APPLICATION OF THE ATTORNEY-CLIENT PRIVILEGE TO DISPUTES BETWEEN OWNERS AND MANAGERS OF CLOSELY-HELD ENTITIES

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INTRODUCTION

The attorney-client privilege is an evidentiary privilege. It protects communications made in confidence by a client to his attorney for the purpose of obtaining legal advice from disclosure in judicial proceedings.[1] The privilege encourages a client to confide fully in his attorney by removing any risk of unauthorized disclosure of such communications. One reason for the privilege is the belief that full and open discussions between a client and his attorney will produce a more effective legal system and will benefit society.[2] Another justification is that a client has an expectation of privacy when dealing with his attorney.[3]

The attorney-client privilege is not unqualified; it may be waived by the client.[4] Also, the courts have tailored certain exceptions where the justifications for the privilege are outweighed by the potential harm to society that may result from a failure to disclose the confidential information.[5]

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1. The attorney-client privilege is the oldest of the privileges for confidential communications known to the common law. 8 JOHN HENRY WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW § 2290 (McNaughton rev. 1961). The privilege acknowledges that responsible legal counsel or advocacy best serves public ends when a client completely informs his attorney. Upjohn Co. v. United States, 449 U.S. 383, 389 (1981).

2. Brian R. Hood, Comment, *The Attorney-Client Privilege and a Revised Rule 1.6: Permitting Limited Disclosure After the Death of the Client*, 7 GEO. J. LEGAL ETHICS 741, 749 (1994).

3. *See* Jonathan Rose, *E-Mail Security Risks: Taking Hacks at the Attorney-Client Privilege*, 23 RUTGERS COMPUTER & TECH. L.J. 179, 183 (1997) (detailing a client's purpose for communicating with his attorney).

4. *Id.* at 187.

5. *See, e.g.*, Clark v. United States, 289 U.S. 1, 15 (1933) (summarizing the crime-fraud exception to the attorney-client privilege by stating, "[t]here is a privilege protecting communications between attorney and client. The privilege takes flight if the relation is abused. A client who consults an attorney for advice that will serve him in the commission of a fraud will have no help from the law. He must let the truth be told"); United States v. Zolin, 491 U.S. 554, 558 (1989) (addressing the crime-fraud exception with respect to sealed tax documents); Garner v. Wolfinbarger, 430 F.2d 1093, 1103-04

Interesting issues have arisen concerning the extent of protection afforded communications made by a corporation to its attorney. The rules of professional conduct require that attorneys respect confidences.[6] Furthermore, the law of attorney-client privilege provides that the corporate entity is the client and, as the client, may invoke or waive the privilege.[7] However, because the corporation must communicate through individuals, the courts have had to determine which individuals should be considered representatives of the corporation. In *Upjohn Co. v. United States*,[8] the United States Supreme Court held that if corporate employees communicate confidentially to an attorney on the corporation's behalf as directed by the employees' superiors in order to obtain legal advice for the corporation, then the employees' communication would be protected.[9]

Therefore, in representing a corporation, the attorney's client is the corporation, not its directors, officers or shareholders. However, confidential communications made by those corporate representatives to the corporation's attorney may be privileged. Likewise, the attorney for a limited liability company, or any other entity, represents the

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(5th Cir. 1970) (stating that shareholders could overcome corporate management's claim of attorney-client privilege by demonstrating "good cause" why the corporation should not be permitted to assert the privilege).

6. *See* MODEL RULES OF PROFESSIONAL CONDUCT pmbl. (1994) (stating that attorneys need to keep in confidence information which relates to representing a client). The relevant text of Model Rule 1.13 reads as follows:

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

MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(a) (1994).

The relevant text of the Restatement (Third) Governing Lawyers reads as follows:

"When the client is not an individual but a corporation or other organization, it may be necessary to consider the organization's internal structure and the law governing it to determine whether someone with authority to speak for the organization has communicated its intent that a lawyer represent it." RESTATEMENT (THIRD) GOVERNING LAWYERS § 26 cmt. f (Tentative Draft No. 5, 1992).

7. *See, e.g.*, Commodity Futures Trading Comm. v. Weintraub, 471 U.S. 343, 348 (1985) (observing that "for solvent corporations, the power to waive the corporate attorney-client privilege rests with the corporation's management and is normally exercised by its officers and directors"); Tail of the Pup, Inc. v. Webb, 528 So. 2d 506, 506-07 (Fla. Dist. Ct. App. 1988) (stating that even though an individual shareholder was also an officer and a director, he had no authority to waive or assert the privilege against the board of directors' wishes).

8. 449 U.S. 383 (1980).

9. Upjohn Co. v. United States, 449 U.S. 383, 394-98 (1980). Previously, those corporate individuals capable of possessing an identity analogous to the corporation as a whole were deemed to be the "control group" and typically would be the senior management who guides and integrates the corporation. Communications with members of this category would meet the "control group" test, but communications with those outside it would not qualify for the privilege. The Court determined that using the "control group" test foiled the privilege's purpose by discouraging the client's employee from communicating relevant information to the attorney representing the client corporation. *Upjohn Co.*, 449 U.S. at 390-92.

entity and not its members.[10] However, as in the case of a corporation, certain communications by members or managers of the limited liability company, or other entity, to its attorney may be privileged. The "entity is the client" rule refers to the view that the attorney-client privilege rests specifically with the entity itself. Thus, an artificial being, the entity, not its managers, owners or employees, has the right to the privilege and may invoke or waive it. Consequently, whether the dispute is between shareholders and management in the corporate setting or between members and managers of a limited liability company, confidential communications to the entity's attorneys are privileged. These communications are not subject to discovery by the shareholder or member complaining about corporate mismanagement or misconduct, unless the privilege is waived by the entity.

Some courts have determined that when a dispute arises in a closely-held corporation, the "entity is the client" rule should not be followed.[11] The courts have held that the attorney represents the entire board of directors and, therefore, when the dispute is between a director who is a shareholder and another director/shareholder, the attorney-client privilege does not apply.[12] Some commentators have argued for a more broad-based piercing of the privilege in closely-held entities. They contend that in the closely-held corporation the attorney represents all the shareholders and, therefore, there is no confidential information that should be protected in any dispute between management and shareholders, whether or not the shareholders are also directors.[13]

In addition, even with respect to publicly-held corporations, an exception to the attorney-client privilege exists in shareholder derivative suits.[14] This so-called fiduciary exception to the attorney-client privi-

10. The limited liability company ("LLC") is a business entity which combines attractive attributes of both the partnership and the corporation. As such, it can provide significant advantages over both limited partnerships and S corporations. Taxed as a partnership, the LLC offers flow-through tax treatment to its owner-members and managers while still protecting them from personal liability for the entity's obligations. Furthermore, unlike limited partners, LLC members can participate in managing the entity without jeopardizing their limited liability protection. Finally, because the LLC avoids many of the burdens placed on S corporations by federal law, the LLC offers significant income tax advantages over the S Corporation.

11. Moore Bus. Forms, Inc. v. Cordant Holdings Corp., No. Civ. A. 13911, 14595, 1996 WL 307444, at *4 (Del. Ch. June 4, 1996).

12. *See Moore*, 1996 WL 307444, at *6 (holding that the board of directors was the client and, absent an agreement to the contrary, there was no distinction among directors as to who was entitled to information).

13. *See, e.g.*, Note, *An Expectations Approach to Client Identity*, 106 HARV. L. REV. 687, 689 (1993) (observing that the "entity as client" rule is appropriate between a publicly-held corporation and its attorney, but when a closely-held corporation is involved this rule is more questionable).

14. *Garner*, 430 F.2d at 1103-04.

lege makes communications between a corporation's management and its attorneys discoverable in shareholder suits that charge a breach of fiduciary duty, if the shareholder can convince the court that good cause exists to disclose the communications.[15] Finally, the crime-fraud exception to attorney-client privilege has been applied, on occasion, to disputes in closely-held corporations, when the complaining shareholder can convince the court that the contemplated actions of the defendant directors, officers, employees or other shareholders will constitute fraud.[16]

Notwithstanding these cases and commentary, in most instances, a shareholder in a closely-held corporation who has brought suit against the management of the corporation and seeks to discover communications between the corporation and its attorney will be precluded from obtaining such information. Typically, the court will follow the "entity is the client" rule and deem the entity's communications with its attorney privileged, unless waived.[17] Corporate management controls the corporation's decision-making with respect to all matters, including whether or not to assert the attorney-client privilege.[18] Management, who typically are the defendants, will not waive the privilege, and the complaining shareholder will not receive the requested communications.

This Article suggests an alternative analysis of the attorney-client privilege to apply to disputes in closely-held corporations, limited

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15. *Id.* In determining whether to pierce the attorney-client privilege in a derivative action, the Fifth Circuit listed nine factors to measure "good cause":

> the number of shareholders and the percentage of stock they represent; the bona fides of the shareholders; the nature of the shareholders' claim and whether it is obviously colorable; the apparent necessity or desirability of the shareholders having the information, and the availability of it from other sources; whether, if the shareholders' claim is of wrongful action by the corporation, it is of action criminal, or illegal but not criminal, or of doubtful legality; whether the communication related to past or to prospective action; whether the communication is of advice concerning the litigation itself; the extent to which the communication is identified versus the extent to which the shareholders are blindly fishing; [and] the risk of revelation of trade secrets . . . .

Id. at 1104.

16. *See supra* note 4.

17. *See* Hoiles v. Superior Court, 157 Cal. App. 3d 1192, 1197, 1201 (1984) (deciding that the corporation could raise the attorney-client privilege against a minority shareholder/director who had filed suit for breach of fiduciary duty and dissolution of the corporation).

18. *See* REVISED MODEL BUS. CORP. ACT [hereinafter R.M.B.C.A.] § 8.01 (1984) (discussing who shall exercise the corporate powers). Section 8.01 provides, in part:

> (a) Except as provided in section 7.32, each corporation must have a board of directors.
>
> (b) All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any litigation set forth in the articles of incorporation or in an agreement authorized under section 7.32.

R.M.B.C.A. § 8.01.

liability companies, and other closely-held entities. In many instances this analysis would result in piercing the privilege with respect to communications between management and the attorney for the closely-held entity. This analysis continues to treat the entity, whether a corporation, a limited liability company, or a partnership, as the client so that present law with respect to attorney disqualification and attorney's duties to shareholders, members, and individual partners would not be changed. This analysis focuses on who should be entitled to assert or waive the privilege for the closely-held corporation, limited liability company or partnership. Consequently, in many cases, it will be unnecessary for courts to address whether the crime-fraud or fiduciary exception to the attorney-client privilege is applicable.

TRADITIONAL APPROACHES

In *Hoiles v. Superior Court*,[19] the California Court of Appeals for the Fourth District followed the traditional approach in addressing the applicability of the attorney-client privilege in the context of a dispute between a shareholder and managers in a closely-held corporation.[20] Harry Hoiles was a director and minority shareholder of Freedom Newspapers, Inc.[21] As a result of Hoiles' threatened dissolution of the corporation, Hoiles' brother and sister, their families, and various other officers of the company held a series of meetings with the corporation's long-time corporate attorney.[22] Hoiles brought suit for breach of fiduciary duty by the other directors and for dissolution of the corporation.[23] During the discovery process, Hoiles sought information and documents concerning these meetings, but the corporate attorney invoked the attorney-client privilege on behalf of the corporation.[24] The lower court held that the privilege applied.[25] On appeal, Hoiles argued that (1) a closely held corporation has no attorney-client privilege regarding communications by some owners when these communications are sought by other owners; (2) a closely -held corporation's privilege does not protect the attorney's communications with officers, directors, and shareholders; and (3) as a director, Hoiles was entitled to question the corporate attorney.[26]

19. 157 Cal. App. 3d 1192 (1984).
20. Hoiles v. Superior Court, 157 Cal. App. 3d 1192, 1198 (1984).
21. *Hoiles*, 157 Cal. App. 3d at 1195.
22. *Id.* at 1196. Hoiles' brother, sister, and their adult family members were all shareholders and were either directors, officers, or spouses of directors or officers. *Id.*
23. *Id.* at 1195.
24. *Id.* at 1197.
25. *Id.* at 1195.
26. *Id.* at 1197. Additionally, Hoiles argued that the "fraud exception" to the attorney-client privilege applied. *Id.*

With respect to Hoiles' first two arguments, the appellate court held that California law clearly stated that the entity was entitled to the privilege and there was no exception for closely-held corporations.[27] With respect to Hoiles' third argument, the court stated that Hoiles brought suit not as a director, but as a shareholder.[28] The court indicated, however, that even if Hoiles had brought suit as a director, he would have been entitled to inspect only those corporate books and records that were unrelated to the substance of the suit brought against management.[29]

The *Hoiles* case is consistent with the entity principle of the MODEL RULES OF PROFESSIONAL CONDUCT ("Model Rules"). The Model Rules state that the attorney's client is the corporation and not its officers, directors, or shareholders.[30] The "entity is the client" concept of the Model Rules is based on the agency principle that the attorney is the agent of the employing organization and is professionally responsible to the organization, not to the employing organization's owners or agents.

The traditional approach of *Hoiles* has since been questioned. In *Milroy v. Hanson*,[31] Michael Milroy was a director and minority shareholder of Sixth Street Food Stores ("Sixth Street"), a closely-held Nebraska corporation.[32] For many years, Milroy owned approximately thirty percent of Sixth Street's common stock, with the remaining shares divided equally between John and Jerry Hanson.[33] Several years prior to Milroy's lawsuit, each of the Hansons sold stock to his respective son, so that each son then owned one percent of the common stock outstanding.[34]

After the sons became shareholders, the Hanson group offered to buy Milroy's shares but Milroy refused.[35] Milroy alleged that it was at this point that the Hansons began their efforts to "freeze" him out of his shareholder benefits.[36] He asked the court for both injunctive relief and monetary damages.[37]

In conjunction with his suit, Milroy sought, via discovery, to obtain several documents that were in the possession of Sixth Street's

27. *Id.* at 1198-99.
28. *Id.* at 1201-02.
29. *Id.*
30. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13.
31. 875 F. Supp. 646 (D. Neb. 1995).
32. Milroy v. Hanson, 875 F. Supp. 646, 647 (D. Neb. 1995).
33. Memorandum and Order at 2, Milroy v. Hanson, No. 4-94-3012 (D. Neb. Nov. 3, 1994).
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.* at 4.

attorneys.[38] The attorneys refused to produce the requested documents, asserting attorney-client privilege.[39] After being denied his documents, Milroy filed a motion to compel.[40] In response to this action, Sixth Street sought a protective order.[41]

Magistrate Judge David Piester held that Milroy, "as a director of Sixth Street, is part of the collective corporate 'client' who holds and controls the corporation's attorney-client privilege, and thus the privilege cannot be invoked against him as it could against an outsider."[42] This analysis is similar to the treatment afforded communications among parties who engage a single attorney to advise them with respect to forming a business entity. In such a situation, parties are considered co-clients and, unless otherwise agreed, it is questionable whether a privilege exists with respect to communications between the parties and the attorney during the formation stage.[43] However, Magistrate Piester's analysis is more limited than the co-client scenario because it allows only individuals who are directors or shareholder/directors of the closely-held corporation to pierce the privilege and obtain confidential communications between other directors, officers, employees, and shareholders of a closely-held corporation and its attorney. Under Magistrate Piester's analysis, the attorney-client privilege in the closely-held corporation can be asserted successfully against a complaining shareholder who is not also a director. Likewise, Magistrate Piester's analysis, as applied to a limited liability company, appears to allow complaining managers or member-managers to obtain confidential communications between other managers and the company attorney, but would not apply to a complaining non-manager member who seeks confidential communications between the managers and the company attorney.

Magistrate Piester's analysis provides less opportunity for piercing the privilege than does the expectation analysis of some commentators.[44] One commentator argued that shareholders in a closely-held

38. *Milroy*, 875 F. Supp. at 647.
39. *Id.*
40. *Id.*
41. *Id.*
42. Memorandum and Order at 26, *Milroy*, (No. 4-94-3012).
43. *See* RESTATEMENT (THIRD) GOVERNING LAWYERS § 26 cmt. f (Tentative Draft No. 5, 1992) (discussing some of the necessary considerations for an attorney in helping form a corporation).
44. *See* Note, *An Expectations Approach to Client Identity*, 106 HARV. L. REV. 687, 691-704 (1993) (arguing that the "reasonable constituent's expectation" approach (RCEA) offers lawyers substantial guidance in determining representation). *See also* Lawrence E. Mitchell, *Professional Responsibility and the Close Corporation: Toward a Realistic Ethic*, 74 CORNELL L. REV. 466, 471-73 (1989) (noting that the failure of both the Code and Model Rules to account for major changes in substantive law has rendered their directives meaningless in the context of the close corporation); Bryan J. Pechersky,

corporation have different expectations with respect to confidentiality and privacy than shareholders in a publicly-held corporation.[45] Therefore, according to these commentators, the applicability of the attorney-client privilege to disputes between shareholders and managers in closely-held corporations should be determined based on the reasonable expectations of the parties in a given situation.[46] The expectation analysis might result in the attorney-client privilege being pierced in any suit by a shareholder of a closely-held corporation against its managers, whether or not the shareholder was also a director. The expectation analysis also differs from Magistrate Piester's analysis because it requires a case by case determination, while Magistrate Piester's analysis allows the privilege to be pierced automatically, if a director or director/shareholder seeks the information in a dispute between the director and the management of a closely-held corporation.

On appeal, in *Milroy*, District Judge Kopf disagreed with Magistrate Piester's concept of a "collective corporate client."[47] Judge Kopf agreed with the *Hoiles* decision and held that the attorney-client privilege vests with the management of the corporation.[48] Judge Kopf also stated that "[t]here is no showing that Milroy has offered to review the documents solely in his fiduciary capacity as a director . . ." though Judge Kopf did not indicate how or why this would have changed his opinion in this particular case.[49] Neither did he indicate what documents a director could obtain if he or she brought suit in his or her capacity as a director.

In *Moore Business Forms, Inc. v. Cordant Holdings Corp.*,[50] the Delaware Court of Chancery employed the "collective corporate client" concept.[51] Moore Business Forms, Inc. ("Moore") invested eleven million dollars to help finance a management buy-out of Cordant, Inc. ("Cordant") by Cordant Holdings, Inc. ("Holdings").[52] Moore received convertible redeemable preferred stock in Holdings and was also enti-

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Note, *Representing General Partnerships and Close Corporations: A Situational Analysis of Professional Responsibility*, 73 TEX. L. REV. 919, 926, 947-50 (1995) (suggesting a situational analysis determining who should be the client and providing a number of factors which would guide an attorney in any given situation).

45. *See* Note, 106 HARV. L. REV. at 689 (arguing that applying the "entity as client" rule ignores the differences between the closely-held corporation and the publicly-held corporation.

46. *Id.*

47. *Milroy*, 875 F. Supp. at 647.

48. *Id.* at 650-51.

49. *Id.* at 647.

50. No. Civ. A. 13911, 14595, 1996 WL 307444, at *1 (Del. Ch. June 4, 1996).

51. Moore Bus. Forms, Inc. v. Cordant Holdings, Corp., No. Civ. A. 13911, 14595, 1996 WL 307444, at *6 (Del. Ch. June 4, 1996).

52. *Moore*, 1996 WL 307444, at *1.

tled to designate one director on both the Cordant and Holdings' boards of directors.[53] The Preferred Stock Purchase Agreement provided that Holdings, upon appropriate notice, could purchase the preferred stock from Moore at fair market value.[54] The Agreement provided that a "big eight" accounting firm selected by Holdings' independent directors was to determine fair market value.[55] The Holdings' board decided to have an accounting firm value the preferred stock and to negotiate with a bank for a commitment to finance a potential purchase of the stock.[56] Neither decision was disclosed to the Holdings' director designated by Moore or to Moore.[57] Holdings' law firm had given legal advice to the Holdings' directors, with the exception of Moore's designee, concerning the Preferred Stock Purchase Agreement.[58] During the course of discovery, Holdings' attorney (who also was a board member) was asked questions regarding the legal advice he had given to directors concerning Holdings' rights under the Purchase Agreement, the negotiations concerning financing the purchase of the preferred stock, and the accountant's valuation report.[59] The attorney asserted the attorney-client privilege and declined to answer.[60]

Vice Chancellor Jacobs stated that "a corporation cannot assert the privilege to deny a director access to legal advice furnished to the board during the director's tenure."[61] He stated:

> there was a single 'client,' namely, the entire board, which includes all its members. That is, a director seeking information furnished to the board that is the subject of the privilege claim is a 'client' not in his or her individual capacity, but as a member of the collective body (the board) of which the director is one member.[62]

In another recent case, the Delaware Chancery court has applied a case-by-case approach to determine the applicability of the privilege in disputes in closely-held corporations. In *A.O.C. Limited Partnership v. Horsham Corp.*,[63] the plaintiff moved to compel the production of documents which defendants claimed were protected by the attor-

53. *Id.* at *1-*2.
54. *Id.* at *2.
55. *Id.*
56. *Id.*
57. *Id.*
58. *Id.* The law firm did not inform Moore's designee because, "'[n]umerous contracts . . . being negotiated between Moore and Cordant' would have been jeopardized if Moore knew that its interest in Holdings might soon be repurchased." *Id.*
59. *Id.* at *2-*3.
60. *Id.* at *2.
61. *Id.* at *4.
62. *Id.* at *4 n.4.
63. No. Civ. A. 12480, 1992 WL 97220, at *1 (Del. Ch. May 5, 1992).

ney-client privilege.[64] The plaintiff owned forty percent, and the Horsham Corporation owned sixty percent, of A.O.C. Holdings, which, in turn, owned one hundred percent of Clark Oil and Refining Corporation ("Clark").[65] The shareholders had entered into a shareholder agreement which, in part, had provisions limiting future sales of stock by Clark.[66] The plaintiff claimed that the defendants had violated the agreement and breached fiduciary duties owed to the plaintiff.[67] The plaintiff had two representatives on the Clark board and sought information that had been provided to Clark by its attorney.[68] Vice Chancellor Chandler, like Vice Chancellor Jacobs in *Moore Business Forms*, stated that the plaintiff was a board member of Clark and was "just as much the 'client'" as Clark.[69] However, Vice Chancellor Chandler made some additional interesting comments. Evidently, the defendants also argued that the advice had been given to Horsham, not to Clark and, therefore, no attorney-client relationship existed between plaintiff and the attorney.[70] Vice Chancellor Chandler stated that even if the attorney had given the advice as an attorney for Horsham the result would be the same. He reasoned that Horsham was the indirect majority shareholder of Clark and the plaintiff was the indirect minority shareholder and, therefore, Horsham owed fiduciary duties to the plaintiff.[71] Arguably, Vice Chancellor Chandler would pierce the privilege in appropriate circumstances, even if the complaining party was a shareholder, but not a director.

However, Vice Chancellor Chandler would not agree that the complaining party, whether a director or not, was automatically entitled to the information. A minority shareholder could pierce the claim of privilege only by showing good cause.[72] The factors to be considered included: "the number of shareholders and the percentage ownership they represent, the availability of the information from other sources, the risk of revealing trade secrets, and the obvious colorability of the claims."[73] The court determined that the plaintiff as a forty percent shareholder, with a colorable fiduciary duty claim, who had no other access to the information and who posed no risk of revealing a trade

64. A.O.C. Ltd. Partnership v. Horsham Corp., No. Civ. A. 12480, 1992 WL 97220, at *1 (Del. Ch. May 5, 1992).

65. *A.O.C. Ltd. Partnership*, 1992 WL 97220, at *1.

66. A.O.C. Ltd. Partnership v. Horsham Corp., No. Civ. A. 12480, 1992 WL 136474, at *2 (Del. Ch. June 17, 1992).

67. *A.O.C. Ltd. Partnership*, 1992 WL 136474, at *1.

68. *A.O.C. Ltd. Partnership*, 1992 WL 97220, at *1.

69. *Id.*

70. *Id.*

71. *Id.* at *2.

72. *Id.*

73. *Id.*

secret, had demonstrated good cause to pierce the privilege.[74] *A.O.C. Limited Partnership* supports the proposition that any shareholder of a closely-held corporation, whether or not a director, might be able to pierce the privilege in appropriate circumstances.

In *Garner v. Wolfinbarger*, a publicly-held corporation asserted the attorney-client privilege in a shareholder derivative suit brought against it and its officers for alleged violations of the securities laws.[75] The United States Court of Appeals for the Fifth Circuit held that the attorney-client privilege is available to a corporation defending a derivative suit, but a shareholder may overcome the privilege by showing good cause.[76] The Fifth Circuit did not define good cause, but offered a non-exclusive list of factors to be considered.[77] These factors have been criticized as providing too vague a guideline to be useful to the corporate managers who must determine whether communications are, or are not, discoverable.[78] Also, the *Garner* analysis has not been applied to nonderivative suits where the plaintiff shareholder attempts to obtain a personal benefit from the litigation, rather than to provide a benefit for all shareholders.[79] Thus, because in most closely-held corporate disputes the plaintiff is seeking a personal benefit, the *Garner* analysis has not been applied in the closely-held setting and, therefore, *A.O.C. Limited Partnership* is a departure.

COMMENTATORS' SUGGESTIONS

Commentators considering an attorney's ethical obligations have argued that the "entity is the client" rule must be modified in the closely-held corporate context.[80] Professor Mitchell points out that

74. *Id.*

75. 430 F.2d 1093 (5th Cir. 1970).

76. Garner v. Wolfinbarger, 430 F.2d 1093, 1095 (5th Cir. 1970).

77. *Garner*, 430 F.2d at 1104.

78. Ronald C. Minkoff, *The Fiduciary Exception to the Attorney-Client Privilege*, N.Y. L.J., May 1, 1990, at 1 (outlining the history of *Garner's* fiduciary exception to the attorney-client privilege). Articulated first by the Fifth Circuit in 1970, the fiduciary exception has since been roundly criticized by many commentators, and at least one court. *Id.* The *Garner* factors are vague and overlapping, and difficult to apply in a predictable fashion. *Id.* Commentators feared that those clients who would most benefit from frank, open discussion with their attorneys might be reluctant to confide in them. *Id.* Many commentators also believe that "the 'crime-fraud' exception to the attorney-client privilege" adequately protects shareholders. *Id.*

79. *See* David J. Haydon, *Identifying and Preserving the Attorney-Client Privilege in Various Business Transactions*, 61 J. KAN. B. ASS'N. 24, 29 (1992) (discussing shareholder suits against the corporation and/or management "on charges of acting inimically to shareholders interests"). Presumably, *Garner* allows the shareholder plaintiff in a derivative action to "pierce the corporation's attorney-client privilege upon demonstrating good cause," but there is a greater burden to show good cause in nonderivative actions. *Id.* at 29.

80. *See infra* note 81 and 86 and accompanying text.

the drafters of the MODEL RULES OF PROFESSIONAL CONDUCT accepted the publicly-held corporation as their model and did not consider the effect that the distinguishing characteristics of closely-held corporations should have on an attorney's ethical obligations and legal duties.[81] Shareholders in closely-held corporations are often considered partners in their dealings with one another; therefore, the "entity is the client" rule should not be applied to this form of business association. Mitchell argues that the reality of the relationship among the parties in a closely-held corporation and the need for a clear rule requires that each shareholder be considered the client.[82] Mitchell's analysis would result in piercing the privilege in most attorney-client privilege disputes between shareholders and managers of closely-held corporations. Unfortunately, his analysis raises the possibility that an attorney might be disqualified in any case in which the attorney who represented the corporation (and according to Mitchell's analysis, all of its shareholders) continued to represent the corporation in an action by a shareholder against the corporation and/or its other shareholders.[83] This result is not consistent with how courts presently treat the disqualification issue in similar circumstances.[84] Furthermore, Mitchell's analysis would mean that an attorney had a duty to each shareholder, which would have serious implications for malpractice actions.[85]

Another commentator, Pechersky, also contends that a situational analysis of professional responsibility issues is necessary with respect to disputes in partnerships and closely-held corporations.[86] Pechersky believes a situational analysis is required, rather than a rule that

81. Mitchell, 74 CORNELL L. REV. at 470-72.

82. *Id.* at 472. *See* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 661 (Mass. 1976) (holding that the standard of duty owed by majority shareholders to minority shareholders and to one another in a closely-held corporation "is one of utmost good faith and loyalty").

83. *See* Rosman v. Shapiro, 653 F. Supp. 1441, 1445 (S.D.N.Y. 1987) (suggesting that in a closely-held corporation "it is indeed reasonable for each shareholder to believe that the corporate counsel is in effect his own individual attorney"). *See, e.g.,* Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C., 309 N.W.2d 645, 648-50 (Mich. Ct. App. 1981) (holding that notwithstanding the absence of an attorney-client relationship, a plaintiff who is also a fifty percent shareholder properly stated a cause of action against corporate counsel).

84. *See, e.g.*, Bobbitt v. Victorian House, Inc., 545 F. Supp. 1124, 1127-28 (N.D. Ill. 1982) (holding that the corporation's attorney would not be disqualified from representing the corporate defendant, and other defendants, although the director plaintiff had previously sought unrelated legal advice from the defendant's attorney).

85. *See, e.g.*, Felty v. Hartweg, 523 N.E.2d 555, 556-58 (Ill. App. Ct. 1988) (stating that a stockholder in an ordinary corporation does not thereby become a beneficiary of the attorney-client relationship between corporate counsel and the corporation).

86. Bryan J. Pechersky, Note, *Representing General Partnerships and Close Corporations: A Situational Analysis of Professional Responsibility*, 73 TEX. L. REV. 919, 923-25 (1995).

the entity or the shareholder is the client in all cases, and he suggests a number of factors to guide an attorney attempting to determine who the client is in a particular case.[87] One such factor is fully disclosing to individuals the implications of common representation.[88]

DISQUALIFICATION AND MALPRACTICE LIABILITY CASES

The general rule that the entity rather than its individual owners, managers or representatives is the client has significant implications for issues other than application of the attorney-client privilege. An attorney's ethical obligations or potential malpractice liability depends on whether an attorney-client relationship exists.[89] For example, in *Rosman v. Shapiro*,[90] Rosman and Shapiro each owned fifty percent of Filtomat, Inc., which had an agreement with Filtration to distribute its products in the United States.[91] Rosman and Shapiro subsequently met with attorneys seeking legal advice concerning the provisions of the Filtomat-Filtration agreement.[92] Rosman also met individually with the attorneys on two occasions to discuss this agreement.[93] Rosman and Shapiro disagreed about the interpretation of this agreement, and Rosman alleged that their continued disagreement led to a deadlock in the management of Filtomat, Inc.[94] Subsequently, Rosman brought suit against Shapiro and Filtomat.[95]

The attorneys who had represented Filtomat in the past represented Shapiro and Filtomat in the new action.[96] Rosman moved to disqualify them claiming that an attorney-client relationship existed between Rosman and the attorneys and that their representation of Shapiro and Filtomat presented a conflict of interest.[97] The court held that it must protect Rosman's reasonable expectation of confidentiality and if Rosman reasonably believed that the attorney was acting as his counsel, the court would find that an attorney-client relationship existed.[98] The court held:

> It is clear that Rosman reasonably believed that [the attorneys were] representing him. Although in the ordinary corpo-

87. *Id.* at 947-50.
88. *Id.*
89. *See* Meyer v. Mulligan, 889 P.2d 509, 514 (Wyo. 1995) (reflecting the difficulty of determining who the client is in the closely-held business association and noting that the "entity is the client rule" is unworkable for the closely-held corporation).
90. 653 F. Supp. 1441 (S.D.N.Y. 1987).
91. Rosman v. Shapiro, 653 F. Supp. 1441, 1443 (S.D.N.Y. 1987).
92. *Rosman*, 653 F. Supp. at 1444.
93. *Id.*
94. *Id.* at 1443.
95. *Id.* at 1444.
96. *Id.* at 1445.
97. *Id.*
98. *Id.*

> rate situation, corporate counsel does not necessarily become counsel for the corporation's shareholders and directors (citations omitted) where, as here, the corporation is a close corporation consisting of only two shareholders with equal interest in the corporation, it is indeed reasonable for each shareholder to believe that the corporate counsel is in effect his own individual attorney.[99]

Thus, Judge Sprizzo's decision in *Rosman* recognized that a dispute in a closely-held corporation, at least in certain circumstances, might require an exception to the "entity is the client" rule, whether the issue is the applicability of the attorney-client privilege or the scope of the attorney's ethical obligation.

The disqualification issue is not treated consistently in the context of disputes in closely-held corporations. For example, in *Bobbitt v. Victorian House, Inc.*,[100] Bobbitt owned one-half of Victorian House's shares and was a member of its board of directors.[101] He brought suit in the United States District Court for the Northern District of Illinois for dissolution and for an accounting of corporate funds because of an alleged misapplication by the corporation's president.[102] Bobbitt also moved to disqualify the law firm that had represented the corporation and was representing it in this dispute.[103] The district court stated that no conflict of interest existed because the attorney never represented the director.[104] The court acknowledged that it is more difficult to draw the line between individual and corporate representation when the dispute arises in a closely-held corporation, but found no evidence that individual representation existed.[105]

Identification of the client is also a crucial issue in certain attorney malpractice cases. For example, in *Felty v. Hartweg*,[106] a shareholder in a closely-held corporation brought suit in the Appellate Court of Illinois against the corporation's attorney for failing to disclose a corporate officer's misconduct of which the attorney knew and assisted.[107] The court affirmed the lower court's motion to dismiss and stated that a shareholder does not become a beneficiary of an attorney-client relationship between an attorney and a corporation.[108]

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99. *Id.*
100. 545 F. Supp. 1124 (N.D. Ill. 1982).
101. Bobbitt v. Victorian House, Inc., 545 F. Supp. 1124, 1125 (N.D. Ill. 1982).
102. *Bobbitt*, 545 F. Supp. at 1125.
103. *Id.*
104. *Id.* at 1126.
105. *Id.*
106. 523 N.E.2d 555, 555-56 (Ill. App. Ct. 1988).
107. Felty v. Hartweg, 523 N.E.2d 555, 555-56 (Ill. Ct. App. 1988).
108. *Felty*, 523 N.E.2d at 556-58.

According to the court, the attorney for the corporation owes no duty to its shareholders.[109]

However, courts deciding legal malpractice cases also recognize that identifying the client can be a difficult issue with respect to disputes that arise in a closely-held corporation.[110] In *Meyer v. Milligan*,[111] two groups, the Johnsons and the Meyers, engaged attorney Milligan to form a corporation and draft the necessary documents for acquisition of a motel.[112] Evidently, contracts relating to the acquisition that the Meyer group believed had been assigned to the newly formed corporation were not assigned, and the Meyer group brought suit against Milligan for malpractice.[113] The Supreme Court of Wyoming held that it was unclear from the facts whether the attorney represented the recently formed entity, the incorporators of the entity, or its shareholders.[114] Therefore, the court was unable to determine whether or not the attorney owed a duty to the Meyer group, and the court reversed the district court's summary judgment in favor of the attorney.[115]

Indeed, whether an attorney should be disqualified from representing a party or should have to defend a malpractice action raises different issues than whether or not the attorney-client privilege applies. Therefore, it might be useful to have a different analytical approach with respect to application of the attorney-client privilege.

TREATING THE ATTORNEY-CLIENT PRIVILEGE AS A CORPORATE ASSET

Another approach to resolving the attorney-client privilege issue that arises in disputes in closely-held corporations is to treat the privilege as an asset of the corporation. All the traditional rules with respect to the use of corporate assets would then be applicable. Thus, in the absence of a contrary provision in the articles of incorporation, bylaws, or shareholder agreement, the board of directors is responsible for managing the business and affairs of the corporation.[116] Unless a sale of all or substantially all the corporate assets is involved, a majority of the board has the sole power to determine how to use, or

109. *Id.* at 557.
110. *Id.* at 556.
111. 889 P.2d 509 (Wyo. 1995).
112. Meyer v. Milligan, 889 P.2d 509, 511-12 (Wyo. 1995).
113. *Meyer*, 889 P.2d at 513.
114. *Id.* at 515.
115. *Id.* at 515-16, 518.
116. REVISED MODEL BUS. CORP. ACT [hereinafter R.M.B.C.A.] § 8.01(b) (1984).

whether to sell or lease, a corporate asset.[117] Similarly, subject to certain rules to protect creditors, a majority of the board has the power to distribute corporate assets to shareholders.[118] If a shareholder believes that the corporate assets are being mismanaged or have been sold for a price below market value, the shareholder can bring suit on behalf of the corporation for damages or to enjoin the action. However, the board of director's decision with respect to the use of the corporate asset ordinarily would be protected by the business judgment rule.[119]

However, when the use, distribution, or sale of an asset is challenged because the decision-maker had a conflict of interest with respect to the particular transaction, rather than on the grounds of negligent management, different rules apply. When the issue involves the decision-maker's duty of loyalty, the business judgment rule is not applicable.[120] Usually, if divided loyalties of the decision-maker are demonstrated, the burden of proof is on the decision-maker to prove the entire fairness of the transaction.[121]

Modern corporate statutes create procedures which, if followed, protect certain conflict of interest transactions from attack. If these

117. *Compare* R.M.B.C.A. § 8.01(b) *with* R.M.B.C.A. § 12.02 (stating in relevant part:

> (a) A corporation may sell, lease, exchange, or otherwise dispose of all, or substantially all, of its property (with or without the good will), otherwise than in the usual and regular course of business, on the terms and conditions and for the consideration determined by the corporation's board of directors, if the board of directors proposes and its shareholders approve the proposed transaction)

118. *See* R.M.B.C.A. § 6.40 (1984) (stating in relevant part: "(a) A board of directors may authorize and the corporation may make distributions to its shareholders subject to restrictions by the articles of incorporation and the limitation in subsection (c)"). Subsection (c) provides restrictions for the protection of creditors. R.M.B.C.A. § 6.40(c).

119. The business judgment rule traditionally protects directors from liability for specific business decisions that result in losses to the corporation. The rule is directed at the process the board of directors used in reaching a given decision, rather than the results of that decision. Therefore, a court will not interfere with internal management and substitute its judgment for that of the directors, to enjoin or set aside the transaction, if (a) in the course of management, directors arrive at a decision, within the corporation's powers and their authority, and (b) they act in good faith, as the result of their independent discretion and judgment, uninfluenced by any consideration other than what they honestly believe to be the best interests of the corporation. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1988) (holding that the board's decision to approve a cash-out merger was not the product of informed business judgment).

120. *See* R.M.B.C.A. § 8.30(d) (1984) (providing the rebuttable presumption that directors act in good faith, as ordinarily prudent persons, in a manner they believe to be in the best interests of the corporation). If these criteria are missing, the courts will then scrutinize the decision as to its intrinsic fairness to the corporation and the minority shareholders by applying the business judgment rule. R.M.B.C.A. § 8.30 cmt. 4.

121. *See* Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 109-10 (Del. 1952) (holding that a parent hotel corporation which was the majority shareholder of subsidiary occupied a fiduciary relation to minority shareholders of the subsidiary and had the burden of establishing the fairness of the proposed plan of merger).

procedures are not followed, the court determines whether or not the transaction is fair to the corporation, and the burden of proving fairness is on the party having the conflict. For example, the REVISED MODEL BUSINESS CORPORATION ACT ("R.M.B.C.A.") provides that a director has a conflicting interest in any proposed or effected transaction of the corporation in which he, or a related person, is a party or has a significant beneficial financial interest.[122] If the attorney-client privilege is considered an asset of the corporation, then a decision by directors to make use of this corporate asset by asserting the privilege to protect them from an adverse result in the underlying dispute between the complaining shareholder and management is within the R.M.B.C.A.'s definition of a conflict of interest transaction.

Under the R.M.B.C.A., conflict of interest transactions may not be enjoined, set aside, or give rise to an award of damages in a proceeding by a shareholder if the appropriate procedures are followed or the transaction is fair to the corporation.[123] The statutory procedure that cleanses a conflict transaction is a majority vote of qualified shares or a majority vote by qualified directors.[124] For shares to be considered qualified shares, they may not be beneficially owned by a director, or a related party, who has a conflicting interest regarding the transaction. A qualified director is any director who does not have either:

a) a conflicting interest regarding the transaction, or
b) a familial, financial, professional, or employment relationship with a second director who does have a conflicting interest with regard to the transaction, which relationship would, under the circumstances, reasonably be expected to exert an influence on the first director's judgment when voting on the transaction.[125]

These statutory procedures are designed to limit judicial inquiry into the economic fairness of conflict of interest transactions. However, in the absence of a sufficient number of qualified shares or quali-

122. *See* R.M.B.C.A. § 8.31(a) (1984) (providing in relevant part:
(a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest. A conflict of interest is not voidable by the corporation solely because of the director's interest in the transaction if any one of the following is true:
(1) the material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved, or ratified the transaction;
(2) the material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved, or ratified the transaction; or
(3) the transaction was fair to the corporation).
123. *Id.*
124. R.M.B.C.A. § 8.31(a)(1) & (2).
125. *Id.*

fied directors, the court must determine whether or not the conflict of interest transaction is fair to the corporation.

When the attorney-client privilege is raised in a dispute between a shareholder and managers of a closely-held corporation, those asserting the privilege often are shareholders, but their shares will not be considered qualified shares because they are beneficial owners who have a conflicting interest. Likewise, often there will be no qualified directors in such disputes. Moreover, in closely-held entities most, if not all, of the shareholders are also officers and directors of the corporation. Typically, the complaining shareholder in such disputes would be claiming a "freeze out," squeeze out, or other breach of duty of loyalty by the other shareholder/directors.[126] Therefore, the cleansing procedures of the R.M.B.C.A. would not be applicable and the court would be called upon to determine whether asserting the privilege is fair under the circumstances. The burden would be on the parties asserting the privilege to demonstrate that their use of the privilege was fair. Unless disclosure of the communications between the corporation and its attorneys would lead to revealing trade secrets, or the communications were unrelated to the underlying cause of action, it appears quite difficult for this privilege to be successfully asserted in such disputes.

Typically, the fairness inquiry is an economic one. The question is whether the party with the conflict paid a fair price for the purchase or use of the corporate asset. Did he or she pay what a third party would have paid? It is apparent that this economic analysis is not appropriate because the attorney-client privilege is an asset for which there is no third-party market. However, the party asserting the privilege has the burden of proving the entire fairness of its use. The parties to the dispute have had a special fiduciary relationship in this closely-held entity and to deny any party information necessary to resolve the dispute is unlikely to meet an entire fairness standard, without exceptional circumstances. Courts can utilize the same *in camera* inspection procedures that are now followed when the crime-fraud exception has been raised to determine whether exceptional circum-

126. *See* Donahue v. Rodd Electrotype Co. of New England, 328 N.E.2d 505, 513 (Mass. 1975) (finding that majority stockholders took the opportunity to "freeze-out" or disadvantage minority stockholders by refusing them the equal opportunity to sell ratable numbers of shares to the corporation at the same price offered the majority). *See also* F. Hodge O'Neal, *Oppression of Minority Shareholders: Protecting Minority Rights*, 35 CLEV. ST. L. REV. 121, 127 (1987) (discussing "squeeze outs"). A "squeeze-out" is a variation of the "freeze-out," whereby a minority shareholder is eliminated from the board of directors and released from company employment by controlling shareholders in a closely-held corporation.) *Id.* at 126. Excluding a shareholder from employment effectively denies him anything more than a meager return on his investment. *Id.* This will occur even if he has a substantial investment. *Id.*

stances exist.[127] The same approach can be applied to disputes in other closely-held entities whenever those with authority to assert or waive the privilege have a conflict of interest.

Under this analysis, the "entity is the client" rule need not be disturbed. Existing court decisions with respect to an attorney's ethical obligations and legal duties will be unaffected by developments with respect to the availability of the attorney-client privilege in the resolution of disputes in closely-held corporations and similar entities. Also, this analysis will have little impact on disputes in publicly-held entities and on the practicality of the *Garner* analysis. In suits by a shareholder in a publicly-held corporation in which a shareholder seeks communications between the board and the corporate attorney, qualified directors often will be present and their decision would be protected by the business judgment rule.

127. United States v. Zolin, 491 U.S. 554, 557 (1989).