Conflicts in
Representing Closely Held Entities

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Hypothetical

The Best and the Worst of Thymes

Three old acquaintances – Darnay, Cruncher and Lorry -- decide to form and operate a new catering business, "A Moveable Feast," which offers nothing but healthful food selections, including whole grain breads and rolls, organically grown herbs, fruits and vegetables, a wide selection of vegetarian dishes, and very lean cuts of organically raised meat. Darnay is independently wealthy, and has agreed to provide most of the capital required to finance start up operations. Cruncher has a food service industry background in middle management and operations, and will be responsible for the day-to-day operations of the business. Lorry is a banker, and the brains behind the operation; he came up with the concept and business plan for "A Moveable Feast." The three approach Carton, a local attorney, and ask for his assistance in forming the company and taking care of all of the legal niceties required to start up and operate the new catering business.

At the outset, Darnay, Cruncher and Lorry agree to own the equity of the company in equal shares. Because Darnay is the only one of the three with money, he is required to personally guarantee the quarter million dollar bank loan, which will be advanced by DeFarge State Bank. Carton, coincidentally, is the bank's outside counsel. Lorry is a vice president and a minority shareholder of the bank. After executing the loan documents, which Carton first reviewed and approved on behalf of the borrower, the bank deposits the sum of $250,000 into the new checking account of "A Moveable Feast."

Initially, business is slow. After a few months, however, favorable comments from satisfied clients spread by word of mouth around the community and demand grows exponentially. Cruncher finds himself working 80 hours a week. While the success of the business requires Lorry and Darnay to spend a bit more of their time on company matters than before, the demands on their time are nothing like Cruncher's. After many months of long, difficult work days, Cruncher grows resentful and decides that he should be entitled to at least half of the company's profits, not just a third.

In addition, Cruncher decides to take advantage of an opportunity to make some money on the side. Through his contact with the local bakery, Cruncher learns that the owner of the bakery is planning to retire soon, and is willing to offer very favorable terms – including seller financing -- to anyone who will purchase the bakery. Without informing Darnay and Lorry, Cruncher agrees to purchase the bakery, which supplies all of the bread products used in the company's business. Cruncher plans to increase

the prices of all products sold to "A Moveable Feast," which will assuredly result in a healthy return on his investment in the bakery.

Cruncher approaches Carton and asks him to represent him in connection with the purchase of the bakery, and in connection with the realignment of the three equity owners' interests in "A Moveable Feast." Carton agrees. Unfortunately, the negotiations break down. A short time later, Darnay and Lorry file a lawsuit seeking equitable relief against Cruncher and the appointment of a receiver to operate the business pending a final court order.

1. Who is/are Carton's client(s)?

2. What are Carton's ethical obligations at the outset of the representation?

3. Did Carton engage in unethical conduct in connection with the loan transaction?

4. What ethical responsibilities did Carton have in connection with Cruncher's purchase of the bakery?

5. Can Carton represent Cruncher in the litigation?

Excerpts from the Minnesota Rules of Professional Conduct

Rule 1.2: Scope Of Representation and Allocation of Authority Between Client and Lawyer

* * *

(c) A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.

Comment

* * *

Agreements Limiting Scope of Representation

[6] The objectives or scope of services to be provided by a lawyer may be limited by agreement with the client or by the terms under which the lawyer's services are made available to the client. When a lawyer has been retained by an insurer to represent an insured, for example, the representation may be limited to matters related to the insurance coverage. A limited representation may be appropriate because the client has limited objectives for the representation. In addition, the terms upon which representation is undertaken may exclude specific means that might otherwise be used to accomplish the client's objectives. Such limitations may exclude actions that the client thinks are too costly or that the lawyer regards as repugnant or imprudent.

[7] Although this rule affords the lawyer and client substantial latitude to limit the representation, the limitation must be reasonable under the circumstances. If, for example, a client's objective is limited to securing general information about the law the client needs in order to handle a common and typically uncomplicated legal problem, the lawyer and client may agree that the lawyer's services will be limited to a brief telephone consultation. Such a limitation, however, would not be reasonable if the time allotted was not sufficient to yield advice upon which the client could rely. Although an agreement for a limited representation does not exempt a lawyer from the duty to provide competent representation, the limitation is a factor to be considered when determining the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation. See Rule 1.1.

Rule 1.7: Conflict Of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client, unless:

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to

another client, a former client or a third person, or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation will to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

Excerpts from Comments to Rule 1.7 –

Special Considerations in Common Representation

[30] A particularly important factor in determining the appropriateness of common representation is the effect on client-lawyer confidentiality and the attorney-client privilege. With regard to the attorney-client privilege, the prevailing rule is that, as between commonly represented clients, the privilege does not attach. Hence, it must be assumed that if litigation eventuates between the clients, the privilege will not protect any such communications, and the clients should be so advised.

[31] As to the duty of confidentiality, continued common representation will almost certainly be inadequate if one client asks the lawyer not to disclose to the other client information relevant to the common representation. This is so because the lawyer has an equal duty of loyalty to each client, and each client has the right to be informed of anything bearing on the representation that might affect that client's interests and the right to expect that the lawyer will use that information to that client's benefit. See Rule 1.4. The lawyer should, at the outset of the common representation and as part of the process of obtaining each client's informed consent, advise each client that information will be shared and that the lawyer will have to withdraw if one client decides that some matter material to the representation should be kept from the other. In limited circumstances, it may be appropriate for the lawyer to proceed with the representation when the clients have agreed, after being properly informed, that the lawyer will keep certain information confidential. For example, the lawyer may reasonably conclude that failure to disclose one client's trade secrets to another client will not adversely affect representation involving a joint venture between the clients and agree to keep that information confidential with the informed consent of both clients.

* * *

Organizational Clients

[34] A lawyer who represents a corporation or other organization does not, by virtue of that representation, necessarily represent any constituent or affiliated organization, such as a parent or subsidiary. See Rule 1.13(a). Thus, the lawyer for an organization is not barred from accepting representation adverse to an affiliate in an unrelated matter, unless the circumstances are such that the affiliate should also be considered a client of the lawyer, there is an understanding between the lawyer and the organizational client that the lawyer will avoid representation adverse to the client's affiliates, or the lawyer's obligations to either the organizational client or the new client are likely to limit materially the lawyer's representation of the other client.

[35] A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at board meetings while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.

Rule 1.13: Organization As Client

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

* * *

(e) In dealing with an organization's directors, officers, employees, members, shareholders, or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(f) 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. 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.

Comment

The Entity as the Client

[1] An organizational client is a legal entity, but it cannot act except through its officers, directors, employees, shareholders, and other constituents. Officers, directors, employees, and shareholders are the constituents of the corporate organizational client. The duties defined in this comment apply equally to unincorporated associations. "Other constituents" as used in this comment means the positions equivalent to officers, directors, employees, and shareholders held by persons acting for organizational clients that are not corporations.

[2] When one of the constituents of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is protected by Rule 1.6. Thus, by way of example, if an organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client's employees or other constituents are covered by Rule 1.6. This does not mean, however, that constituents of an organizational client are the clients of the lawyer. The lawyer may not disclose to such constituents information relating to the representation except for disclosures explicitly or impliedly authorized by the organizational client in order to carry out the representation or as otherwise permitted by Rule 1.6.

[3] When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. Paragraph (b) makes clear, however, that when the lawyer knows that the organization is likely to be substantially injured by action of an officer or other constituent that violates a legal obligation to the organization or is in violation of law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. As defined in Rule 1.0(f), knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious.

[4] In determining how to proceed under paragraph (b), the lawyer should give due consideration to the seriousness of the violation and its consequences, the responsibility in the organization and the apparent motivation of the person involved, the polices of the organization concerning such matters, and any other relevant considerations. Ordinarily, referral to a higher authority would be necessary. In some circumstances, however, it may be appropriate for the lawyer to ask the constituent to reconsider the matter; for example, if the circumstances involve a constituent's innocent misunderstanding of law and subsequent acceptance of the lawyer's advice, the lawyer may reasonably conclude that the best interest of the organization does not require that the matter be referred to higher authority. If a constituent persists in conduct contrary to the lawyer's advice, it will be necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization. If the matter is of sufficient seriousness and importance or urgency to the organization, referral to higher authority in the organization may be necessary even if the lawyer has not communicated with the constituent. Any measures taken should, to the extent practicable, minimize the risk of revealing information relating to the representation to persons outside the organization. Even in circumstances where a lawyer is not obligated by Rule 1.13 to proceed, a lawyer may bring to the attention of an organizational client, including its highest authority, matters that the lawyer reasonably believes to be of sufficient importance to warrant doing so in the best interest of the organization.

[5] Paragraph (b) also makes clear that when it is reasonably necessary to enable the organization to address the matter in a timely and appropriate manner, the lawyer must refer the matter to higher authority, including, if warranted by the circumstances, the highest authority that can act on behalf of the organization under applicable law. The organization's highest authority to whom a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation.

* * *

Clarifying the Lawyer's Role

[9] There are times when the organization's interest may be or become adverse to those of one or more of its constituents. In such circumstances the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussions between the lawyer for the organization and the individual may not be privileged.

* * *

Dual Representation

[11] Paragraph (f) recognizes that a lawyer for an organization may also represent a principal officer or major shareholder.

Derivative Actions

[12] Under generally prevailing law, the shareholders or members of a corporation may bring suit to compel the directors to perform their legal obligations in the supervision of the organization. Members of unincorporated associations have essentially the same right. Such an action may be brought nominally by the organization, but usually is, in fact, a legal controversy over management of the organization.

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

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345 N.W.2d 775
Melvin E. EVANS, Respondent,
v.
Gordon L. BLESI, Appellant,
and
Blesi-Evans Co., Appellant.
No. CO-83-1471.
Court of Appeals of Minnesota.
Feb. 22, 1984.
Review Denied June 12, 1984.

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Syllabus by the Court

1. Evidence sustained trial court's finding that partner in closely held corporation breached his fiduciary duty to co-partner by manner in which he obtained co-partner's resignation.

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2. Post-appeal order is null and void because the perfecting of appeal divested the district court of jurisdiction.

3. Trial court made appropriate findings and a new trial is not required.

4. The reduction of punitive damages to one-half was an appropriate means of dealing with any prejudicial effect of improper attorney conduct on the proceedings.

Alan R. Nettles, Daniel B. Johnson, Minneapolis, for appellant.

Gordon L. Blesi, pro se.

Ernest A. Lindstrom, Robert W. Gislason, Edina, for respondent.

Heard, considered and decided by PARKER, P.J., and WOZNIAK and LANSING, JJ.

OPINION

PARKER, Judge.

This appeal arises from litigation between owners of a closely held corporation.

Plaintiff Melvin Evans and defendant Gordon Blesi were co-owners and shareholders of defendant Blesi-Evans Company. Evans and Blesi were the sole, equal shareholders from 1955 to 1977, when Evans transferred a share of stock to Blesi, thereby giving Blesi a majority interest. In 1982, Blesi, who was then president, demanded and received Evans' written resignation from employment and also Evans' written consent to certain changes in the corporate structure. Evans brought this action, claiming that he had acted under fraud and duress when he transferred the stock and resigned, alleging a breach of fiduciary duty by Blesi and seeking damages and equitable relief against both Blesi and Blesi-Evans Company.

The trial court empanelled an advisory jury which found that a fiduciary duty existed which Blesi had violated and awarded both compensatory and punitive damages to Evans. On June 30, 1983, the trial court adjudged the 1982 resignation and consents null and void, ordered Evans reinstated with full compensation to date of judgment, and awarded Evans compensatory damages of $277,000 jointly and severally against Blesi and Blesi-Evans Company, as well as punitive damages of $500,000 against Blesi individually. An attempt

was made by the trial court to amend the judgment by a post-appeal order on October 4, 1983, reducing the punitive damages to $250,000 and vacating the order of reinstatement of Evans, together with other orders not necessary to be detailed here.

Defendants appeal from the judgment entered June 30, 1983, and as purported to be amended by order dated October 4, 1983.

We affirm in part, modify in part, vacate in part and remand to set up a mechanism for a buyout of the Blesi-Evans Company.

FACTS

The facts deemed material to this decision are as follows. Evans and Blesi were co-owners and shareholders of Blesi-Evans Company, a manufacturer's representative for large heating and ventilating equipment makers. They were college classmates, close friends and business associates.

In 1953, the parties took jobs with the Albert C. Price Company, a manufacturer's representative business and predecessor of the Blesi-Evans Company. Within six or seven months, Mr. Blesi was discharged by Mr. Price. Later, Mr. Price sold his company to Mr. Evans and a man named Lloyd Steirly. Blesi wanted to come back into the business and so Steirly and Evans sold him 18 percent of their stock. The remaining stock was owned equally by Evans and Steirly.

In 1955, Evans and Blesi combined their 41 percent and 18 percent interests to vote out Steirly as president and director. Evans loaned Blesi enough money to enable Blesi to purchase 50 percent of the stock. They formalized their relationship on March 31, 1955, by entering into a shareholder's control agreement tantamount to a partnership agreement, and continued on an equal basis until 1977, sharing equal salaries, management duties and benefits.

Between 1975 and 1977, Mr. Evans had some health problems including high blood pressure, very high anxiety and tremors in his hands. Blesi claimed that Evans was making harmful ordering and pricing mistakes because of his illness. Blesi confronted Evans with the problems he perceived in Evans' job performance and told Evans that he was considering leaving or dissolving the company.

Evans testified that Blesi went into a temper tantrum and demanded that Evans sign certain stock transfer documents or he would liquidate the company and take all the accounts away. Evans transferred one share of stock to Blesi on November 21, 1977, thus surrendering majority control to him.

After the stock transfer, Evans and Blesi worked equal hours, drawing equal pay and benefits and sharing equally in the day-to-day management of the company. However, Blesi contended that Evans continued to make harmful ordering and pricing mistakes.

On February 8, 1982, Blesi consulted an attorney to discuss the "problem." Blesi was advised by the attorney to seek Evans' resignation before using his majority voting power to remove him, if necessary.

An associate of the law firm prepared documents of resignation and minutes of an informal action of shareholders which had the effect of consolidating Blesi's control by eliminating cumulative voting, lowering to "majority" the vote required for amending by-laws, and purporting to increase the authorized capital. This document was to be executed by both parties if Evans resigned voluntarily. Alternatively, the attorney prepared a notice of shareholders meeting to be called for the purpose of removing Evans as an officer, director and employee if he refused to resign.

On February 19, 1982, Blesi met with Evans. Evans testified that Blesi again shouted at him, slammed the door, accused him of incompetence and dishonesty, and threatened to fire Evans' son from the sales force if Evans did not resign voluntarily. Evans signed the

resignation and the informal minutes that the attorney had drafted.

Three days after Evans signed the letter, he retained legal counsel who sent a notice of revocation of Evans' signature on the resignation and on the informal action of shareholders. Blesi contacted his attorneys, who advised him to ignore it.

Blesi followed this advice. Evans was not paid salary, was refused his annual bonus, and Blesi refused to make the $31,250 yearly contribution for Evans to the company's pension and profit-sharing trusts. Approximately one month in advance of the stock transfer meeting with Evans, Blesi had had documents prepared which empowered him to disqualify employees from eligibility for pension and profit-sharing payments if employment was terminated before the end of the fiscal year. On the last day of the company's fiscal year in 1982, after Evans' resignation in February, Blesi then invoked the disqualification clause and refused to make the payments.

On April 30, 1983, the advisory jury and the trial court independently found that Blesi had obtained the stock transfer, the resignation and the consents by "misrepresentation, intimidation, threat and duress" and that Blesi had breached a fiduciary duty toward Evans. The jury found and the trial court ordered $277,000 compensatory damages, to be awarded jointly and severally, against Blesi and Blesi-Evans Company, and further awarded $500,000 punitive damages against Blesi individually.

On August 19, 1982, the trial court heard oral arguments on post-trial motions. On September 29, 1983, while the motions were still under advisement, defendants filed a notice of appeal from the judgment of June 30, 1982. On October 4, 1983, the trial court signed an order reducing the punitive damages to $250,000 and setting aside Evans' reinstatement because the extreme acrimony resulting from the lawsuit would adversely affect corporate operations. All other motions by defendants were denied.

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ISSUES

1. Whether the evidence was sufficient to support the trial court's finding of fact that Gordon Blesi breached a fiduciary duty to Melvin Evans;

2. Whether the trial court, on June 30, 1983, awarded the proper amount of compensatory damages;

3. Whether the post-appeal order of the trial court is of any effect;

4. Whether the trial court made appropriate findings and whether the special verdict form was so defective that it was an error of law and abuse of discretion to enter judgment upon it; and

5. Whether the conduct of plaintiff's counsel during the trial was so extreme and prejudicial that appellants were deprived of a fair trial.

ANALYSIS

This case involves two parties whose many years of friendship were inextricably intertwined with the operation of a very successful business. The litigation was bitterly fought, but the conflicts were only partially resolved by the trial court's judgment. At oral argument before this court, defense counsel suggested that it would be in the long-run interest of all concerned were we to put an end to the litigation. The appeal is to the plenary powers of the court to end the extensive and self-defeating litigation.

Rule 103.04 of the Minnesota Rules of Civil Appellate Procedure provide:

The appellate courts may reverse, affirm or modify the judgment or order appealed from or take any other action as the interest of justice may require.

On appeal from or review of an order the appellate courts may review any order affecting

the order from which the appeal is taken and on appeal from a judgment may review any order involving the merits or affecting the judgment. They may review any other matter as the interest of justice may require.

Counsel suggested that Mr. Evans' salary be paid to the present and that a mechanism for a buyout of the corporation be established. Under the foregoing rule, we modify the award of Evans' salary to the time of trial by extending it up to the present, thus totalling $381,136, to be a joint and several award against Blesi and the Blesi-Evans Company.

On this appeal, we are presented with 13 assignments of error. It is not practical to consider each one separately, nor does each one require separate consideration. Fewell v. Tappan, 223 Minn. 483, 27 N.W.2d 648 (1947); Prince v. Sonnesyn, 222 Minn. 528, 25 N.W.2d 468 (1946).

1. The decisive question is whether the evidence was sufficient to support the trial court's finding of fact that Gordon Blesi breached a fiduciary duty to Melvin Evans. The evidence will be viewed in the light most favorable to the prevailing party, and the trial court's factual findings will not be overturned unless clearly erroneous. Theisen's, Inc. v. Red Owl Stores, Inc., 309 Minn. 60, 243 N.W.2d 145 (1976).

Blesi and Evans were partners in a closely held corporation. Because of this, the relationship between them was fiduciary. The law imposes on each the highest standard of integrity in their dealings with each other. In an analogous case, Fewell, 223 Minn. at 494, 27 N.W.2d at 654, the Minnesota Supreme Court held that a shareholder in a closely held corporation has a fiduciary duty to deal openly, honestly and fairly with other shareholders.

In Prince, the Supreme Court put it thus:

The relations between partners is essentially one of mutual trust and confidence, and the law imposes upon them highest standards of integrity and good faith in their dealings with each other.

222 Minn. at 535, 25 N.W.2d at 472.

Measured by that yardstick, Blesi's conduct toward Evans fell short.

The evidence showed that Blesi followed the same intimidating tactics in obtaining the majority share of stock in 1977 and in forcing the resignation in 1982. On both occasions, he did everything preparatory in secret, including conferences with lawyers

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and advance preparation of legal documents. On both occasions, Blesi approached Evans when everyone else had left the office for the day, shouted at him, slammed the door and made threats to dissolve the company and take all the business. Evans was afforded no opportunity to obtain the advice of counsel before signing the stock transfer or the letter of resignation.

The trial court stated in its memorandum that the verdict and judgment finding a breach of fiduciary duty by Blesi was based upon the abrasive and intimidating manner used by Blesi to accomplish the transfer of stock in 1977 and Evans' resignation in 1982. Based upon the above evidence, the trial court's finding was well supported.

2. On June 30, 1983, the trial court approved the advisory jury verdict of $277,000 compensatory damages to Evans for his lost salary up to the time of trial. We modify the order to $381,136, awarded jointly and severally against Blesi and the Blesi-Evans Corporation, to compensate for lost salary up to the present.

3. The trial court also independently awarded in its June 30, 1983, order the sum of $500,000 as punitive damages against Blesi individually; this was identical with the advisory jury's verdict. However, in a post-appeal order dated October 4, 1983, the trial court ordered a

remittitur of $250,000 of the punitive damages because the damages appeared to have been given under the influence of passion or prejudice attributable to plaintiff's counsel.

Respondent contends that the post-appeal order of the trial court is null and void because the trial court had lost jurisdiction to this court once appellant filed a notice of appeal. We hold that the order of October 4, 1983, is of no effect.

The scheme of civil appellate rules reveals an apparent anomaly. Under Rule 28.02, subd. (4)(3) of the Minnesota Rules of Criminal Procedure, post-trial motions delay the start of the time period for taking an appeal from the judgment until entry of the order denying the motion. A similar provision does not exist in the Rules of Civil Appellate Procedure. As a result, an order that is not really late, if entered after an appeal is taken, is of no effect. The jurisdiction over the subject matter of defendants' motions had shifted from the district court to the Court of Appeals at the time of filing of the notice of appeal on September 29, 1983. Kath v. Kath, 238 Minn. 120, 55 N.W.2d 691 (1952).

While the order is of no effect, we think the trial court was in a unique position to evaluate the effect of the alleged misconduct by plaintiff's counsel on the jury. We are taking cognizance of it for the insight it affords. As observed by the trial court, plaintiff's counsel's conduct may well have affected the award. Therefore we order, as the trial court attempted, that the punitive damages be reduced from $500,000 to $250,000.

4. Appellants also complain of the form of the special interrogatories submitted to the advisory jury. The assignments of error are numerous. Were this a jury verdict which the trial court might be bound to accept in the absence of perversity, it might be error requiring retrial. But, if the form of the special interrogatories was less than perfect, it is harmless because the trial court, in addition to adopting the answers of the advisory jury, also found independently the same facts on the same evidence. Wormsbecker v. Donovan Const. Co., 251 Minn. 277, 87 N.W.2d 660 (1958). Therefore, we hold that the trial court made appropriate findings and a new trial is not required.

5. Appellants claim that they were deprived of a fair trial because plaintiff's counsel called, as adverse witnesses, attorneys from the same law firm as appellants' trial counsel. The appellants' law firm had advised Blesi to seek Evans' resignation, had drafted the letter of resignation and the minutes of an informal action of shareholders. The firm continued to represent Blesi throughout the trial. The trial court compelled two members of that firm to testify as to communications between themselves and Blesi on the theory that by representing both the majority shareholder

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and the corporation, the lawyers were in a conflict of interest position and had a duty to advise Mr. Evans, the minority shareholder, of their advice regarding corporate matters. Therefore, their conversations with Blesi were not privileged.

We agree with the trial court and view with disapproval and some concern the practice of an attorney representing a client at trial, knowing his partners will be called as witnesses, particularly where calling them is not a mere stratagem by opposing counsel to seize unfair advantage.

This was only one among many allegations of improper conduct directed at all counsel in the case. The trial court was in the best position to evaluate the degree to which this affected the proceedings. Taking advantage of the trial court's position to gain insight, we hold that the reduction of punitive damages to one-half was an appropriate means of dealing with any prejudicial effect, and that a new trial is not warranted.

DECISION

We affirm the trial court's determination that Mr. Blesi breached his fiduciary duty to Mr. Evans. Accepting the trial court's view that it was Blesi's intimidating manner which constituted the breach of fiduciary duty, these were ultra vires acts, and we order that the $250,000 punitive damage award be entered against Mr. Blesi individually.

We modify the order for compensatory damages from $277,000 to $381,136, to be entered jointly and severally, against Mr. Blesi and Blesi-Evans Company.

We remand to the trial court for the purpose of setting up a mechanism for a buyout of the corporation with the following directions:

1. That the stock is to be evaluated by one skilled and knowledgeable in evaluating the shares of a closely held corporation, said person to be appointed by the court and paid by the Blesi-Evans Company.

2. After the evaluation, Mr. Blesi will be given the first opportunity to buy out Mr. Evans' shares at the value set for those shares by the court-appointed evaluator. If within one year from the date of this decision, Mr. Blesi has not bought Evans' shares at the price set by the evaluator, Mr. Evans shall then have the opportunity to buy out Mr. Blesi's share at the value set by the evaluator within the year following.

3. We enjoin both Mr. Blesi and Mr. Evans from dissolving or attempting to dissolve the Blesi-Evans Company for a period of two years from the date of this decision or until one of them has bought out the shares of the other.

4. We enjoin both Mr. Blesi and Mr. Evans from entering business as a representative of manufacturers of heating and ventilating equipment in the State of Minnesota for a period of two years from the date of this decision or until one has bought out the shares of the other.

5. We vacate the trial court's order of October 4, 1983, as null and void. The trial court's order of June 30, 1983, remains in effect insofar as it is not inconsistent with this decision.

LEXSEE 394 F.3D 1062

Positive
As of: Jan 30, 2007

Patrick T. Manion, Jr., Appellant, v. Stephen E. Nagin; Herzfeld & Rubin; Herzfeld & Rubin, P.C.; Nagin Gallop Figueredo, P.A., Appellees, Boat Dealers' Alliance, Inc., Defendant. Patrick T. Manion, Jr., Plaintiff, Stephen E. Nagin; Herzfeld & Rubin; Herzfeld & Rubin, P.C.; Nagin Gallop Figueredo, P.A., Defendants-Appellees, v. Boat Dealers' Alliance, Inc., Defendant - Appellant.

No. 04-1579, No. 04-1705

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

394 F.3d 1062; 2005 U.S. App. LEXIS 586

October 18, 2004, Submitted
January 13, 2005, Filed

SUBSEQUENT HISTORY: US Supreme Court certiorari denied by *Manion v. Nagin, 2005 U.S. LEXIS 4874 (U.S., June 20, 2005)*

PRIOR HISTORY: **[**1]** Appeals from the United States District Court for the District of Minnesota. *Manion v. Nagin, 392 F.3d 294, 2004 U.S. App. LEXIS 26100 (8th Cir. Minn., 2004)*

DISPOSITION: Affirmed. Appellees' motion to supplement the record was denied.

COUNSEL: For PATRICK T. MANION, JR., Plaintiff - Appellant: Richard Allen Lockridge, Martin A. Carlson, LOCKRIDGE & GRINDAL, Minneapolis, MN; Willaim J. French, CONANT & FRENCH, Dallas, TX.

For STEPHEN E. NAGIN, HERZFELD & RUBIN, HERZFELD & RUBIN, P.C., NAGIN GALLOP FIGUEREDO, P.A., Defendants - Appellees: Thomas Jerome Shroyer, Mathew M. Meyer, MOSS & BARNETT, Minneapolis, MN.

For BOAT DEALERS' ALLIANCE, INC., Defendant: Eric John Magnuson, Richard James Nygaard, John Juneau Wackman, Peter D. Gray, RIDER & BENNETT, Minneapolis, MN.

JUDGES: Before MURPHY, HEANEY, and BEAM, Circuit Judges.

OPINION BY: HEANEY

OPINION: **[*1064]** HEANEY, Circuit Judge.

Patrick T. Manion, Jr., sued attorney Stephen E. Nagin, and the law firms of **[*1065]** Herzfeld & Rubin, Herzfeld & Rubin, P.C., and Nagin Gallop Figueredo, P.A., for breach of fiduciary duty, negligence, and tortious interference with contract stemming from Nagin's conduct in the creation and representation of the Boat Dealers' Alliance, Inc. (BDA). n1 The district court n2 dismissed Manion's suit, and we affirm.

n1 Manion's companion suit against BDA and its members is also the subject of an appeal. We have issued a separate decision in that case. See *Manion v. Nagin, 392 F.3d 294, 2004 U.S. App. LEXIS 26100, Nos. 03-2869 & 03-2870 (8th Cir. Dec. 16, 2004)*.

[2]**

n2 The Honorable Ann D. Montgomery, United States District Judge for the District of Minnesota.

BACKGROUND

Because this matter reaches us following a motion to dismiss the complaint, we construe the pleadings liberally in favor of Manion and accept the allegations in his complaint as true. *Wisdom v. First Midwest Bank, 167 F.3d 402, 406 (8th Cir. 1999)*. n3 Patrick Manion worked for many years in the pleasure boat industry. In 1995, he came up with a plan to organize, own, and operate an entity made up of retail boat dealers, who would use their buying power to purchase marine equipment at significant discounts.

n3 The district court properly considered the motion as one to dismiss rather than one for summary judgment because the only matters beyond the pleadings relied upon by the district court were matters of public record. Accord *Porous Media Corp. v. Pall Corp., 186 F.3d 1077, 1079 (8th Cir. 1999)* (noting that district court may consider public records from other proceedings in ruling on a motion to dismiss).

[3]**

Stephen Nagin held himself out as an attorney who was experienced in representing buying groups. When Manion contacted Nagin about Manion's idea to create his marine buying group, Nagin boasted that he was a "world class lawyer" working at a "world class law firm." (Appellant's App. at 32.) He claimed to be one of the few lawyers in the country who had expertise in organizing buying groups. In the spring of 1995, Nagin agreed to represent Manion in creating and running BDA. Nagin told Manion that he would charge $ 300 per hour for his work on BDA, but eventually the two agreed that Nagin would charge $ 150 an hour but also receive ten percent of BDA's preferred stock. Owners of the preferred stock received ten percent of BDA's annual distributable income. Until Nagin suggested he take an ownership interest in BDA's preferred stock, Manion intended to be the sole owner of it.

Nagin incorporated BDA in Florida. Manion questioned whether it was wise to incorporate in this venue, but Nagin shrugged off Manion's concern, stating "I am the attorney. I am the one who is well versed in this. Let me do my job and you do yours." (Appellant's App. at 34.) When Nagin prepared BDA's By-Laws, **[**4]** Manion noticed that preferred stock shareholders could only vote for certain changes in the By-Laws, while common stock shareholders had unrestricted voting rights. He questioned Nagin about how he, owning only preferred stock, could control BDA if he could not vote on general matters. Nagin advised Manion that he maintained control over BDA because the value of his preferred stock was so much greater than the value of common stock, and because of a Management Agreement that Nagin had drafted to serve as Manion's employment contract with BDA. Nagin assured Manion that the Management Agreement precluded BDA from removing Manion from his position as executive director for any reason for twenty years.

By 1996, Nagin had become unhappy with his fee structure. He wrote to Manion, asserting that he was not receiving the **[*1066]** amount of compensation they had anticipated in crafting the fee agreement. The two agreed on a new fee structure, whereby Nagin received a greater percentage of the preferred stock dividends. Manion was the only other shareholder of the preferred stock, meaning that the increased legal fees would be paid from monies originally due to Manion.

On February 13, 1999, BDA held **[**5]** a special meeting at which BDA terminated Manion. In arbitration proceedings related to Manion's claims of wrongful termination, BDA successfully argued that its termination of Manion was proper because he acted in bad faith against the interests of BDA. The district court confirmed the arbitration award, and this court affirmed. See *Manion v. Nagin, 2004*

U.S. App. LEXIS 26100, Nos. 03-2869 & 03-2870 (8th Cir. Dec. 16, 2004). Manion, still a majority shareholder of the preferred stock, decided to attend BDA's April 10, 1999 meeting. At the meeting, Manion learned that Nagin had asked BDA's Finance Committee to search for additional grounds to justify BDA's termination of Manion. When Manion learned about this, he asked Nagin who he was representing. Nagin responded that he represented BDA. Up until this point, Nagin had not told Manion that he did not represent Manion, and Manion considered Nagin to be his lawyer.

Manion filed suit against BDA, its individual members, Nagin, and his law firms. The district court directed arbitration with regard to Manion's complaint against BDA and its members pursuant to the terms of his contract, and stayed his claims against Nagin and the law firms pending the outcome **[**6]** of the arbitration. This court affirmed. *Manion v. Nagin, 255 F.3d 535 (8th Cir. 2001)*. Following the arbitrator's decision, Nagin and the law firms moved to dismiss Manion's complaint, contending that the claims were either legally deficient, collaterally estopped, or barred for failure to comply with a Minnesota statute concerning legal malpractice claims. The district court dismissed Manion's complaint, and this appeal followed.

ANALYSIS

The district court found that Manion's tortious interference with contract claim and some of his negligence claims were barred by the doctrine of collateral estoppel, also known as issue preclusion. "We look to state law in determining whether to apply issue preclusion," *Liberty Mut. Ins. Co. v. FAG Bearings Co., 335 F.3d 752, 758 (8th Cir. 2003)*, and review the district court's ruling on the matter de novo, Nat'l *Union Fire Ins. Co. v. Terra Indus., Inc., 346 F.3d 1160, 1164 (8th Cir. 2003)*. A party is precluded from litigating an issue if the following conditions are met: 1) the issue to be litigated is identical to one already decided in a prior adjudication; 2) the earlier case resulted **[**7]** in a final judgment on the merits; 3) the party raising the issue was a party to or in privity with a party to the prior case; and 4) the party was given a full and fair opportunity to be heard on the issue. *Crumley v. City of St. Paul, 324 F.3d 1003, 1006 (8th Cir. 2003)* (stating Minnesota legal standard for the doctrine of collateral estoppel); *Cmty. Bank of Homestead v. Torcise, 162 F.3d 1084, 1086-87 & n.7 (11th Cir. 1998)* (recognizing similar elements under Florida substantive law). n4

> n4 There is a question as to whether Minnesota or Florida law governs Manion's claims. We have included citations to both, as the result is the same under either state's law.

Manion first argues that the district court erred by relying on findings in his related arbitration proceeding against BDA and its members when deciding if any of his claims were collaterally estopped against Nagin and the law firms. We disagree. An arbitration award counts as a final judgment for collateral estoppel **[**8]** **[*1067]** purposes. *Wellons, Inc. v. T.E. Ibberson Co., 869 F.2d 1166, 1168-69 (8th Cir. 1989)*. While Manion complains that he did not get a full and fair hearing in the arbitration, we have considered this argument at length in the related appeal of *Manion v. Nagin, 2004 U.S. App. LEXIS 26100, Nos. 03-2869 & 03-2870 (8th Cir. Dec. 16, 2004)*, and rejected Manion's position.

Manion's tortious interference with contract claim stems from his allegation that Nagin interfered with his employment rights under his Management Agreement. In order to prove tortious interference, Manion is required to show that he had valid contract rights which Nagin knew about and procured another party to breach without justification, and that he was damaged by the breach. *Guercio v. Prod. Automation Corp., 664 N.W.2d 379, 389 (Minn. Ct. App. 2003)*; accord *Salit v. Ruden, McClosky, Smith, Schuster, & Russell, P.A., 742 So. 2d 381, 385-86 (Fla. Dist. Ct. App. 1999)* (stating that under Florida law, a plaintiff alleging tortious interference must prove the existence of a business relationship accompanied by legally enforceable rights, the intentional and unjustified interference with that relationship, **[**9]** and damages). Manion arbitrated the issue of whether BDA breached his Management Agreement without justification. The arbitrator interpreted the contract to permit BDA to terminate Manion if he was grossly negligent or acted in bad faith. Finding that Manion demonstrated bad faith in three instances where he failed to act in BDA's financial interest, the arbitra-

tor held that BDA was justified in terminating Manion's employment contract.

The arbitration decision precludes Manion's tortious interference with contract claim against Nagin and his firms. Manion alleged that Nagin assisted BDA in breaching Manion's contract. But, as the arbitrator found, BDA was justified in terminating Manion's contract because of his bad faith conduct. To sustain his claim, Manion must prove that Nagin assisted BDA in terminating him without justification, *Guercio, 664 N.W.2d at 389*; *Salit, 742 So. 2d at 385-86*, and he cannot do so here on account of the arbitrator's contrary ruling.

The same analysis applies to the negligence claims dismissed by the district court on collateral estoppel grounds. Manion alleged that Nagin was negligent in not protecting Manion's ownership **[**10]** rights to his preferred stock, and that he was damaged by the loss of the stock. The arbitrator, however, found that Manion was still the rightful owner of the preferred stock and entitled to all benefits attendant to ownership. Since Manion's claimed damages flowed from his alleged loss of the stock, and the arbitrator found that Manion never in fact lost his stock, he has suffered no injury. Proof of damages or a cognizable injury is essential to a negligence claim. *Lubbers v. Anderson, 539 N.W.2d 398, 401 (Minn. 1995)*; *Fla. Power & Light Co. v. Lively, 465 So. 2d 1270, 1273 (Fla. Dist. Ct. App. 1985)*. Manion cannot establish the essential elements of negligence for his action concerning his preferred stock.

The district court dismissed the remainder of Manion's suit, which alleged negligence and the breach of fiduciary duty related to Nagin's legal work, because it found he failed to state a claim. The lynchpin of this holding was the district court's determination that Nagin was never working as Manion's personal lawyer, and thus owed Manion no duty whatsoever.

To maintain a claim for negligence deriving from legal malpractice, the plaintiff **[**11]** must demonstrate the existence of an attorney-client relationship. *Wartnick v. Moss & Barnett, 490 N.W.2d 108, 112 (Minn. 1992)*; *Horowitz v. Laske, 855 So. 2d 169, 173 (Fla. Dist. Ct. App. 2003)*. Similarly, **[*1068]** an attorney undertaking an attorney-client relationship assumes fiduciary duties, the breach of which may be actionable. *STAR Ctrs., Inc. v. Faegre & Benson, L.L.P., 644 N.W.2d 72, 77 (Minn. 2002)*; *Behr v. Foreman, 824 So. 2d 222, 223-24 (Fla. Dist. Ct. App. 2002)*.

In Minnesota, an attorney-client relationship can be created through contract or tort theory. *Gramling v. Mem'l Blood Ctrs., 601 N.W.2d 457, 459 (Minn. Ct. App. 1999)*. Under the former, the plaintiff must show the creation of the relationship through either express or implied contract. Id. The tort theory of representation recognizes the existence of an attorney-client relationship "whenever an individual seeks and receives legal advice from an attorney in circumstances in which a reasonable person would rely on such advice." *Id. at 460*. Likewise, in Florida the test for determining if an attorney-client relationship **[**12]** exists depends on the client's belief that he is consulting with an attorney for the manifest purpose of obtaining legal advice. *Fla. Bar v. Beach, 675 So. 2d 106, 109 (Fla. 1996)*. In both states, though, an individual's subjective expectation that a lawyer will represent the person is insufficient as a matter of law to create the relationship. Id.; *Gramling, 601 N.W.2d at 460*.

The district court held that the complaint did not sufficiently show that Nagin and Manion had established an attorney-client relationship. The court noted that Nagin's work was solely related to the creation and operation of BDA, and that Nagin never worked on anything for Manion individually. Invoking the well-established rule that a corporate employee does not generally enjoy an attorney-client relationship with corporate counsel, the court dismissed the claims which required proof of that relationship as an element.

Florida and Minnesota have both adopted rules of professional conduct which govern the actions of their states' lawyers. Both states have nearly identical rules about the representation of corporations and similar entities, making clear that the attorney's **[**13]** duty attaches to the entity, not its constituents. Minn. R. Prof. Conduct 1.13(a); *R. Regulating Fla. Bar 4-1.13*. Cases interpreting these rules have adhered to this proposition. See *Humphrey v. McLaren, 402 N.W.2d 535, 540 (Minn. 1987)* (noting that in representing a corporation against one of its officers or employees, corporate counsel's "allegiance is to the organization"); *Brennan v. Ruffner, 640 So. 2d 143, 145-46 (Fla. Dist. Ct. App. 1994)*

(holding that generally an attorney representing a closely held corporation "owes no separate duty of diligence and care to an individual shareholder absent special circumstances or an agreement to also represent the shareholder individually"). The district court also turned for guidance to a Wisconsin Supreme Court case, *Jesse v. Danforth, 169 Wis. 2d 229, 485 N.W.2d 63 (Wisc. 1992)*. Jesse involved a medical malpractice suit against a few named health care professionals. Two of the doctors moved to disqualify the plaintiffs' law firm because the firm had helped those doctors to create a corporation for the purpose of purchasing and operating MRI equipment. The corporation was not a party **[**14]** to the Jesse suit. The question presented to the Wisconsin Supreme Court was whether the plaintiffs' law firm must be disqualified where one of its members represented the defendant doctors in their formation of the MRI-related corporation. The court noted that at the initial stages of the firm's relationship with the doctors, it was representing them personally because no corporation had yet been formed. Still, since the representation was limited solely to the creation of the MRI corporation, the court retroactively applied the entity rule to hold that the firm never actually represented the doctors individually:

> **[*1069]** Where (1) a person retains a lawyer for the purpose of organizing an entity and (2) the lawyer's involvement with that person is directly related to that incorporation and (3) such entity is eventually incorporated, the entity rule applies retroactively such that the lawyer's pre-incorporation involvement with the person is deemed to be representation of the entity, not the person.

Id. at 67.

Relying on Jesse, the district court invoked the entity rule to find that Nagin exclusively represented BDA. We agree that if Nagin's only interaction with **[**15]** Manion was to create BDA, Nagin could not be considered Manion's lawyer. Liberally construing the complaint in Manion's favor, though, we cannot agree that Nagin only operated as BDA's attorney. While Nagin may well have represented BDA as its corporate counsel, this does not preclude a finding that Nagin also provided Manion with legal advice and thus established an attorney-client relationship. n5 Manion alleged that he sought and received guidance about how he could maintain control of the corporation. Nagin's advice here was not to BDA, but to Manion personally. Similarly, Manion used Nagin to draft an employment agreement between himself and BDA. Manion expressed his concern that the agreement sufficiently protect his interests, and Nagin accordingly drafted the agreement in a manner that he told Manion would ensure a twenty-year term of employment. When Nagin renegotiated his payment agreement, he and Manion agreed that Nagin would receive a portion of Manion's preferred share dividends. In other words, Nagin was paid for his services, at least in part, out of Manion's pocket.

> n5 The rules professional conduct of both Minnesota and Florida in fact contemplate that corporate counsel may also act as the attorney for an officer or employee of the corporation and generally permit such conduct. Minn. R. Prof. Conduct 1.13(e); *R. Regulating Fla. Bar 4-1.13(e)*.

[16]**

When Manion asked questions about the incorporation documents and his employment agreement, he was seeking an opinion about the legal interpretation of the documents and whether they benefitted him as contemplated. These matters were not directly related to the formation of BDA-they concerned Manion's personal concerns of how he would be employed, and whether he would have control of the corporation. Cf. *Jesse, 485 N.W.2d at 67* ("Where the person who retained the lawyer provides information to the lawyer not directly related to the purpose of organizing an entity, then it is the person, not the corporation, which holds the privilege for that communication."). Providing Manion with advice about his personal interest in BDA and the Management Agreement was obviously beyond the scope of Nagin's job as BDA's attorney, and perhaps contrary to it. If Nagin was truly working exclusively as BDA's lawyer, he

should have responded to Manion's questions by clarifying that he worked only for BDA and suggested Manion seek outside counsel. See Minn. R. Prof. Conduct 1.13(d) (requiring corporate counsel who is dealing with a shareholder or employee to "explain the identity of **[**17]** the client when it appears that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing"); *R. Regulating Fla. Bar 4-1.13(d)* (same). Instead, Nagin advised Manion that he maintained control over BDA by having a strong financial interest in the preferred stock shares and by holding a twenty-year employment contract. Manion sought and received legal advice on these matters from Nagin, and that is sufficient to establish that an attorney-client relationship existed between the two **[*1070]** of them. *Gramling, 601 N.W.2d at 460*; *Beach, 675 So. 2d at 109*.

Nonetheless, Manion has not stated a cognizable claim related to his attorney-client relationship with Nagin. Manion has sufficiently alleged that he established an attorney-client relationship with Nagin relating to Manion's employment contract and control of the corporation. But the arbitrator in Manion's related action against BDA found that Manion operated in bad faith against the corporation's interests by overpaying himself and other BDA shareholders and by failing to disclose financial data which would have revealed his bad faith. Bound by that finding, the defect **[**18]** in Manion's claims becomes obvious: he asks us to hold that Nagin committed legal malpractice by not warning him that he may lose control of BDA for committing malfeasance toward it, or protecting Manion from termination once Manion operated in that manner. Such a claim is not viable under either Minnesota or Florida law. Accord Minn. R. Prof. Conduct 1.2(c) (forbidding an attorney from assisting a client in fraudulent or deceitful conduct); *R. Regulating Fla. Bar 4-1.2(d)* (same). Accordingly, we affirm the district court's dismissal of Manion's breach of fiduciary duty and negligence claims as they related to Nagin's legal work. See *Tademe v. Saint Cloud State Univ., 328 F.3d 982, 990 (8th Cir. 2003)* (noting that this court may affirm the district court's grant of summary judgment on any basis supported by the record).

CONCLUSION

We affirm the district court, and deny the appellees' motion to supplement the record.

LEXSEE 485 N.W.2D 63

Positive
As of: Jan 30, 2007

Jean C. Jesse, by her Guardian ad Litem, David W. Reinecke and Vern Jesse, Sr., Plaintiffs-Respondents-Petitioners, v. R. Clarke Danforth, M.D., R. Clarke Danforth, M.D., S.C., Donald P. Ullrich, M.D., Neurodiagnostic Associates, a Partnership, Neurosurgical Specialists, S.C. and Neurodiagnostic Associates, a Division of Neurosurgical Specialists, S.C., Defendants-Appellants, W. Gregory Von Roenn, M.D., W. Gregory Von Roenn, M.D., S.C., Michael V. Darnieder, M.D., Wisconsin Patients Compensation Fund, Physicians Insurance Company of Wisconsin, Inc., The Professionals Insurance Company and The Medical Protective Company, Defendants, Blue Cross & Blue Shield United of Wisconsin, Milwaukee County Department of Health & Human Services, as agent for Wisconsin Department of Health & Social Services, Division of Health, Subrogated Parties

No. 90-1312

SUPREME COURT OF WISCONSIN

169 Wis. 2d 229; 485 N.W.2d 63; 1992 Wisc. LEXIS 320

May 27, 1992, Oral argument
June 23, 1992, Decided
June 23, 1992, Filed

PRIOR HISTORY: [*1]**
Review of a decision by the Court of *Appeals, 163 Wis. 2d 1044, 473 N.W.2d 532 (Ct. App. 1991).*

DISPOSITION:

By the Court. -- The decision of the court of appeals is reversed and the cause is remanded to the circuit court for further proceedings not inconsistent with this opinion.

COUNSEL:

For the plaintiffs-respondents-petitioners there were briefs by Jack R. DeWitt, John D. Varda and DeWitt, Porter, Huggett, Schumacher & Morgan, S.C., Madison and oral argument Mr. Varda.

For the defendants-appellants, R. Clarke Danforth, M.D. and R. Clarke Danforth, M.D., S.C., there was a brief by Kathleen E. Bonville, Mark E. Larson and Gutglass, Erickson & Bonville, S.C., Milwaukee and oral argument by Mr. Larson.

For the defendants-appellants, Donald P. Ullrich, M.D., Neurodiagnostic Associates and Neurosurgical Specialists, there was a brief by Michael P. Malone, Susan R. Tyndall and Hinshaw & Culbertson, Milwaukee and oral argument by Ms. Tyndall.

JUDGES:

Day, J. Justices Louis J. Ceci and William A. Bablitch withdrew from participation.

OPINION BY:

DAY

OPINION: [64]**

[*234] DAY, J. This is a review of a published decision of the court of appeals n1 that reversed a non-final order of the Circuit Court for **[***2]** Milwaukee County, William J. Haese, Judge, which denied defendants Drs. Danforth's and Ullrich's motions to disqualify DeWitt, Porter, Huggett, Schumacher & Morgan, S.C. (DeWitt) as plaintiffs' counsel.

n1 *163 Wis. 2d 1044, 473 N.W.2d 532 (Ct. App. 1991).*

The issue in this case is whether a conflict of interest exists such that DeWitt should be disqualified from representing plaintiffs in their medical malpractice action against defendants. Because we find no conflict of **[*235]** interest to exist, we hold that the DeWitt firm should not be disqualified from representing plaintiffs in their action against the defendants. We therefore reverse the court of appeals and remand the cause to the circuit court for reinstatement of the DeWitt firm as plaintiffs' counsel.

[65]** Defendants Drs. Danforth and Ullrich are involved in several entities that own and operate sophisticated and expensive diagnostic tools, as well as entities that provide medical services. The relationship between these entities is complex.

Neurodiagnostic **[***3]** Associates is a division of Neurosurgical Specialists, S.C. Both are defendants in this case. Neurodiagnostic Associates is a partnership formed in 1975 to own and operate a computerized axial tomography scanning machine (CAT). The CAT scanner was subsequently sold to Dr. Ullrich who, in turn, leased it to Neurodiagnostic Associates. Drs. Danforth and Ullrich are both partners in Neurodiagnostic Associates.

In 1985, a group of twenty-three physicians, including Drs. Danforth and Ullrich, retained Attorney Douglas Flygt (Flygt) of DeWitt to assist them in creating a corporate entity for the purpose of purchasing and operating a magnetic resonance imaging (MRI) machine. An MRI scanner is currently the most advanced radioimaging technology and is an improvement on the previously available CAT scanner.

Flygt incorporated MRI Associates of Greater Milwaukee (MRIGM) in January, 1986 and continues as its corporate counsel. The twenty-three physicians, including Drs. Danforth and Ullrich, became the shareholders of MRIGM and Dr. Danforth became its president. Dr. Danforth was, and is, the main contact of DeWitt with MRIGM. In 1987, MRIGM formed a service corporation **[*236]** and **[***4]** elected subchapter S treatment under the Internal Revenue Code which permits a qualified small business corporation and its shareholders to elect to be taxed as a partnership while retaining the benefits of a corporation.

MRIGM is a general partner in Milwaukee Magnetic Resonance Consortium, which owns and operates a free-standing MRI facility in Milwaukee, and a partner in MRI Physicians of Greater Milwaukee, which provides the professional services at Milwaukee Magnetic Resonance Consortium. Neither MRIGM, Milwaukee Magnetic Consortium, nor MRI Physicians of Greater Milwaukee are parties to this action.

In May 1988, plaintiffs retained Attorney Eric Farnsworth (Farnsworth), of DeWitt, to represent them in a medical malpractice action against defendants. After consulting with the Jesse family, Farnsworth conducted an internal conflicts check that apparently did not list Drs. Danforth or Ullrich as clients. Farnsworth filed an initial summons and complaint as well as several amended summons and complaints.

The complaints allege, *inter alia*, that defendants were negligent for failing to obtain a tomography of sufficient quality or resolution to accurately serve as a diagnostic **[***5]** tool. The CAT scanner employed for plaintiff Jesse was allegedly the one owned by Dr. Ullrich which he leased to Neurodiagnostic Associates. Plaintiffs allege that Neurodiagnostic Associates made the CAT scanner available in the course of plaintiff's treatment and charged a fee to plaintiff Jesse. Plaintiffs further allege that a portion of that fee was shared with, or refunded to, defendants as a financial incentive for them to utilize the machine.

Drs. Danforth and Ullrich moved for disqualification of the DeWitt firm alleging a conflict of in-

terest. On May 21, 1990, Judge Haese, ruling from the bench, **[*237]** denied the motions for disqualification and awarded DeWitt statutory costs. A written order denying the motions was subsequently issued. Drs. Danforth and Ullrich appealed, and on July 16, 1991, the court of appeals issued its decision reversing the circuit court's order. We granted petitioners' petition for review and now reverse the court of appeals.

We begin with *SCR 20:1.7*, the conflict of interest rule. n2 Subsection (a) states: "A **[**66]** lawyer shall not represent a client if the representation of that client will be directly adverse to another, unless. . . ." **[***6]** n3 Thus, the question is, who did or does DeWitt represent, *i.e.*, who were and are DeWitt's clients?

n2 **SCR 20:1.7 Conflict of interest: general rule**

> (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 in writing 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 in writing 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.

n3 Because the attorneys Flygt and Farnsworth are both associated with the DeWitt firm, *SCR 20:1.10* Imputed disqualification: general rule, applies. SCR 20:1.10 states in part:

> (a) While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7 [Conflict of Interest: General Rule], 1.8(c) [Conflict of Interest: Prohibited Transactions], 1.9 [Conflict of Interest: Former Client] or 2.2 [Intermediary].

[*7]**

[*238] It is undisputed that DeWitt, through Farnsworth, represents Jean Jesse in this case. What remains disputed is whether Drs. Danforth or Ullrich were ever or are currently clients of DeWitt.

Defendants argue that Drs. Danforth and Ullrich are clients of the DeWitt firm due to Flygt's pre-incorporation representation of the twenty-three physicians and due to other advice provided to Drs. Danforth and Ullrich by Flygt. Defendants argue that, under *SCR 20:1.7*, DeWitt's representation of the plaintiffs is "directly adverse" to DeWitt's representation of defendants Drs. Danforth and Ullrich and therefore a conflict of interest exists disqualifying the DeWitt firm from representing plaintiffs.

Defendants argue that one must look to the facts of each particular case to determine whether an attorney-client relationship exists. Defendants cite to and quote affidavits and documents, discussed later in this opinion, which, to them, show that Drs. Danforth and Ullrich were DeWitt's clients.

Plaintiffs argue that DeWitt never represented Drs. Danforth or Ullrich. They readily concede that DeWitt, through Flygt, originally incorporated MRIGM and that Flygt remains corporate counsel **[***8]** to MRIGM. However, plaintiffs assert that DeWitt's representation of MRIGM does not translate into representation of its shareholders.

Plaintiffs argue, under the "entity rule," as expressed by *SCR 20:1.13*, n4 that where a firm represents **[*239]** a corporate organization, the organization, not the shareholders, is the lawyer's client. Therefore, plaintiffs argue that DeWitt's representation of MRIGM does not equate with representation of Drs. Danforth or Ullrich. Plaintiffs conclude that because DeWitt never represented Drs. Danforth or Ullrich, there is no conflict of interest.

n4 **SCR 20:1.13 Organization as client**

> (a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents. . . .
>
> (d) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.
>
> (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. 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.

[*9]**

We conclude that the entity rule does extend to Drs. Danforth and Ullrich such that DeWitt's pre-incorporation involvement with Drs. Danforth and Ullrich is properly characterized as representation of MRIGM, not Drs. Danforth or Ullrich, *i.e.*, DeWitt's client was and is MRIGM, not Drs. Danforth or Ullrich.

The entity rule contemplates that where a lawyer represents a corporation, the client is the corporation, not the corporation's constituents. n5 First, the title of **[**67]** the section is demonstrative, it states, "*Organization* as Client." (Emphasis added.) Second, subsection (a) states, "A lawyer employed or retained by an organization *represents the organization* acting through its duly authorized constituents." (Emphasis added.) Third, subsection (d) states, "In dealing with an organization's . . . constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are **[*240]** adverse to those of the constituents with whom the lawyer is dealing." This clearly implies it is the organization, not the constituent that is the lawyer's client. Fourth, subsection (e) begins, "A lawyer representing an organization may also represent **[***10]** any of its . . . constituents. . . ." The use of the phrase "may also represent" implies that the lawyer does not automatically represent the constituent when he or she represents the corporate entity. Fifth, the Comment to *SCR 20:1.13* states in part:

> When one of the constituents of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is protected by Rule 1.6 [Confidentiality of Information]. Thus, by way of example, if an organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client's employees or other constituents are covered by Rule 1.6. *This does not mean, however, that constituents of an organizational client are the clients of the lawyer*.

SCR 20:1.13 (emphasis added).

n5 The Comment to *SCR 20:1.13* defines "constituent" to be the corporation's officers, directors, employees and shareholders.

Thus, the **[***11]** clear purpose of the entity rule was to enhance the corporate lawyer's ability to represent the best interests of the corporation without automatically having the additional and potentially conflicting burden of representing the corporation's constituents.

If a person who retains a lawyer for the purpose of organizing an entity is considered the client, however, then any subsequent representation of the corporate entity by the very lawyer who incorporated the entity would automatically result in dual representation. This **[*241]** automatic dual representation, however, is the very situation the entity rule was designed to protect corporate lawyers against.

We thus provide the following guideline: where (1) a person retains a lawyer for the purpose of organizing an entity and (2) the lawyer's involvement with that person is directly related to that incorporation and (3) such entity is eventually incorporated, the entity rule applies retroactively such that the lawyer's pre-incorporation involvement with the person is deemed to be representation of the entity, not the person.

In essence, the retroactive application of the entity rule simply gives the person who retained the lawyer **[***12]** the status of being a corporate constituent during the period before actual incorporation, as long as actual incorporation eventually occurred.

This standard also applies to privileged communications under *SCR 20:1.6*. n6 Thus, where the above standard is met, communications between the retroactive constituent and the corporation are protected under *SCR 20:1.6*. And, it is the corporate entity, not the retroactive constituent, that holds the privilege. This tracks the Comment to *SCR 20:1.13* which states in part: "When one of the constituents of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is **[*242]** protected by Rule 1.6." *See also Bobbitt v. Victorian House, Inc., 545 F. Supp. 1124 (1982).*

n6 **SCR 20:1.6 Confidentiality of information**

(a) A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraphs (b), (c) and (d) . . . .

[*13]**

However, where the person who retained the lawyer provides information to the lawyer not directly related to the purpose of organizing an entity, then it is the person, not the corporation which holds the privilege for that communication.

[68]** Applying the above standard to the case at hand, we observe that the evidence cited and quoted by the defendants demonstrates that the above standard is met and that DeWitt represented MRIGM, not Drs. Danforth or Ullrich.

For example, defendants Drs. Danforth and Ullrich point to Flygt's affidavit wherein Flygt states that he was contacted "*to assist a group of physicians in Milwaukee in organizing an entity* to own and operate one or more magnetic resonance imaging ('MRI') facilities. . . ." (Emphasis added.)

Dr. Danforth points to a January 29, 1986 letter from Flygt to Dr. Danforth wherein Flygt stated:

Regarding other matters, I would suggest that *the corporation* come to a quick resolution of the subchapter S corporation question. I think it would be beneficial for me to put together a brief outline of the issues concerning this. (Emphasis added.)

Drs. Danforth and Ullrich point to a May 5, 1986 letter from Flygt to Richard **[***14]** Canter, a non-DeWitt attorney who represents various hospitals, which discusses the need for financial projections concerning MRIGM as a subchapter S corporation and states, "The doctors will need some time to digest those numbers before they can **[*243]** have a meaningful discussion as to how to finally structure the entity."

Drs. Danforth and Ullrich point to a May 5, 1986 letter from Flygt to Dr. Danforth which states, "One of the reasons why the doctors in MRIGM were making the large investment and wanted the corporation to be taxed as an S corporation was to take advantage of any tax losses flowing through to them as general partners." The letter goes on to discuss attorneys fees concluding, "to the extent that there are common expenses of the partnership, such as drafting documents, etc., *it would be appropriate to have the entity pay those fees while the attorneys fees of each individual group are its own cost*." (Emphasis added.)

Dr. Danforth and Ullrich point to a May 13, 1987 memorandum Flygt wrote to the "Shareholders" of MRIGM. The memorandum begins, "The purpose of this letter is to advise you as to a decision *which must be made by the corporation* at this **[***15]** time." (Emphasis added.) The memorandum then discusses the option of converting MRIGM to a service corporation and the liability benefits to the shareholders flowing from such a conversion.

This evidence overwhelmingly supports the proposition that the purpose of Flygt's pre-incorporation involvement was to provide advice with respect to organizing an entity and that Flygt's involvement was directly related to the incorporation. Moreover, that MRIGM was eventually incorporated is undisputed.

In addition, with respect to Flygt's advice concerning the structure of the entity, the fact that a particular corporate structure may benefit the shareholders or the fact that there was communication between Flygt and the shareholders concerning such structuring does not **[*244]** mean that Drs. Danforth and Ullrich were the clients of the law firm. Again, the very purpose of the entity rule is to preclude such automatic dual representation.

We are in complete agreement with the circuit court's finding that the services rendered by Flygt were of a corporate nature. The circuit court stated in part:

> At first blush it's difficult for the court to see any conflict except an identity **[***16]** of names. You've got a corporation here consisting of something in excess of 20 doctors. *The services previously rendered were of a corporate nature, advice, counsel given to a number of the doctors that were involved with this corporation and the present lawsuit involves a question of personal malpractice on the part of a person who happens to be a shareholder and member of that firm [corporation]*. (Emphasis added.)

Drs. Danforth and Ullrich also contend that they provided certain confidential information to attorney Flygt that should disqualify DeWitt under *SCR 20:1.6*, the confidential information rule. Defendants **[**69]** point to questionnaires Flygt provided to the physicians involved in the MRI project which inquire, in part, as to the physicians' personal finances and their involvement in pending litigation.

Because MRIGM, not the physician shareholders, was and is the client of DeWitt, and because the communications between Drs. Danforth and Ullrich were directly related to the purpose of organizing MRIGM, we conclude that Drs. Danforth or Ullrich cannot claim the privilege of confidentiality.

Dr. Ullrich asserts that there is also a conflict of interest between DeWitt's **[***17]** undisputed representation of MRIGM and DeWitt's undisputed representation of the **[*245]** plaintiffs. We disagree. For a conflict to exist, the representation of one client must be "directly adverse" to the representation of another client. Defendant Ullrich asserts that DeWitt's representation of plaintiff Jesse is directly adverse to DeWitt's representation of MRIGM by arguing that Drs. Danforth and Ullrich could lose their licenses to practice medicine if plaintiff Jesse prevails and MRIGM would face the loss of two of its shareholders and its president. Defendant Ullrich argues that, in light of plaintiffs'

"financial incentive" allegations concerning the use of the CAT scanner, prosecution of this case could "mar" MRIGM's reputation and result in an adverse financial impact. Defendant Ullrich argues that DeWitt possesses information that most persons would consider confidential and, if DeWitt is allowed to continue as plaintiff Jesse's counsel, it may be difficult for MRIGM to secure additional shareholders who fear disclosure of such information.

Such possibilities fall short of "direct" adversity. While "directly adverse" and "indirectly adverse" are somewhat nebulous **[***18]** and factually dependent terms, the possible ramifications of DeWitt's representation of plaintiff Jesse are simply insufficient to be characterized as "directly adverse" to DeWitt's representation of MRIGM.

Motions to disqualify are reviewed under the abuse of discretion standard. *State v. Miller, 160 Wis. 2d 646, 654, 467 N.W.2d 118 (1991).*

> The trial court "possesses broad discretion in determining whether [attorney] disqualification is required in a particular case, and the scope of our review is limited accordingly." Generally, we will not find an abuse of discretion if the record shows that discretion was in fact exercised and we can perceive a **[*246]** reasonable basis for the trial court's decision. However, "we have never hesitated to reverse discretionary determinations where the exercise of discretion is based on an error of law."

Berg v. Marine Trust Co., 141 Wis. 2d 878, 887, 416 N.W.2d 643 (Ct. App. 1987) (citations omitted).

Our review of the record persuades us that the circuit court did not abuse its discretion. Based on the substantial difference in representing a corporate entity and representing one in an action against some of the shareholders **[***19]** of that entity, and based upon the finding that the services rendered by DeWitt to MRIGM were of a corporate nature, the circuit court's decision was firmly grounded on a reasonable basis. Furthermore, the circuit court's legal conclusion that no conflict of interest existed was correct.

We conclude that the circuit court did not abuse its discretion in denying Drs. Danforth's and Ullrich's motions for disqualification. We therefore reverse the court of appeals and remand the cause to the circuit court to reinstate DeWitt as legal counsel for the plaintiffs.

By the Court. -- The decision of the court of appeals is reversed and the cause is remanded to the circuit court for further proceedings not inconsistent with this opinion.

02-06: Corporate Representation; Multiple Representation; Lawyer-Client Relationship; Confidentiality; Conflicts of Interest

09/2002

A lawyer may form a business entity for various individuals and be counsel only for the yet-to-be-formed entity, if appropriate disclosures and consents occur. Alternatively, a lawyer may represent all of the incorporators, collectively, with appropriate disclosures.

FACTS[1]

Lawyer is a business law practitioner who currently represents several businessmen in various matters. The existing clients ask the lawyer to form a new entity corporation for them and to be counsel only for the entity.

QUESTIONS PRESENTED

1. May a lawyer represent a yet-to-be-formed entity during formation?
2. Can a lawyer represent the prospective entity without being deemed to also represent the incorporators?
3. If so, what disclosures must the lawyer make to the constituents to clarify who is the client?

RELEVANT ETHICAL RULES

ER 1.6. Confidentiality of Information

(a) A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraphs (b), (c) and (d) or ER 3.3(a)(2).

(b) A lawyer shall reveal such information to the extent the lawyer reasonably believes necessary to prevent the client from committing a criminal act that the lawyer believes is likely to result in death or substantial bodily harm.

(c) A lawyer may reveal the intention of his client to commit a crime and the information necessary to prevent the crime.

(d) A lawyer may reveal such information to the extent the lawyer reasonably believes necessary to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceedings concerning the lawyer's representation of the client.

ER 1.7. Conflict of Interest: General Rule

(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.

*** * * ***

ER 1.13. Organization as Client

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

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal

obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include among others:

(1) asking reconsideration of the matter;

(2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and

(3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.

(c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer may resign in accordance with ER 1.16.

(d) In dealing with an organization's directors, officers, employees, members, shareholders, or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(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 ER 1.7. If the organization's consent to the dual representation is required by ER 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.

OPINION

1. Can a lawyer represent an entity that does not yet exist?

Yes, as long as the incorporators understand that they are retaining counsel on behalf of the yet-to-be-formed entity and will need to ratify this corporate action, *nunc pro tunc,* once the entity is formed. According to ER 1.13(a), a lawyer may represent an "organization." The Comments to the Rule explain that an "organizational client is a legal entity, but it cannot act except through its officers, directors, employees, shareholders and other constituents. . . . The duties defined in this comment apply equally to unincorporated associations."

An "organizational client" or "entity" can be a separate client. For purposes of the ethical analysis, this Opinion will refer to "corporations" as the entity at issue, but the analysis also is applicable to other legal entities.

To determine whether a lawyer ethically may represent a yet-to-be-formed corporation, the analysis must include a review of Arizona corporate and partnership statutes. A.R.S. § 10-203 provides:

A. Unless a delayed effective date is specified in the articles of incorporation, incorporation occurs and the corporate existence begins when the articles of incorporation and certificate of disclosure are delivered to the commission for filing.

Under this statute, a corporation does not exist as a separate legal entity until its articles of incorporation are filed with the Corporation Commission.[2] Section 10-204 of the Arizona Revised Statutes further cautions that individuals who attempt to transact business as a corporation, knowing that no corporation exists, will be jointly liable for their actions. Presumably, however, a newly formed corporation may ratify pre-incorporation acts of the corporation, *nunc pro tunc.*

A decision from Wisconsin specifically holds that a lawyer hired to form an entity can represent the to-be-formed entity, not the incorporators, and the "entity" rule applies retroactively. *Jesse v. Danforth,* 485 N.W.2d 63 (Wis. 1992). This view would be consistent with the "entity" theory of representation, under ER 1.13(a). The "entity" theory holds that a lawyer may represent the corporation and does not, necessarily, represent any of the constituents that act on behalf of the entity - even if it is a closely held corporation. *See, e.g., Skarbrevik v. Cohen, England & Whitfield,* 282 Cal. Rptr. 627 (Cal. App. 1991); *Bowen v. Smith,* 838 P.2d 186 (Wyo. 1992).

An alternative view is the "aggregate" theory in which the lawyer is found to represent the incorporators/constituents collectively as joint clients. *See Griva v. Davison,* 637 A.2d 830 (D.C. 1994). Under the aggregate theory, a lawyer represents multiple co-clients during formation of the corporation and then once the entity is formed, the clients must determine whether the lawyer will continue to represent all of the constituents *and* the entity, or just the entity. Who a lawyer *may* represent depends upon whether the lawyer's independent professional judgment would be materially limited because of the lawyer's duties to another client or third person. *See* ER 1.7(b); *Matter of Shannon,* 179 Ariz. 52, 876 P.2d 548 (1994). As discussed below in Section 3, there are specific disclosures that a lawyer must make to co-clients, in order for them to consent to a joint representation.

Thus, a lawyer may represent an entity during the formation process, as long as the constituents who are acting on behalf of the yet-to-be-formed entity understand and agree to the entity being the client.

2. Can a lawyer represent *only* the yet-to-be-formed entity and not the constituents?

Who a lawyer represents depends upon the reasonable perceptions of those who have consulted with the lawyer. *In re Petrie,* 154 Ariz. 295 (1987). When two or more individuals consult with a lawyer about forming an entity, it is the responsibility of the lawyer at that initial meeting to clarify who the lawyer will represent. ER 1.13 provides that a lawyer may represent an entity and the Rule suggests that the lawyer will not automatically be considered counsel for the constituents because paragraph (e) of the Rule provides:

A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of ER 1.7. If the organization's consent to the dual representation is required by ER 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.

In *Samaritan v. Goodfarb,* 176 Ariz. 497, 508, 862 P.2d 870 (1993), the Arizona Supreme Court confirmed that a lawyer representing an entity does not automatically represent the constituents. Therefore, unless a lawyer *wants* to be counsel to all of the incorporators and the entity, the lawyer should specify that the lawyer does *not* represent the constituents collectively - the lawyer only represents the entity. If an engagement letter or oral representation by the lawyer suggests that the constituents are represented as an aggregate, then the lawyer will have ethical obligations to *each* constituent. Aggregate representation also is ethically proper if the disclosure to each client includes an explanation that the lawyer may have to withdraw from representing *each* client if a conflict arises *among* the clients.

3. What disclosures should a lawyer make to the incorporating constituents to obtain their informed consent to the limited representation of the entity?

> The underlying premise of the conflict Rules is loyalty to clients. Where a lawyer's independent professional judgment for a client is materially limited due to *anything or anyone,* a conflict may exist. Thus, in order to avoid inadvertent conflicts caused by misunderstandings of constituents in corporate representations, it is crucial for lawyers to specify exactly who they represent, who they do *not* represent, and how information conveyed to the lawyer by constituents of an entity client will be treated, for confidentiality purposes. The *Restatement Third, The Law Governing Lawyers,* Comment b to § 14 provides in part: "A lawyer may be held to responsibility of representation when the client reasonably relies on the existence of the relationship. . . ."

See also Comment *f*: "[A] lawyer's failure to clarify whom the lawyer represents in circumstances calling for such a result might lead a lawyer to have entered into client-lawyer representations not intended by the lawyer."

Therefore, it is crucial that a lawyer specify in the engagement agreement if the lawyer is not representing the constituents of an entity client.

Even if the engagement letter specifies that the constituents are not clients, lawyers still should regularly caution constituents that they are not clients - particularly when they consult with counsel. Lawyers who represent entities also must be aware of the *entity's* potential fiduciary duties to the constituents, so that the lawyer does not run afoul of those statutory or common law obligations. For instance, there are cases that have held that lawyers may have fiduciary duties to non-clients, depending upon whether the *entity* represented had fiduciary duties to the third parties. *See Fickett v. Superior Ct. of Pima Cty,* 27 Ariz. App. 793, 558 P.2d 988 (1976); *Matter of Estate of Shano*, 177 Ariz. 550, 869 P.2d 1203 (App. 1993) (lawyer disqualified as counsel to administrator for an estate because of prior representation of one beneficiary and derivative duty of neutrality to all beneficiaries). Accordingly, lawyers for entities should be mindful of this potential responsibility and that a derivative fiduciary duty to constituents may cause a conflict of interest for the lawyer.

The engagement letter also should explain that once the entity is created, the constituents agree to ratify the lawyer's services, *nunc pro tunc* on behalf of the entity.

With respect to confidentiality obligations, lawyers should specify how information conveyed to the lawyer will be treated for confidentiality purposes. If the firm is representing only the entity, constituents must be advised that their communications to the lawyer will be conveyed to the other decision-makers for the entity and are not confidential as to the entity. The information is confidential, however, according to Rule 1.6(a), to the "outside world." Similarly, information shared by one co-client that is necessary for the representation of the other joint clients will be shared with the other co-clients because there is no individual confidentiality when a joint representation exists.

Finally, if the lawyer has chosen to represent multiple clients, including the constituents and the entity, the lawyer should explain, at the beginning of the joint representation, that in the event that a conflict arises among the clients, the lawyer most likely will need to withdraw from representing *all* of the co-clients. However, some commentators, including the *Restatement Third,* note that the engagement agreement may provide that in the event of a conflict, the lawyer may withdraw from representing one of the co-clients and continue to represent the remaining clients. The usefulness of

such provisions was recently demonstrated in *In re Rite Aid Corp. Securities Litigation v. Grass*, 139 F. Supp. 2d 649 (E.D. Pa. April 17, 2001), where the court permitted the law firm to withdraw as counsel for one of the executives of Rite Aid and continue as counsel for the entity in a class action suit, primarily because the engagement agreement provided for such action.

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[1] **Formal Opinions of the Committee on the Rules of Professional Conduct are advisory in nature only and are not binding in any disciplinary or other legal proceedings. Ó State Bar of Arizona 2002**

[2] Partnerships, however, are not required to make a filing to establish their existence; a partnership exists once there is an "association of two or more persons to carry on as co-owners [of] a business for profit. . . whether or not the persons intend to form a partnership." A.R.S. § 29-1012.A.

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April 20, 2008

A Moveable Feast
c/o Charles Darnay
c/o Jerry Cruncher
c/o Jarvis Lorry

Re: Representation of "A Moveable Feast"

Dear Messrs. Darnay, Cruncher and Lorry:

Thank you for asking Carton Law Offices LLP (the "Firm") to represent the entity the three of you intend to form in this matter. The purpose of this letter is to confirm the scope and terms of the Firm's representation. At the outset, I would like to emphasize the importance the Firm places on clearly understanding its clients' expectations. I invite and encourage you to communicate directly with me whenever you believe the client's expectations have changed or whenever you believe the Firm can more effectively or efficiently meet the client's expectations. If you have questions concerning any of these provisions, please do not hesitate to let me know.

1. Identification of the Client. For purposes of this engagement, the Firm's sole client will be the entity-to-be formed, which, you have advised me, will be named "A Moveable Feast" (the "Company"). It is my understanding the Company will be organized as a Subchapter S corporation, or as a limited liability company. Except as otherwise agreed in writing, the Firm will not be representing any other person or entity. This will confirm that by agreeing to represent the Company, the Firm will not have an individual attorney-client relationship with Charles Darnay, Jerry Cruncher, or Jarvis Lorry. To the extent one or more of you require individual legal representation in matters that are unrelated to the Company, I will be happy to discuss the possibility of undertaking the separate representation of your interests in such matters. If you should seek individual representation in connection with matters related to the Company, however, please be advised that applicable rules of professional conduct and ethical principles may preclude such representation in the absence of full disclosure to each affected client, and the informed, independent consent of each affected client.

2. Scope of Engagement. The Company has retained the Firm to represent its interests in connection with the incorporation, organization, capitalization, financing, and the procurement of all necessary permits and zoning variances that are required to commence business operations. This includes drafting and filing the articles of incorporation or other organizational documents, and the preparation of the Company's bylaws and member or shareholder control agreement. The Firm's representation will also entail assisting the

Company obtain the necessary debt financing required to fund start-up operations. Finally the Firm will assist the Company procure all governmental permits and variances that are required prior to commencement of operations. While the Firm is available to work with the Company on a wide range of other matters, this will confirm that the Firm's engagement at this point is limited to the performance of those services described above. By your signatures below, the Company agrees that the scope of the Firm's representation at this time is limited to the specific matters identified above. The Company agrees that it will advise the Firm in writing of any requests to expand or narrow the scope of the Firm's engagement.

3. Firm Personnel Assisting You. I will be the lawyer primarily responsible for representing the Company in the matters described above. While hourly rates for attorneys and paraprofessional staff are adjusted from time to time, my billing rate is currently $400 per hour. When appropriate, I will use the services of other attorneys, paralegals and other Firm personnel to represent the Company's interests efficiently and effectively. Billings for professional services will be based on all of the considerations discussed in the enclosed Engagement Terms and Policies, and not simply on the hours expended and hourly rates. We will send statements for professional fees and expenses to your attention on a monthly basis.

4. Information and Availability. We will provide legal counsel to you in accordance with this letter and in reliance on information and guidance provided by you. We will keep you reasonably informed of progress and developments in the matter, and will timely respond to your inquiries. To enable us to represent the Company effectively, it is critical that you cooperate fully with us in all matters relating to our representation. We must rely on you to disclose fully and accurately all facts and documents that may be important to the matter and to provide other information we request. For us to represent the Company effectively, you may need to make yourselves and other representatives reasonably available to attend meetings, conferences, and other proceedings as may be necessary. As particular matters progress, we may express opinions, beliefs or assessments concerning the subject of our representation and the results or outcome that might be anticipated. Statements made by any partner or employee of the Firm are intended only to be expressions of opinions based on the information available to us at the time, and are not, of course, a promise, assurance or guarantee of a particular result or outcome.

5. Attorney/Client Privilege. Generally speaking, as representatives of the Company, our communications and discussions are protected by the attorney/client privilege. This means that you cannot be required to reveal to others what you have discussed with members of the Firm. This protection will not apply, however, unless you keep our discussions confidential. Therefore, you should never reveal the substance of our discussions to persons who are not authorized representatives of the Company, or anyone else, without first checking with me.

6. Firm Policies. In order to assist you in understanding our billing practices, I have provided you with our standard Firm Engagement Terms and Policies. It is attached. Please review it carefully.

7. Potential Conflicts. You have advised me of the possibility that the Company may apply for a business loan from DeBarge State Bank (the "Bank"). This will confirm that I serve as

outside counsel to the Bank. Pursuant to the Minnesota Rules of Professional Conduct, I may not represent the Company in any matter that is directly adverse to the interests of the Bank without (1) making full disclosure of all relevant facts to each affected client, (2) forming the reasonable belief that I will be able to provide competent and diligent representation to each affected client; and (3) obtaining the informed consent of each affected client, confirmed in writing. This means that without the Bank's informed consent, confirmed in writing, I will be unable to represent the Company negotiate, document and/or consummate a loan transaction with the Bank. You need to be aware of this limitation on my ability to represent the Company, and be prepared to engage independent legal counsel on behalf of the Company if you should decide to proceed with the loan transaction with the Bank. You have my assurance that neither I nor any other lawyer in the Firm will represent the Bank in such a transaction without satisfying the ethical requirements described above.

8. Termination. The Company may terminate this representation at any time, and for any reason, by giving us specific notice of the Company's intention to discharge the Firm, preferably in writing. As explained in more detail in the attached Engagement Terms and Policies, upon termination of the representation, the Firm will take all steps reasonably practicable to protect the Company's interests, by, among other things, promptly transferring to you or to your new attorney all papers, files and property to which the Company is entitled under applicable ethical rules.

Again, we very much appreciate this opportunity to work with you and assist you. We look forward to working with you and to assisting you to complete this matter as quickly and as efficiently as possible. Please do not hesitate to contact me with any questions or comments you have regarding any matter discussed in this letter or with respect to our representation in general.

Very truly yours,

CARTON LAW OFFICES L.L.P.

_____
Sydney X. Carton

Agreed and accepted this ____ day
of _____, 2007.

[Company]
By:

_____

Its:

_____