawyer's door is extraordinary.⁸³ Therefore, they must rely on counsel to guide them.

The implications of counsel's role as illustrated by this hypothetical are not, of course, restricted to the choice of organizational form. They arise repeatedly with respect to capital structure, corporate finance, control mechanisms, organic transactions, and every similar decision that occurs during the life of the corporation. They further highlight the deficiencies in the Codes. Each requires counsel to pledge allegiance to the entity. However, as a matter of substantive law, there is virtually no entity interposed between John and Sue. Each Code permits counsel to represent both 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 John and Sue because their interests conflict.⁸⁴

This does not mean that counsel should never undertake such representation. Reasons of economy and efficiency suggest that, where possible, such representation is desirable.⁸⁵ The hypotheti-

⁸³ Perhaps somewhat less so for John than Sue, since John obviously has made similar investments. Query whether John's greater sophistication should affect the lawyer's role. See *infra* note 105 and accompanying text. Cf. *Helms v. Duckworth*, 249 F.2d 482, 487-88 (D.C. Cir. 1957) (shareholder in close corporation who had both legal and business education and who drafted agreement between himself and the other shareholder had greater fiduciary responsibility to treat other shareholder fairly because of his greater sophistication).

⁸⁴ See *In re Brownstein*, 288 Or. 83, 602 P.2d 655 (1979). See also Aronson, *supra* note 30, at 826 (lawyer may subconsciously favor one client over another). Cf. Fried, *supra* note 32, at 1076 (corporations are only formal arrangements through which individuals pursue their interests). I further suggest that it is irresponsible to leave the decision to John and Sue. See Brown & Dauer, *supra* note 15, at 523. Clients in this position rarely will have the experience and sophistication to determine whether they will be prejudiced by counsel's representation of competing interests. It is inconsistent with professional self-regulation for us to ask our clients to make our hard choices for us. Cf. Brown & Dauer, *supra* note 15, at 523 (suggesting that the profession should not "leave the definition of legal problems to its clients"); Pierce, *supra* note 21, at 359-60 (observing that the CPR's requirement of client consent for dual representation is illusory).

It may, however, seem unduly paternalistic to deny clients the right to consent to joint representation notwithstanding conflict. An analysis of the concept of informed consent is beyond the scope of this Article. However, where the lawyer's professional judgment can be expected to be compromised notwithstanding such consent, it seems reasonable to require her, in the circumstances discussed *infra*, to refuse to undertake the representation. But see *Developments in the Law, supra* note 21.

⁸⁵ See sources cited *supra* note 34. It has been suggested that joint representation should be permitted in order to avoid the adversary element injected into negotiations by the presence of several lawyers. The fear of conflict among participants at the planning stage can even lead to irresponsibility on the part of counsel. See Hetherington, *Special Characteristics, supra* note 8, at 17 n.65 ("A prominent Wisconsin commercial lawyer told the writer that when clients who come to him to form a closely held enterprise are so concern[e]d about possible future disagreement that they want binding agreements to resolve such difficulties in advance, he may advise them not to go into business together."). This attitude is, without additional facts, nothing short of astonishing!

cal suggests that the propriety of counsel's undertaking such representation depends on the existence of factors suggesting inherent conflict among the participants.⁸⁶ The CPR and MRPC throw the balancing of these considerations back into the lawyer's lap. While presuming that the lawyer will act in good faith and exercise her best judgment,⁸⁷ the Codes provide no guidelines for formulating a judgment.⁸⁸ Judgments will vary and this variation will result in inconsistent approaches and in an absence of standards other than case-by-case good faith application of personal judgment.⁸⁹

It should be possible to set clearer standards in order to develop a more unified approach to these problems.⁹⁰ With this in mind, I have developed a typology of close corporations to help determine whether a pattern exists.

⁸⁶ See *supra* notes 74-80 and accompanying text; *infra* note 113; *infra* notes 157-59 and accompanying text.

⁸⁷ Cf. Patterson, *supra* note 3, at 59 ("The ultimate issue in determining whether rules of ethics are to be an integral part of the law is whether they serve as effective guidelines for the good lawyer as well as a basis for disciplining the bad lawyer."); Wedginton, *A Fresh Approach to Preserving Independent Judgment—Canon 6 of the Proposed Code of Professional Responsibility*, 11 ARIZ. L. REV. 31, 34 (1969) (one reason for the existence of ethics codes is to prevent lawyers from putting themselves in positions in which they cannot properly function). Note, too, that a lawyer is a fiduciary to her client, and courts have indicated that her role is analogous to that of a corporate director. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13 comment (1983).

⁸⁸ Cf. Aronson, *supra* note 30, at 813 ("The key to preventing unintentional or unwitting violations [of ethical norms] lies in anticipating the probability or possibility that a conflict situation will develop.").

⁸⁹ For varying approaches of lawyers to ethical dilemmas, see J. CARLIN, *supra* note 35.

Consistency for its own sake is not to be lauded. Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 259 (1967) (questioning the value of consistency in the law); Emerson, *Self-Reliance*, in SELECTED WRITINGS OF RALPH WALDO EMERSON 263 (Gilman ed. 1965) ("A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines." And, it might be added, lawyers.). However, in the context of professional ethics, where few external constraints exist (and where enforcement depends upon the identification of a breach, which is made difficult by existing rules, particularly for unsophisticated clients), consistency has the virtue of facilitating both compliance and professional self-regulation and insures that clients will be treated equally.

⁹⁰ "Lawyers do not view all potential conflicts of interest with equal trepidation." Davis & Elliston, *Conflict of Interest*, in ETHICS AND THE LEGAL PROFESSION 280 (M. Davis & F. Elliston eds. 1986); Kipnis, *supra* note 34, at 287 ("If the potential for conflict of interest is understood well enough by the attorney and the prospective clients, it may be that agreement can be reached as to the attorney's obligations if events occur that would ordinarily give rise to an actual conflict of obligations."); cf. Pierce, *supra* note 21, at 369 (it might be reasonable to define the lawyer's professional role in relation to his clients' expectations); *Developments in the Law*, *supra* note 21, at 1338 (obtaining "meaningful consent" to the joint representation of shareholders in a close corporation is a "realistic possibility.").

II

A TYPOLOGY OF CLOSE CORPORATIONS

The following typology, based upon reported cases, academic commentary, and practical experience, classifies close corporations as consisting of three types: the incorporated proprietorship; the family corporation; and the incorporated partnership. While it cannot pretend to exhaust (and I do not contend that it should exhaust) the types of close corporations which actually exist or may be formed, I believe that it does describe the most common types of close corporations.⁹¹ By examining the typology we can identify various factors to suggest whether or not a particular corporate representation should be undertaken (or continued) by counsel without separate representation for some or all shareholders.

A. The Incorporated Proprietorship

The incorporated proprietorship⁹² is, of course, the simplest case. By this term I mean a corporation, all of the stock of which (except perhaps for directors' qualifying shares)⁹³ is legally and beneficially owned by a single individual. The fact that directors and officers other than the "proprietor" exist should be irrelevant.⁹⁴ There is complete unity of interest in this model, for the ultimate residual claimant of all of the corporation's income and assets will be the single proprietor.⁹⁵ However, at some point in the life of the

⁹¹ Empirical evidence in the field of close corporations is hard to come by. *But see Statutory Needs of Close Corporations*, *supra* note 8. Although some corporation statutes require close corporation status to be reflected in corporate charters, most do not. *Id.* Furthermore, a charter is not particularly informative with respect to the number or identity of the shareholders. Thus the cases are all that is available for analysis. I recognize that this might result in a bias inherent in the typology since the reported cases will be those in which conflict materialized. For this reason I explicitly discuss some cases in which counsel's conduct was not in question.

⁹² The terminology is derivative. *See* Hetherington & Dooley, *supra* note 39; Israels, *supra* note 8; Comment, *supra* note 8, at 138.

⁹³ DEL. CODE ANN. tit. 8 § 141(b) (1986); N.Y. BUS. CORP. LAW § 701 (McKinney 1986); UTAH CODE ANN. § 16-10-33 (Supp. 1987).

⁹⁴ For purposes of discussion and analysis I have ignored the legitimate concern of courts for the interests of third party creditors and other corporate constituents. At various stages in the development of corporate law and in a variety of circumstances the interests of third parties have led courts to restrict the extent to which the actions of a shareholder can supercede or be substituted for those of the nonshareholder directors. *See, e.g.,* Somers v. AAA Temporary Servs., Inc., 5 Ill. App. 3d 931, 284 N.E.2d 462 (1977); Baldwin v. Canfield, 26 Minn. 43, 1 N.W. 261 (1879); W. CARY & M. EISENBERG, *supra* note 12, at 150-92.

⁹⁵ *But see* Parker v. Frazier (*In re* Freedom Solar Center, Inc.), 42 Bankr. 261 (1984) (holding that in the case of an incorporated proprietorship in Chapter 7 proceedings the interests of the debtor corporation and its sole shareholder were not congruent where the sole shareholder formed a new corporation to acquire the assets of the debtor). Analysis of these issues in light of the rich economic literature which examines the question of the identity of the residual owner of the corporation is beyond the scope of this

corporation additional shareholders may appear (through gift or intestacy, through sale of a portion of the proprietor's interest, or through sale by the corporation of newly issued shares.) When this occurs, counsel must reevaluate her representation of the corporation (assuming the new shareholders are not otherwise represented) under one of the other relevant models.

B. The Family Corporation

The family corporation consists of two sub-types: 1) a corporation which begins as an incorporated proprietorship and in which all shareholders are members of the same family, receiving their stock from the sole stockholder (hereinafter referred to as a "true family corporation")⁹⁶ and 2) a corporation in which all shareholders are members of the same extended family (hereinafter referred to as a "family incorporated partnership"). As explained below, the family incorporated partnership is only superficially a family corporation and therefore is classified and analyzed as an incorporated partnership.

Professor O'Neal describes a source of dissension in true family corporations which, although similar to behavior in family incorporated partnerships and incorporated partnerships, reflects different motives.

Sometimes all of the shareholders are descendants of the original founder, *and the founder may have directed by will or otherwise that the business be used for the continued support of the family.* This outlook leads to the use of corporate assets by members of the family, loans to members of the family without interest, intermingling of corporate and individual money and assets, payment of compensation to officers without formal board authorization, and a gen-

Article. See, e.g., POSNER & SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* (1980); Fama & Jensen, *supra* note 8. Instead I have followed the traditional legal model which acknowledges the shareholders as the exclusive residual owners.

⁹⁶ The term "family corporation" is frequently used by commentators. See, e.g., H. HENN & J. ALEXANDER, *supra* note 4, at § 258; F. O'NEAL & R. THOMPSON, *supra* note 8, § 1.05, at 11.

The close corporation, all of the stock of which is owned by a wife and husband, is not separately addressed here. Such a corporation surely will be a true family corporation under the reasoning set forth in this Article (and under a traditional view of the marital relationship), at least while the marriage is stable. If the marriage deteriorates, and certainly if separation or divorce occurs, the corporate stock may become marital property under the laws of the relevant state. This issue, while similar in kind to that presented in the context of the true family corporation, *see infra* notes 121-39 and accompanying text, will be different in degree because an actual conflict will exist with regard to the distribution of the founder's wealth. The rules governing multiple representation in these contexts is beyond the scope of this Article. See, e.g., Woods v. Superior Court, 149 Cal. App. 3d 931, 197 Cal. Rptr. 185 (1983); *In re Brandsness*, 299 Or. 420, 702 P.2d 1098 (1985); *In re Banks*, 283 Or. 459, 584 P.2d 284 (1978).

eral failure to observe the separate entity of the corporation and the formalities of corporate action. This lax handling of the enterprise's affairs sets the stage for dissension.⁹⁷

The mere creation of a true family corporation does not signal the likelihood of potential conflicts which make joint representation of the shareholders inappropriate. The true family corporation evolves from the incorporated proprietor in which, as I have already argued, no ethical problems exist for counsel.⁹⁸ The potential for problems only develops as the stock is distributed among family members. At various points, counsel may have to advise the founder about the distribution of control and earnings to take place when he retires or after his death. This may put counsel in the midst of conflict with those who will *become* the corporation's owners, as well as with family members who already are shareholders and who will expect to maintain, if not improve, their status within the corporation in relation to other family members.⁹⁹ In particular, those family members who are active in the business will expect a greater return on their investment than those who are not.¹⁰⁰ The question facing the lawyer in this situation generally will not be whether initially to accept the representation but at what point in the evolution of the corporation to choose her client from among the shareholders and recommend separate representation to the other constituents.¹⁰¹

On closer examination, however, these potential conflicts diminish in significance. That is because the distribution of corporate ownership in a true family corporation has little to do with risk diversification or acquisition of managerial talent. It has to do with the transmission of wealth. Therefore, the founder will not consult

⁹⁷ F. O'NEAL & R. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS 2:10 (2d ed. 1985) (emphasis added). See, e.g., *Glazer v. Glazer*, 374 F.2d 390 (5th Cir.), cert. denied, 389 U.S. 831 (1967); *Lowder v. All Star Mills, Inc.*, 309 N.C. 695, 309 S.E.2d 193 (1983).

⁹⁸ Similarly, no problems should exist where the true family corporation *originates* with several family members holding stock as long as the corporation is the alter ego of the founder. See *In re Banks*, 283 Or. 459, 584 P.2d 284 (1978).

⁹⁹ See, e.g., *Hoiles v. Superior Court*, 157 Cal. App. 3d 1192, 204 Cal. Rptr. 111 (1984).

¹⁰⁰ The solution may not always be as simple as payment of salaries, for occasionally the "working shareholders" will resent those they believe are profiting from their labors. This resentment may itself lead to conflict.

¹⁰¹ Cf. B. WUNNICKE, ETHICS COMPLIANCE FOR BUSINESS LAWYERS 235 (1987) (lawyer for fictional close corporation should not represent any faction in the dispute); *Goldstein v. Lees*, 46 Cal. App. 3d 614, 120 Cal. Rptr. 253 (1975) (lawyer for corporation is not permitted to take sides in a contest for corporate control); *In re Bristow*, 301 Or. 194, 204, 721 P.2d 437, 442 (1986) (when the interests of joint clients diverge, "the only ethical position for an attorney to adopt . . . is to represent neither [interest]" (quoting *In re Banks*, 283 Or. 459, 475, 584 P.2d 284, 292 (1978))); Braucher, *supra* note 71. See also MRPC Rule 1.16 (with respect to terminating representation).

with counsel regarding whom the appropriate beneficiaries should be, but rather what the best method will be for achieving his wealth transmission goals. Any disagreement the new shareholders have with respect to such wealth transmission will be with the founder in his allocation of stock, and not with counsel who effected that allocation.

The family incorporated partnership presents a set of considerations different from that presented by the true family corporation. This type of family corporation, founded by brothers or sisters, brothers- or sisters-in-law, or other relatives, is formed initially by multiple shareholders, whose purpose is not to distribute their personal wealth throughout the extended family, but rather to diversify risk or acquire management. They know each other because they are related but they do business with each other for business reasons. Thus the family incorporated partnership is more closely analogous to the incorporated partnership.

C. The Incorporated Partnership

The incorporated partnership¹⁰² can be created in a number of ways. It can evolve from an incorporated proprietorship where the owner either has sold a portion of his holdings outside the family to achieve personal liquidity (for retirement, diversification, or other reasons) or where he has caused the corporation to raise additional capital through the sale of newly issued shares.¹⁰³ An incorporated partnership also can be created by friends or family members (and thus includes the family incorporated partnership)¹⁰⁴ or by people previously unacquainted (and sometimes introduced by the lawyer).¹⁰⁵ In this model, there will likely be several shareholders who may initially have, or may come to have, conflicting interests.¹⁰⁶

There is a crucial distinction between the incorporated partnership and the true family corporation. Participants in an incorporated partnership become shareholders either because of special expertise or invested capital; that is, they increase the productivity of the business or diversify the risks attendant upon its formation

¹⁰² As to terminology, see sources cited *supra* note 92.

¹⁰³ Other ethical considerations may arise where other forms of finance, such as options, warrants, etc. are used. A discussion of these is beyond the scope of this Article.

¹⁰⁴ *Klinicki v. Lundgren*, 298 Or. 662, 695 P.2d 906 (1985) (corporation formed by two friends and the father of one of them); *Lehrman v. Cohen*, 43 Del. Ch. 222, 222 A.2d 800 (1966) (corporation formed by two families). Where substantial or controlling ownership of a corporation is owned by the members of a family, counsel should analyze the propriety of representing all of the shareholder-family members in the same way she would analyze the propriety of representing all of the shareholders.

¹⁰⁵ See, e.g., *DelaMaria v. Powell, Goldstein, Frazer & Murphy*, 612 F. Supp. 1507 (N.D. Ga. 1985); *In re Brownstein*, 288 Or. 83, 602 P.2d 655 (1979).

¹⁰⁶ See F. O'NEAL & R. THOMPSON, *supra* note 8.

and operation.¹⁰⁷ Participants in a true family corporation, on the other hand, become shareholders primarily because of their relationship to the founder, rather than because of any abilities, talents, or capital they may be able to contribute.¹⁰⁸ As will be seen, this observation suggests a different approach to evaluating the propriety of multiple representation.

Several distinctions among incorporated partnerships may have an impact on the propriety of joint representation:

(1) A distinction exists between a situation where the parties have previously been acquainted¹⁰⁹ and one where counsel introduces the parties.¹¹⁰

(2) A further distinction might be drawn between a case in which all parties had been clients of the same counsel for some time¹¹¹ and where one of the parties is a relatively new client.¹¹²

(3) A third distinction is based upon the nature of the participants, as where a corporation is formed by an entrepreneur and a venture capital fund or a sophisticated independent investor (John, in my earlier hypothetical).¹¹³ This might also include another subtype of close corporation created by the privatization of a public corporation through a management leveraged buy-out.¹¹⁴

Counsel may have to consider many additional factors when determining the propriety of her undertaking multiple representation. These factors include how well the parties know one another, how well counsel knows each of the parties, and whether the nature and experience of one or more of the parties is sufficient to signal, at the outset, clear goals intrinsic to the participant.¹¹⁵ In my evaluation, however, none of these distinctions or factors is of independent or controlling significance. The factor which I believe to be determina-

¹⁰⁷ KLEIN & COFFEE, *supra* note 59; *cf.* Fama & Jensen, *supra* note 8, at 306; Torres v. Divis, 144 Ill. App. 3d 958, 494 N.E.2d 1227 (1986).

¹⁰⁸ See generally STERN, *INSIDE THE FAMILY-HELD BUSINESS* (1986).

¹⁰⁹ See, e.g., White v. Perkins, 213 Va. 129, 189 S.E.2d 315 (1972).

¹¹⁰ See, e.g., DeLaMaria v. Powell, Goldstein, Frazer & Murphy, 612 F. Supp. 1507 (N.D. Ga. 1985); Hill v. Okay Constr. Co., 312 Minn. 324, 252 N.W.2d 107 (1977); *In re Brownstein*, 288 Or. 83, 602 P.2d 655 (1979).

¹¹¹ See, e.g., *Brownstein*, 288 Or. 83, 602 P.2d 655.

¹¹² See, e.g., *DeLaMaria*, 612 F. Supp. 1507.

¹¹³ Note that representation of a syndicate of venture capital funds formed for the purpose of making a portfolio investment presents different problems which are beyond the scope of this Article. Halloran, *Some Aspects of Representation of the Investor Groups in a Venture Capital Financing*, in M. HALLORAN, L. BENTON & J. LOVEJOY, *VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION* 479 (1984). Furthermore, corporations financed in this manner may depart significantly from the typical close corporation model. See Fama & Jensen, *supra* note 8, at 306 n.9 ("The analysis predicts that when venture capital is put into small entrepreneurial organizations by outsiders, mechanisms for separating the management and control of important decisions are initiated.").

¹¹⁴ F. O'NEAL & R. THOMPSON, *supra* note 8, § 1.08, at 32.

¹¹⁵ These factors have been noted by others. See, e.g., Haynsworth, *supra* note 8.

tive of whether multiple representation of the shareholders of an incorporated partnership should be undertaken in a specific case is *whether the shareholders, individually or in cohesive groups, have relatively equal equity interests and voting power in the corporation*. As will be discussed, it is only in such a case (barring other obvious conflicts) that multiple representation should *not* be undertaken.¹¹⁶

It is important to emphasize that the type or subtype of the close corporation may vary during the life of the corporation.¹¹⁷ Each change of corporate type (or indeed each discussion counsel holds with the participants about prospective changes in corporate type) should lead counsel, assuming she has undertaken sole representation both of the entity and the aggregate, to reevaluate her role.¹¹⁸

III

APPLYING THE TYPOLOGY TO THE CASES

The conflicts of interest among shareholders inherent in the close corporation models presented in the typology become apparent when examining some cases. I will first set out the facts of the cases and then discuss them together. Each case presents an illustration of how close corporation counsel can be caught between the competing interests of shareholders. In several of the cases counsel's conduct is not addressed. In discussing these, I treat counsel's conduct as if it were in issue and analyze the question of whether

¹¹⁶ Cf. S. FITZGIBBON, *supra* note 13, at 13 ("When the corporation is owned in equal shares by the organizers and conducts the business they contemplated from the outset, no purpose would be served by treating the two organizations as distinct and subjecting the attorney to narrow conflicts restrictions."); Hetherington, *Special Characteristics*, *supra* note 8; *Developments in the Law*, *supra* note 21, at 1346 (counsel may generally assume that management, even if allied or congruent with controlling shareholders, speaks for the corporation). See also *infra* note 154 and accompanying text. Professor Hetherington's position will be discussed in more detail in Part III.

¹¹⁷ F. O'NEAL & R. THOMPSON, *supra* note 8, § 2.03, at 5-6; G. HAZARD, *supra* note 6, at 75-76. Cf. Hazard, *supra* note 33, at 35-36 ("One problem in thinking through the lawyer's responsibilities in triangular relationships is that the relationship may not be continuously triangular.")

¹¹⁸ A last type of close corporation to be mentioned is the partially-owned subsidiary corporation. This can come into being when the parent wishes to establish a new line of business in, or to hive-off an existing line of business into, another corporation for business or tax reasons. It can also come into being when the parent makes a substantial equity investment in an existing corporation. Counsel facing this situation has four potentially competing clients or categories of clients (assuming the parent is closely held): the shareholders of the closely-held parent, the parent *qua* entity (which includes the parent as shareholder of the subsidiary), the minority shareholders of the subsidiary, and the subsidiary *qua* entity. This type of close corporation will not be discussed separately both because of its own complexities and because of the possibility of drawing analogies from the ethical responses posed with respect to the incorporated partnership. Obviously, the ethical duties of counsel to the wholly-owned subsidiary can be analyzed under the incorporated proprietorship model.

counsel should have recognized the conflict to begin with; that is, whether the nature of the corporation should have signalled that if conflict occurred, counsel would be sufficiently compromised that she should not have undertaken or continued the multiple representation.¹¹⁹ Other cases deal directly with the conduct of counsel in the circumstances presented.¹²⁰ With respect to these, I will discuss the correctness of the judicial response and the appropriateness of the standards applied.

A. The Family Corporation

*Meiselman v. Meiselman*¹²¹ presents the problems of the true family corporation in its clearest form. H.B. Meiselman, an Austrian immigrant, developed a highly successful chain of movie theaters and made a number of profitable real estate investments. These were owned by eight corporations, all wholly-owned by Meiselman, the largest of which appears to have been Eastern Federal Corporation.

During his lifetime, H.B. Meiselman began to transfer stock in the corporations to his two sons, Michael and Ira. The stock gener-

¹¹⁹ It will be assumed in these cases, unless otherwise indicated, that none of the corporation's shareholders were represented by counsel independently of the entity.

¹²⁰ Many of the cases deal with motions to disqualify counsel in litigation against a former officer, director, or shareholder of the corporation. See, e.g., *Bobbitt v. Victorian House, Inc.*, 545 F. Supp. 1124 (N.D. Ill. 1982); *Wayland v. Shore Lobster & Shrimp Corp.*, 537 F. Supp. 1220 (S.D.N.Y. 1982); *Woods v. Superior Court*, 149 Cal. App. 3d 931, 197 Cal. Rptr. 185 (1983); *Jacuzzi v. Jacuzzi Bros.*, 218 Cal. App. 2d 24, 32 Cal. Rptr. 188 (1963); *Meehan v. Hopps*, 144 Cal. App. 2d 284, 301 P.2d 10 (1956); *Terre du Lac Property Owners' Ass'n, Inc. v. Shrum*, 661 S.W.2d 45 (Mo. Ct. App. 1983); *Lowder v. All Star Mills, Inc.*, 309 N.C. 695, 309 S.E.2d 193 (1983). One court has observed that disqualification motions and disciplinary proceedings under the Codes, while distinguishable, have been merged in concept by the courts. *Original Appalachian Artworks, Inc. v. May Dep't Stores Co.*, 640 F. Supp. 751 (N.D. Ill. 1986). But see *Cannon v. U.S. Acoustics Corp.*, 398 F. Supp. 209, 213 (N.D. Ill. 1975) ("[a] motion to disqualify calls to question not only the probity of the individual lawyer, but the legal profession as a whole."), *aff'd in part, rev'd in part*, 532 F.2d 1118 (7th Cir. 1976). In treating disqualification motions as involving similar, although less stringent, considerations as disciplinary proceedings, I am accepting the reasoning of the court in *Original Appalachian Artworks*. The fact that some of these decisions have dealt with a conflict situation occurring where counsel has represented the corporation or its shareholders against a former officer, director, or shareholder, see, e.g., *Bobbitt*, 545 F. Supp. 1124; *Wayland*, 537 F. Supp. 1220; *Meehan*, 144 Cal. App. 2d 284, is not a relevant distinction, since the issue inevitably is whether the corporation's (or shareholders') counsel also represented the former officer, director, or shareholder at the time he was connected with the corporation.

Other decisions have dealt with the question of whether corporate counsel could represent any of the parties in a derivative suit. *Jacuzzi*, 218 Cal. App. 2d 24, 32 Cal. Rptr. 188; *In re Kinsey*, 294 Or. 544, 660 P.2d 660 (1983); *Schmidt v. Magnetic Head Corp.*, 101 A.D.2d 268, 476 N.Y.S.2d 151 (1984).

¹²¹ 309 N.C. 279, 307 S.E.2d 551 (1983). The fact that in this case the parties retained separate counsel at the time of the litigation, *id.* at 284, 307 S.E.2d at 555, is unimportant for purposes of discussing whether separate counsel was ethically required.

ally was distributed equally except that Michael received only about 2.5% of the stock in Eastern Federal and Ira received the balance.¹²² The result was that Michael owned approximately 43% of the consolidated family business (29.8% of which consisted of his stock in Eastern Federal), with Ira owning the balance. Both Michael and Ira were employed by the corporations.

Controversy arose over the ownership of Republic Management Corporation, a corporation formed during H.B. Meiselman's lifetime as the successor to several other corporations which provided management services to the Meiselman family theaters. Although Ira had not owned all of the stock in the predecessors, he was, at the time of the suit, the sole owner of Republic. Republic and Eastern entered into a management contract pursuant to which Eastern agreed to pay Republic 5.5% of its theater admission and concession sales, which was a substantial amount of money. Michael sued Ira alleging that Ira breached his fiduciary duty to the family corporations and seeking recovery by those corporations of Republic's profit. In addition, he sued Ira under North Carolina's corporation law for dissolution of the corporations or other equitable relief on the statutory grounds that such relief was reasonably necessary to protect Michael's rights and interests. Ultimately, Michael requested that he be bought out of the corporations at fair value.¹²³

*In re Radom & Niedorff*¹²⁴ illustrates a problem arising in the family corporation of the extended family type, or the family incorporated partnership. Henry Niedorff and his brother-in-law David Radom owned all the stock of Radom & Niedorff, Inc. Upon Henry's death his stock devolved to his wife, Anna Niedorff (nee Radom, David's sister). David and Anna did not particularly like one another, and shortly after Anna acquired her shares David brought a proceeding for dissolution of the corporation. David (who was president of the corporation) alleged that Anna had been uncooperative with him, had refused to sign his salary checks, and had otherwise caused him countless problems in the operation of

¹²² Why this was so is not entirely clear from the opinion. There is evidence that the relationship between Michael and his father was characterized by occasional conflict. *Id.* at 285, 307 S.E.2d at 556. Furthermore, Michael was unmarried while Ira was married and had two children. Their father's concern that Michael might not marry a Jewish woman, *id.* at 282, 287, 307 S.E.2d at 553, 556, and Ira's greater number of dependents, appear to have been a factors in their father's decision. Another reason might have been that H. B. Meiselman thought Ira was more competent to control the business. But no further evidence is presented to sustain these speculations.

¹²³ *Id.* at 285, 307 S.E.2d at 556. In response to Michael's suit, Ira fired him as an employee of the corporations and terminated his employee fringe benefits. *Id.* at 283, 307 S.E.2d at 554.

¹²⁴ 307 N.Y. I, 119 N.E.2d 563 (1954). This case involved the propriety of dissolution in a deadlock situation.

the business. In addition, he alleged (as grounds for dissolution) that election of directors was impossible because of Anna's refusal to cooperate.

A further example of problems in the family incorporated partnership is provide by *Galler v. Galler*.¹²⁵ Two brothers, Benjamin and Isadore Galler, incorporated a partnership equally owned by them. They became equal shareholders in the new corporation. Thirty years after the corporation was formed (and 35 years after the partnership was formed), they agreed, on their accountant's advice, to enter into an agreement to ensure financial benefits to their immediate families and continued equal control of the corporation by their respective families on their deaths. The undisputed evidence showed that Isadore had, from the inception of the new agreement, no intention of complying with it.¹²⁶ Benjamin died, and Isadore, in fact, did not comply with the agreement, using his control (both practical, since Benjamin was no longer employed in the business, and *de jure*)¹²⁷ to deny Benjamin's widow, Emma, any financial benefits from her stock ownership.

Although the opinions in these cases do not discuss the role of counsel (nor do the opinions indicate whether the parties and the entity were separately represented in corporate matters), they provide an instructive opportunity to examine whether counsel should have undertaken multiple representation of the shareholders.

It should first be noted that in each case, under the Codes, it probably would have been within the bounds of ethical propriety for one lawyer initially to represent the entity (and thus indirectly its shareholders.)¹²⁸ In the cases of *Radom & Niedorff* and *Galler*, the lawyer should have declined multiple representation in the first instance. This is because, as discussed below, each of these cases involved close corporations of the incorporated partnership type in which the parties had equal ownership. *Meiselman*, however, involved a true family corporation. In that case, the lawyer could have undertaken the initial representation because of the presence of a plan of wealth distribution, but should have required the retention of separate counsel for each of the shareholders as soon as their

¹²⁵ 32 Ill.2d 16, 203 N.E.2d 577 (1964). This case involved the propriety of a controlling shareholder depriving a minority shareholder of salary, notwithstanding the existence of an agreement requiring such payments.

¹²⁶ *Id.* at 18, 203 N.E.2d at 580.

¹²⁷ Isadore's *de jure* control came about by his purchase of stock from an employee of the corporation, which stock had been issued to the employee during Benjamin's lifetime. One of the remedies demanded by Emma was the right to buy a *pro rata* portion of those shares.

¹²⁸ In effect at the time of *Radom & Niedorff* and *Galler* were the American Bar Association's Canons of Ethics. Since these are no longer in effect in any jurisdiction, they are not evaluated here.

ownership of any of the entities began to diverge from that initial plan.¹²⁹

Both *Galler* and *Radom & Niedorff* involved separate, though related, families. It should have been perceived at the outset that potential problems could arise. In each case the situation should have been analyzed as a representation of unrelated parties. *Galler* and *Radom & Niedorff* are similar in that, although the shareholders were related, their co-ownership of the business presumably did not arise as a result of their desire to share their individual wealth, but rather as a means of allocating responsibility and risk. Thus the goals of each shareholder would be individual wealth maximization, which would lead to a sharing of corporate wealth only to the extent necessary to achieve this diversification.

Meiselman, however, is different. In *Meiselman*, the brothers' share ownership came about *not* as a result of their father's desire to attract new talent, diversify his risk, or raise additional capital, *but as a means of distributing his wealth*.¹³⁰ The brothers became business "partners" because each of them received an interest in their late father's business by gift and inheritance. Instead of liquidating the business during his lifetime and leaving his sons cash, he left them a capital asset together with the means for continuing their livelihood.¹³¹ Seen in this light, counsel's representation of the shareholders relates to maintenance of the distribution of wealth

¹²⁹ Although it is reasonably clear that upon the occurrence of such conflict counsel should decline to represent either (or any) of the shareholders, B. WUNNICKE, *supra* note 101, there seems to be no reason why such counsel could not continue to represent the "entity" in its business dealings with third parties. Indeed, the same reasoning which compels the conclusion that counsel should not represent any dissenting faction argues strongly in favor of representation of the corporation by independent counsel in such dealings. Resignation of counsel from the representation of any of the shareholders eliminates the problems generated by acquisition of confidential information during the earlier course of her representation of the corporation and its shareholders. However, if counsel continues to represent the corporation in its external business dealings, the corporation will avoid losses resulting from the disappearance of counsel intimately familiar with the corporation's affairs.

¹³⁰ The concurring opinion of Judge Martin in *Meiselman v. Meiselman*, 309 N.C. 279, 313, 315, 307 S.E.2d 551, 571, 573 (1983), clearly recognizes the importance of this fact although it does not fully appreciate its implication with respect to the parties' legitimate expectations. The opinion of Judge Freye, *id.* at 281, 290, 293, 307 S.E.2d at 553, 558, 559, comes closer to appreciating these implications. *Cf.* *Cressy v. Shannon Continental Corp.*, 177 Ind. App. 224, 228, 378 N.E.2d 941, 945 (1978) (with regard to parties' intent and expectations).

¹³¹ *Cf. In re Estate of Riefberg*, 58 N.Y.2d 134, 142, 446 N.E.2d 424, 428, 459 N.Y.S.2d 739, 743 (1983) (holding that buy-sell agreement between shareholders of close corporation requiring corporation to purchase shareholder's shares from his widow was "testamentary substitute"); *Haldeman v. Haldeman*, 176 Ky. 635, 643, 197 S.W. 376, 379-80 (1917) (since term of will dictating management and distribution of corporation had expired, the will "afford[s] no legal standard in determining the rights of [the founder-testator's] children to their property.").

intended by the father. Thus, counsel can be guided by a standard, external to the particular conflict, which defines the scope of the brothers' fiduciary duties to one another. As a result, the brothers' fiduciary obligations to one another, and the ethical duty of counsel to each of them, becomes clear: it is to maintain the distribution of wealth intended by the father.¹³² The problem is as old as the story of Jacob and Esau, but counsel can be guided without divine intervention. As long as none of the shareholders contributes additional capital to the business or provides disproportionate services,¹³³ consistency with the family plan requires proportionate sharing in the corporation's wealth. Put differently, the fiduciary duty of one shareholder to another is determined by the plan of wealth distribution, which establishes the proper allocation of corporate wealth to each of the parties in accordance with their reasonable expectations.¹³⁴

Seen in this light, the true family corporation presents no overwhelming ethical problems for counsel. The plan of control and the balance of corporate wealth is mandated not by agreement or intention of the parties but by the founder's plan for distributing

¹³² Cf. O'Neal, *supra* note 11, recommending this general approach in the substantive context of determining the scope of shareholders' fiduciary duties:

The reasonable expectations of the shareholders, as they exist at the inception of the enterprise, and as they develop thereafter through a course of dealing concurred in by all of them, is perhaps the most reliable guide to a just solution of a dispute among shareholders, at least a dispute among shareholders in the typical close corporation.

Id. at 886. See also Chittur, *supra* note 8, at 170; Hetherington, *Special Characteristics*, *supra* note 8, at 38 n.25; *In re Kemp & Beatley*, 64 N.Y.2d 63, 73, 473 N.E.2d 1173, 1179, 484 N.Y.S.2d 799, 805 (1984) (holding that use of shareholders' "reasonable expectations" in defining oppressive conduct under statute permitting dissolution of corporation for oppressive conduct is appropriate.); cf. S. FITZGIBBON, *supra* note 13, at 11 (charter and by-laws direct lawyers as to how to act for corporate constituents). The presence in the context under discussion of a relatively unambiguous mechanism enabling counsel to determine the proper outcome of a potential disagreement among shareholders similarly is helpful in deciding whether counsel responsibly can discharge his duties to each client. Of course, if one "beneficiary shareholder" explicitly seeks to upset this arrangement, counsel may well be required to resign the multiple representation. See *supra* notes 30-38.

¹³³ These disparities can be dealt with by creating nonvoting securities with a fixed return (which may or may not, depending upon a variety of factors, participate in the residual equity) and paying salaries (pursuant to binding employment agreements) reasonably related to the services performed.

¹³⁴ This concept is hardly radical. It follows logically from the understanding, expressed in *Meiselman v. Meiselman*, 309 N.C. 279, 297, 307 S.E.2d 551, 562 (1983), that the fiduciary duty of shareholders is a flexible concept defined in particular cases by the shareholders' expectations. Cf. O'Neal, *supra* note 11. When applied to the analysis of counsel's ethical duties, it demonstrates that counsel will not be required to choose sides between the parties, at least in a manner inconsistent with their own duties and expectations.

wealth.¹³⁵ Moreover, this factor should not change from one generation to the next; that is, as each of the legatees effects his own plan of wealth distribution. The proportion of corporate wealth due each of the shareholders at any point in time can be determined by tracing through the plan of distribution to the original shareholders.¹³⁶

This is not to suggest that unpleasant and very real internecine conflicts will not develop. Nor does it suggest that the amount of control over the business of the corporation cannot be allocated more heavily in favor of those who are involved in operating the business, or be altered to reflect actual changes in circumstances over time. What it does suggest is that, despite such control, counsel has relatively clear direction as to the proportionate balance of corporate wealth which should nevertheless be maintained.¹³⁷ Thus, it does not appear improper for her initially to undertake multiple representation of the corporation's shareholders. Of course, when conflict becomes tangible she may have to resign the multiple representation, because at that point independence of judgment on behalf of each shareholder client may be impossible.¹³⁸

It is this factor, the origination of the entity with a single ancestor of the shareholders (which is present in *Meiselman*, but not in *Radom & Niedorff* and *Galler*), which suggests that counsel may have sufficient external guidance to undertake and continue the representation of the corporation and its shareholders. The family incorporated partnership, however, appears on analysis to be strikingly similar to the incorporated partnership save for the fact that the shareholders have some relation to one another. A true family corporation may evolve into a family incorporated partnership or an

¹³⁵ At this point it becomes clear that the family corporation is distinctive because the participants are involved primarily because of their relationship to the founder rather than because of their special skills or ability to diversify risk.

¹³⁶ It should be noted that shareholders in an incorporated partnership who have clearly expressed to each other and to counsel the desire to maintain a specific distribution of corporate wealth could appear to be in the same position as the shareholders of a true family corporation. There may be a significant difference, however, in that in the incorporated partnership situation the shareholders will have made an affirmative decision to invest in the corporation rather than, in effect, being given the corporation because of their filial status. It is reasonable in the former case to protect the parties' presumed rights to change their minds or reflect changing circumstances (recognizing, of course, liability for breaches of contract). Consequently, counsel should treat such a corporation under the incorporated partnership model notwithstanding such expressed desires. The proposed rule makes no exception for such a situation.

¹³⁷ Salaries paid to those involved in running the business could become an issue. To the extent that shareholder-employees prefer a greater proportion of their share of the wealth to be distributed in salary, capital structure could be adjusted to account for this.

¹³⁸ Counsel's duties upon resignation are beyond the scope of this Article. *But see supra* note 129.

incorporated partnership. Rarely can a business continue growth and increase profitability without the infusion of external capital and fresh managerial talent.¹³⁹ Whether a close corporation is a true family corporation or a family incorporated partnership will be determined at the time counsel is asked to undertake the representation. If the corporation is a family incorporated partnership, counsel's representation should be analyzed under the incorporated partnership model.

B. The Incorporated Partnership

Cases involving the incorporated partnership are similarly instructive. After examining one case in which the lawyer's conduct was not in question (but should have been), I will discuss several cases dealing specifically with lawyers' conduct. I conclude that multiple representation of the shareholders of an incorporated partnership may be undertaken in any case other than one in which share ownership is equal.

The first example is the famous case of *Lehrman v. Cohen*.¹⁴⁰ N. M. Cohen and Samuel Lehrman incorporated their business, Giant Food, Inc. The corporation was capitalized with two classes of common stock, Class AC stock (owned by the Cohen family) and Class AL stock (owned by the Lehrman family). Each class had the right to elect two of the corporation's four directors.

After Samuel's death, and as a result of disputes among the Lehrman heirs, the Lehrman and Cohen families arranged to consolidate all of the Lehrman family holdings in Samuel's son, Jacob. Because of the possibility of deadlock resulting from equal shareholdings and equal directorships, the two sides agreed to a fifth directorship. The corporation issued a third class of common stock, Class AD stock, to Joseph Danzansky, who had been counsel to the company for the preceding five years. The Class AD stock carried the right to elect one director, but lacked equity participation. Fifteen years later, at a meeting of the stockholders, the Class AC and AD stock, over the objection of the Class AL stock, was voted in favor of making Danzansky president of the company, succeeding N. M. Cohen, with a fifteen year employment contract and a high salary.¹⁴¹

¹³⁹ I am assuming that unrelated executive management of a close corporation will require some compensation in the form of equity. *See, e.g.,* *Galler v. Galler*, 32 Ill.2d 16, 17-18, 203 N.E.2d 577, 579 (1964) (issuance of shares to Rosenberg).

¹⁴⁰ 43 Del. Ch. 222, 222 A.2d 800 (1966).

¹⁴¹ Danzansky's personal conflict of interest in becoming the highly paid and well tenured president of his client is obvious and merits its own diatribe. The reader is spared, however, for the issue is beyond the scope of this Article.

Two other cases, dealing expressly with counsel's conduct, highlight similar problems. *DeLaMaria v. Powell, Goldstein, Frazer & Murphy*¹⁴² was a malpractice suit brought against the defendant law firm and one of its members, John Gornall. DeLaMaria had retained Gornall to help him move a jewelry business from Spain to Atlanta. Apparently at DeLaMaria's request, Gornall recommended to him as a business partner one Hayes who had been a client of Powell, Goldstein. DeLaMaria and Hayes, after agreeing to become equal shareholders in a new corporation organized to own and operate the business, asked Gornall to prepare the corporate papers including "incorporation documents" (presumably including a charter and by-laws), an employment agreement for DeLaMaria and a shareholders' agreement. Subsequently, Hayes volunteered to make an additional contribution to the corporation in the form of a loan, the documentation for which was, at the parties' request, prepared by Gornall.¹⁴³

The corporation did poorly. At a board meeting attended by Gornall, Hayes told DeLaMaria that he would refuse to fund his salary, but that he could continue to work for the corporation on a commission basis. DeLaMaria refused, Hayes left the meeting and Gornall advised DeLaMaria that he would have to seek new counsel.

The court found Gornall deficient in his representation of DeLaMaria in a number of significant respects.¹⁴⁴ However, because this was a malpractice case concerned solely with the care with which Gornall represented DeLaMaria, it did not address the more interesting ethical issue of whether Gornall should have undertaken this multiple representation in the first instance.

A similar case, but one in the nature of a disciplinary hearing, is *In re Brownstein*.¹⁴⁵ In *Brownstein*, Woods, his father and a friend asked Brownstein to organize a corporation in which Woods and his father would each own 35% and a friend would own 30%. Brownstein continued as corporate counsel. As the corporation began to fail, Brownstein introduced Woods to Whitcomb, another of Brownstein's clients who had previously invested in small speculative businesses. Subsequently, Whitcomb agreed to lend money to the corporation and to purchase stock therein. The corporation continued to fail, Brownstein was terminated as corporate counsel, and the corporation defaulted on Whitcomb's loan. Ultimately, Brownstein represented Whitcomb in an action to collect the loan.

¹⁴² 612 F. Supp. 1507 (N.D. Ga. 1985).

¹⁴³ *Id.* at 1509.

¹⁴⁴ Defendants were not held liable to plaintiff, however, since the court could not find Gornall's poor advice to have proximately caused plaintiff's loss.

¹⁴⁵ 288 Or. 83, 602 P.2d 655 (1979).

The court, struck by the fact that Brownstein neither identified who he was representing during the initial negotiations, nor indicated any conflicts which might have existed, laid down the following broad rule for counsel representing a close corporation:

Where a small, closely held corporation is involved, and in the absence of a clear understanding with the corporate movers that the attorney represents solely the corporation and not their individual interests, it is improper for the attorney thereafter to represent a third party whose interests are adverse to those of the stockholders and which arise out of a transaction which the attorney handled for the corporation. . . . *In actuality, the attorney in such a situation represents the corporate owners in their individual capacities as well as the corporation unless other arrangements are clearly made.*¹⁴⁶

This conclusion does not derive from a reading of the Codes nor is it consistently articulated by the courts. I believe, however, that it derives from an appreciation of the substantive law of close corporations¹⁴⁷ and that it is correct. The inconsistency of this decision with others highlights the need for articulated standards.¹⁴⁸ The

¹⁴⁶ *Id.* at 87, 602 P.2d at 657 (emphasis added). See also *In re Bristow*, 301 Or. 194, 721 P.2d 437 (1986); *In re Banks*, 283 Or. 459, 584 P.2d 284 (1978); *Parker v. Frazier (In re Freedom Solar Center, Inc.)*, 42 Bankr. 261 (Bankr. D. Me. 1984); cases cited *supra* notes 5 and 7. But see *In re Kinsey*, 294 Or. 544, 660 P.2d 660 (1983).

¹⁴⁷ See *supra* notes 40-48 and accompanying text.

¹⁴⁸ See cases cited *supra* note 7. The Oregon Supreme Court is the only court which appears to have analyzed systematically the ethical problems of corporate representation in a close corporation. The seminal case is *In re Banks*, 283 Or. 459, 584 P.2d 284 (1978). *Banks* involved a corporation, United Medical Laboratories (UML), owned by Michel, his wife and his two daughters, who together comprised its board of directors. "However, Michel was a completely dominating force and ran the business as his private fief." *Id.* at 461, 584 P.2d at 285. Banks and Thompson, through a law firm in which they were partners, represented the corporation and also performed legal services for individual members of the Michel family. Thompson as part of his duties prepared an employment agreement between Michel and the corporation. "Because of the identity of interests, corporate and private, all legal services were billed to the corporation regardless of whether the work performed was corporate or private." *Id.* Although initially successful, the business began to develop serious financial problems. The Michel's home life also deteriorated, with Michel at various times physically assaulting his wife and one of his daughters. Mrs. Michel and her daughters consulted independent counsel, and also consulted Thompson and Banks (although Thompson continued to counsel Michel as chief executive officer of UML). Mrs. Michel and her daughters organized a voting trust through which they obtained control of the board. Subsequently, Thompson informed Michel that he could no longer represent him. Banks then delivered an opinion to the board that Michel had violated his employment agreement. Finally, after Michel terminated Banks' law firm as counsel for the corporation, Banks and Thompson became stockholders (and Thompson a director) of a competing corporation formed by former employees of UML. The founders requested (and Banks rendered) an opinion regarding the enforceability of the non-competition contracts with UML which Banks' firm had drafted as counsel to UML. The disciplinary proceeding followed.

The court, while recognizing the general rule that counsel to a corporation represents "the entity," *id.* at 469, 584 P.2d at 289-90, found significant the fact that UML was a "family corporation." *Id.* Raising as a question of first impression the issue of whether

question is whether counsel should ever find herself in this position.

Before proceeding to an analysis of these cases in light of the

the entity theory of corporate representation applies to a close corporation, the court said:

At the time the contract was drawn, the individual interests would really dictate what was done because the corporate firm [sic] would be only a method of doing business chosen by the individual for the purpose of promoting his private interests. In such a situation . . . common sense dictates that the corporate entity should be ignored.

Id. at 471, 584 P.2d at 290. Consequently, the court held, it was improper for Banks and Thompson to represent either Michel or the corporation when conflict developed. *Id.* at 473-74, 584 P.2d at 292. This holding was further refined by the court in *In re Brownstein*, 288 Or. 83, 602 P.2d 655 (1979). See *supra* note 145 and accompanying text.

In re Kinsey, 294 Or. 544, 660 P.2d 660 (1983), involved the question of whether counsel could take sides in a derivative action brought by a minority shareholder-director against the controlling shareholder-directors. Kim Lundgren and his friend, F. R. Klinicki, formed a corporation to operate an air taxi service in Berlin. Each owned one third of the corporations' shares, and Lundgren's father Leonard owned another third. Kinsey, who had previously represented Leonard Lundgren, was retained (with Klinicki's consent) to represent the corporation. The board of directors was composed of the two Lundgrens, Kim Lundgren's wife, Klinicki, and Kinsey. The corporation, Berlinair, Inc. ("Berlinair"), applied for rights to an air route between Berlin and Saarbrücken. The parties discussed the possibility of using a new corporation to pursue this application, and Klinicki made clear his desire for *pro rata* ownership in that corporation. Subsequently, the Lundgrens advised Kinsey that Kim and Klinicki had had a falling out, and asked his advice in separating their business interests from those of Klinicki. Kinsey organized Air Berlin Charter Co. ("ABC") as a vehicle for the Lundgrens without informing Klinicki. Subsequently, Klinicki initiated a derivative suit against Kim Lundgren, Berlinair, and ABC, alleging deprivation of a corporate opportunity. Kinsey continued to represent the corporations and the Lundgrens. The disciplinary proceeding followed.

The court first held that Kinsey was justified initially in accepting employment by both the Lundgrens and Berlinair since there was "no substantial reason" for him to believe that doing so "would give rise to any conflict between these clients. . . ." *Kinsey*, 294 Or. at 554, 660 P.2d at 665. Nevertheless, he clearly acted improperly in agreeing to form ABC and advising the Lundgrens with respect to it while also representing Berlinair, and in continuing to represent the Lundgrens and Berlinair after commencement of the derivative suit. *Id.* at 555, 660 P.2d at 666. "Simply stated, in a derivative suit a minority shareholder places himself in the shoes of the corporation to enforce a corporate right, and the interests of the plaintiff-shareholder and the corporate defendant become merged." *Id.* The court distinguished the holding in *Brownstein*, 288 Or. 83, 602 P.2d 655, that counsel to a close corporation in reality represents the shareholders of the corporation, and limited it to situations "where the controlling stockholder [is] the corporation." *In re Kinsey*, 294 Or. at 562-63 n.10, 660 P.2d at 670 n.10. In the case of a close corporation with a minority shareholder such as Klinicki, said the court, the standard ethical precept that counsel represents the entity is applicable. *Id.* Cf. *In re Bristow*, 301 Or. 194, 721 P.2d 437 (1986) (stating that on the facts of that case, the only position the lawyer could ethically take was to represent neither of the two competing factions); *In re Brandsness*, 299 Or. 420, 427-28, 702 P.2d 1098, 1103 (1985) (affirming that "*Banks* stands for the proposition that a closely-held corporation and its dominating alter-ego President are so closely identified so as to preclude a lawyer who represents the corporation from appearing against the president," but further stating that this does not necessarily mean that such a lawyer could represent the president against a non-dominant shareholder.). Thus, although the *Banks* rule does not go as far as the broad dictum in *Brownstein*, its limits are not clearly defined. Obviously, I am disappointed that *Brownstein* is not clearly the generally applicable rule.

typology, it is useful to reexamine the peculiar problems of close corporations. The most intractable problem is that there is no way out; that is, no market for the shares exists, even if transfer is not restricted by law or by charter, by-laws, or contract. Absent a voting agreement or super-majority voting provisions (and sometimes even where such devices are present), the minority shareholder is subject to the will of the majority. The majority, therefore, has the power to restrict distributions of the corporation's income and even to make investment decisions for the minority (by sale of assets, merger or consolidation).¹⁴⁹

All is not bleak, however, for the minority shareholder. The controlling shareholders have a legal obligation to deal fairly with him. More specifically, as shareholders (and as officers and directors, which they typically are), the controlling interests owe a fiduciary obligation to the minority shareholders.¹⁵⁰ The minority shareholder, in accepting a minority position, entrusts the majority with his financial well-being. But some rules, albeit flexible,¹⁵¹ exist to guide the controlling interests in satisfying that trust.

What happens, however, when several shareholders (or cohesive shareholder groups) have approximately equal rights to control the corporation (whether by contract or stock ownership) and relatively equal rights to share in the corporate wealth? Where relatively equal interests exist that have roughly equal claims on corporate wealth and machinery, a different problem arises. None of these parties is likely to entrust the management of their investment to another.¹⁵² Moreover, the laws governing their obligations

¹⁴⁹ For a more thorough examination of the point discussed in this paragraph, see Hetherington & Dooley, *supra* note 39.

¹⁵⁰ I will spare the reader yet another quotation of Cardozo's broad dictum in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928). However, the fiduciary duty of joint venturers described therein has been attributed to controlling shareholders in close corporations. *Galler v. Galler*, 32 Ill.2d 16, 203 N.E.2d 577 (1965); *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975). In *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957), the court reversed a dismissal of summary judgment in favor of a minority shareholder for, among other things, the right to approve certain organic transactions which would otherwise be effected at the majority's will. In addition to finding that the "controlling" minority had a fiduciary obligation to the majority, the court emphasized that the minority shareholder's legal training, together with the fact that he drafted the agreements in question, imposed on the minority shareholder a "special duty" to the majority approaching that of an attorney to his client. *Helms*, 249 F.2d at 488.

¹⁵¹ See *supra* notes 28-31 and 52-59 and accompanying text.

¹⁵² Of course when a relatively equal shareholder actually does entrust his investment to another, the managing shareholder assumes greater fiduciary duties. Cf. *Meinhard*, 249 N.Y. 458, 164 N.E. 545 (asserting this purposition with respect to joint ventures). Such a case is not dealt with under the proposed rule, because even in such a case it would be extraordinary for the passive shareholder to relinquish his voting rights and other rights of stock ownership.

to one another are not entirely clear. It is here, it seems, that the potential for deadlock and insoluble conflict is greatest. The likely resolution in such cases is not through the law, but through negotiation between equals.¹⁵³

This is a point worth noting. Commentators generally have assumed that, because those in control generally are capable of taking advantage of the minority through the corporate machinery, a close corporation in which unequal interests exist presents the greatest potential conflict for counsel. Conversely, equal ownership is said to be less problematic because of the equal bargaining strength of the parties. Thus, Professor Hetherington observes (with respect to the organizational stage):

Where only two parties are involved [in organizing a close corporation] and each takes half of the stock, the lawyer's silence [in failing to point out potential conflicts] may be less of a disservice [than where minority interests exist], since their equal bargaining positions may permit the parties to arrive at a fair ad hoc settlement should difficulties arise. On the other hand, where there is to be a minority stock interest, or where there are more than two parties, the situation is more difficult.¹⁵⁴

This conclusion is based on the correct (and in my view, determinative) assumption that the proportionate shareholdings of the parties is relevant to the duties of counsel. However, by focusing on the parties' equal strength it risks emphasizing their negotiating position to the exclusion of counsel's obligations to each of them.¹⁵⁵ In the case of unequal ownership, at points of conflict 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.¹⁵⁶ In the case of equal (or practically equal) owner-

¹⁵³ Cf. Hetherington & Dooley, *supra* note 39, at 27 (arguing that shareholders in close corporations sue for dissolution, not to effect a termination of the business, but rather to acquire a bargaining chip in negotiations for control).

¹⁵⁴ Hetherington, *Special Characteristics*, *supra* note 8, at 17 (Professor Hetherington makes this statement in the context of a discussion of counsel's disincentives to point out potential intrashareholder conflicts to the shareholders of a close corporation). See *supra* note 85. See also S. FITZGIBBON, *supra* note 13, at 13.

¹⁵⁵ Cf. Hazard, *supra* note 33, at 34, for the proposition that the "formation of corporate ventures" involves an arms-length bargaining process in which separate representation is more appropriate.

¹⁵⁶ It may be objected that this would put counsel in an untenable position *vis-a-vis* the majority on whom she depends for employment. In my experience this simply is not the case. Clients, although perhaps reluctantly, accept counsel's advising them with respect to a minority interest because they recognize that such counseling arises out of a concern for their long-term legal well-being. Cf. Patterson, *supra* note 3, at 48 ("the client's rights and duties determine the lawyer's rights and duties") and 64 ("From a legal standpoint . . . the idea that the lawyer has a duty to conform to client's duties is commonly accepted. The lawyer's failure to do so when it causes harm to the client is grounds for a malpractice action."); Hazard, *supra* note 33, at 32 ("In consultations relat-

ship, however, counsel will be caught directly between equally valid claims. Fairness in such a situation will be significantly more difficult to determine. Almost any resolution of the conflict will harm one of the competing shareholders or groups. Moreover, each of the equal sides will expect counsel to assist in obtaining the advantage sought by it. Therefore, it seems that the better approach would be to permit multiple representation of shareholders in an incorporated partnership only when ownership shares are *not* equal.

The situation of counsel in *Lehrman* and *DeLaMaria* illustrates this point. Even to the extent that counsel assiduously has maintained an equal balance in the drafting of corporate documents allocating control, the lawyer is literally caught in the middle when tangible conflicts arise. In the *Lehrman* case in particular, Danzansky's acceptance of the Class AD stock and election to the fifth directorship ensured that he would be required to take sides in the event of disagreement. This is obviously inappropriate where neither side is represented separately by counsel, for each side will expect that corporate counsel is protecting its interest. It might be argued that in agreeing to the deadlock-breaking device, each of the Class AL and AC stockholders should have recognized that they might be disfavored in a conflict, and that such recognition or constructive recognition was evidence that they did not expect counsel always to take their side. But human nature is such that this may not have been the case, and if it was, it may have been forgotten over time. The point is that corporate counsel's active participation in such a conflict is unseemly and should not be permitted.

Put differently, the parties' consent will never truly be informed unless they anticipate specific, tangible conflict. And in such a situation, counsel is unlikely to provide clear, unbiased advice to each participant unless guidelines external to the conflict (such as the will of the founder in the true family corporation) exist. The conflict is further exacerbated by the equal claim each party has to the corporate wealth. Counsel has a professional duty to avoid being trapped in such a situation.

Brownstein and *DeLaMaria* suggest additional factors to be considered which could tip the balance in unclear situations. One is in the introduction of a prospective business "partner" by counsel. In each case, counsel had previously represented the new partner, while the corporate founder was a new client. This suggests an ini-

ing to the representation, the interests of the third party . . . [to whom the client owes a fiduciary duty] are always in contemplation Because the lawyer *can* interpret what is being done in the same way a court would, the law expects the lawyer *will* in fact have done that, and accordingly assess whether the requisite care and bona fides have been manifested.").

tial allocation of loyalties which should counsel against multiple representation (for if the business fails and the new client goes away, counsel will still have a relationship with the preexisting client).¹⁵⁷

Another factor presented by these cases is the unequal sophistication of each client. In both *Brownstein* and *DeLaMaria*, the investor introduced by counsel was known to have invested previously in similar situations. This factor is highlighted in the case of a venture capital syndicate making a portfolio investment. The venture capital group is in the business of investing in close corporations. The founders typically are creative or scientific types who may previously have worked in business but who are not likely to be skilled or experienced in financial and legal matters. As a consequence of this unequal relationship, the more sophisticated investors may assume greater fiduciary duties which will factor into counsel's advice.¹⁵⁸

The one situation in which equal ownership may be less problematic is where one of the competing interests owns preferred stock (whether or not it has voting rights) or other securities (such as convertible debt) with clearly defined rights. In this situation, the need for individual or class representation is diminished because, as in the case of the true family corporation, the participants' rights to the corporate wealth are relatively clear.¹⁵⁹ This clarity is provided by negotiated charter provisions or other contracts which detail preemptive rights, antidilution, return on investment (in the form of fixed dividends), liquidation preferences, and redemption rights. Even more than in the majority-minority case, in this type of equal ownership the obligations of one class of shareholders (the common shareholders, who generally will manage the business) to the other (the preferred shareholders) are relatively clear, and the advice to be given by counsel is expressly circumscribed by the instruments. Thus, multiple representation subsequent to the initial investment should not be prohibited.¹⁶⁰

¹⁵⁷ See *supra* notes 34, 62 and 96.

¹⁵⁸ See *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957).

¹⁵⁹ This exception loses strength where the preferred stockholders have voting rights equal to the common stockholders and participation rights in the residual equity which would make the situation more closely analogous to the equally-owned incorporated partnership.

¹⁶⁰ Of course this suggests the need for separate representation at the time of investment, when the rights and obligations of the parties are first negotiated. Cf. *Hazard*, *supra* note 33, at 33-35. Thereafter, however, the relationship is more self-operating and should not require the participation of separate counsel. It should be noted too, that the opportunity for counsel familiar with the relationship (i.e., counsel who represented the preferred shareholders in negotiating their investment) to participate in the resolution of a matured conflict serves as an alternative in the event the joint representation becomes problematic.

IV

A PROPOSED RULE OF ETHICS FOR CLOSE CORPORATIONS

Having developed the typology and examined some factual situations within that framework, I shall now propose a rule of ethics governing close corporations. The need for the rule is clear. Consideration of the substantive law governing the relationships among shareholders of close corporations should put to rest the frequently asked question of who the client is. The client is, for purposes of such relationships, the individual shareholders. The Codes have entirely missed the boat by ignoring this fact (in the case of the CPR) and by treating it as exceptional (in the case of the MRPC).

In reality, absent individual representation for each shareholder (or for each cohesive group of shareholders) by independent counsel, counsel for the close corporation must assume that she owes the same professional responsibility to each shareholder and, indeed, that she represents each shareholder with respect to corporate affairs. Proceeding from this conclusion, the rule I propose is designed to guide counsel by using the factors adduced in constructing the typology and applying them to reported factual situations. In other words, the rule is designed to tell counsel when conflicts exist which make multiple representation inappropriate.¹⁶¹

THE RULE

Where counsel is asked to organize or represent a corporation which, under the relevant laws of the state of organization of such corporation, is considered to be close corporation (which includes, where required, situations in which the promoters or shareholders elect to be so treated), counsel must recognize that his or her clients include both the entity itself and, unless counsel is instructed to the contrary, each of the shareholders of the corporation in their dealings with one another. In such a situation, counsel may also represent the corporate entity in its external business dealings if the proportion of shareholders required to elect directors under the laws of the state of incorporation have consented thereto.¹⁶² He or

¹⁶¹ The rule is drafted in the form of a presumption. This is primarily to take account of those situations, as in the disqualification cases noted *supra* note 148, where a current or former shareholder (who may nevertheless be separately represented) asserts that corporate counsel is *his* counsel for the purpose of disadvantaging the corporation and its shareholders, even though the facts suggest that the parties have disavowed this. Thus, the presumption may be rebutted by the introduction of evidence which proves that neither counsel nor the movant considered or expected, at the time the movant was a shareholder, that counsel represented the movant.

¹⁶² Although shareholder approval generally is not required for the retention of counsel, where such counsel will also represent one or more shareholders the additional caution of shareholder approval is appropriate. The proportion required to elect direc-

she may not represent more than one of the shareholders individually with respect to matters involving the corporation unless:

A. (1) each of the shareholders consents to such representation¹⁶³ after counsel informs them of the possible dangers of multiple representation; and

(2) each of the shareholders has been given or inherited their shares directly or indirectly from the original sole shareholder of the corporation; or

(3) the capital structure (or proposed capital structure of the corporation is such that

(a) a majority of the voting power and equity of the corporation is owned by one shareholder and

(b) if more than one class of equity security is issued (or to be issued),

(i) a majority¹⁶⁴ of the common stock of the corporation is owned by one shareholder,

(ii) no class of stock has greater voting rights than the common stock, and

(iii) all classes of stock other than common stock have clearly defined rights, preferences, dividends, and obligations which are set forth in the certificate of incorporation, corporate by-laws, agreements among the shareholders, or any combination of the foregoing; and any person acquiring stock other than common stock is independently represented by counsel when making that acquisition; *provided* that the holders of securities other than common stock do not, in the aggregate, have voting power or equity participation equal to that of the common stock.

B. Where representation of multiple shareholders of a corporation has been undertaken in accordance with subsection (A), counsel ordinarily may not continue such representation of multiple shareholders:

(1) when any such a shareholder notifies counsel that he or she no longer desires that counsel represent him or her;

(2) at such point as the circumstances described in subsection (A) no longer exist; or

(3) at such point as counsel's ability to represent the interests of any shareholder otherwise is compromised.

C. If counsel undertakes the representation of multiple shareholders pursuant to, and in accordance with, this rule, he or she

tors has been selected because of the similar fiduciary relationship of counsel to the corporation.

¹⁶³ It is here that difficult questions of informed consent arise. See *supra* note 84 and accompanying text.

¹⁶⁴ The requirement of a majority draws an arbitrary line and not necessarily in the best place. Query whether a 49% shareholder has the same legitimate expectations as a 51% shareholder. However, my argument suggests that a line needs to be drawn and, for purposes of analysis, placing it at a majority is at least rational.

will be presumed to have undertaken such responsibilities in an ethical manner and without diminishing his or her responsibilities to the corporation and each of its shareholders.

D. For purposes of this rule the term "person" includes any entity. The term "shareholder" includes any "person" and the terms "shareholder" and "person" include a "group of shareholders" or "group of persons." The terms "group of shareholders" and "group of persons" mean two or more persons who own shares in the corporation or intend or expect to own such shares and who have entered into a binding agreement which sets forth the terms upon which they will exercise the voting power of such shares, purchase additional shares, and dispose of their interests in such shares.¹⁶⁵

CONCLUSION

The rule I propose fills the void left by the CPR, which looks no further than the presumed ability of a lawyer to exercise her professional judgment on behalf of each client,¹⁶⁶ and the MRPC, which offers no assistance beyond the lawyer's reasonable belief as to whether multiple representation will adversely affect the interests of each client.¹⁶⁷ These standards, as noted earlier, give no particular guidance to close corporation counsel. This is somewhat understandable, in that they currently function as exceptions to the specific rules governing entity representation (EC 5-18, in the case of the CPR, and Rule 1.13 in the case of the MRPC). In the case of close corporations, the circumstances contemplated by the exceptions have become the rules. It is, therefore, appropriate to give counsel greater guidance with respect to a situation that she can reasonably expect to encounter frequently.

I recognize that this rule is not perfect. In particular, the lines it draws may be too bright, and therefore may occasionally result in the unnecessary proliferation of legal fees resulting from the retention of separate counsel. It may be particularly problematic in smaller communities.¹⁶⁸ In addition, it ignores problems of coun-

¹⁶⁵ A different, but equally defensible, approach might be to define "group" in a manner similar to the Securities and Exchange Commission's definition of "affiliate" as "a person that directly or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified." 17 C.F.R. § 230.405 (1988).

¹⁶⁶ See *supra* note 14 and accompanying text.

¹⁶⁷ See *supra* notes 4-15 and accompanying text.

¹⁶⁸ The answer of the court in *In re Jans*, 295 Or. 289, 666 P.2d 830 (1983) is persuasive in recognizing the irrelevance of the fact that the maintenance of ethical standards may be inconvenient:

We are fully aware that this unyielding rule may raise concerns, particularly in smaller towns where two clients of the same lawyer, with conflicting interests, often request the lawyer to serve each of them regarding a

seling where the activities of directors or officers, independent of their roles as shareholders, present conflict of interest problems.¹⁶⁹ Nonetheless, the rule does attempt to address a problem too often shrugged off as insoluble by the legal community, and relegated to exceptional status by the drafters of the Codes. It recognizes that the substantive law necessitates a rethinking of entity representation in the close corporation context, and it attempts to provide some uniform guidelines for counsel in determining the propriety of her actions in such situations.

transaction between them. There cannot be an exception for small towns.

Id. at 295 n.7, 666 P.2d at 833 n.7.

¹⁶⁹ Such a situation might arise, for example, in counseling a divided board with respect to the unlawful payment of dividends where the directors are jointly and severally liable. DEL. CODE ANN. tit. 8, § 174 (1967).