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Walking the tightrope of representing two-person entities

By Timothy D. Reuben

When representing a two person partnership or corporation, how does a lawyer avoid developing direct fiduciary duties to each equity owner in his or her individual capacity? Significant guidance comes from Division 7 of the 2nd District Court of Appeal in *Sprengel v. Zbylut*, 2019 DJDAR 9643, where Justice Laurie Zelon writing for the court, joined by Justices Dennis Perluss and John Segal, affirmed a summary judgment by Los Angeles County Superior Court Judge Elizabeth Allen White in favor of the lawyers, finding no implied attorney/client relationship ever arose. But representing very small entities requires a lawyer to walk a tightrope in dealing with the individual partners or shareholders so as to avoid a potential claim should the owners, as often happens, have a falling out and sue each other.

Plaintiff Jean Sprengel and Lanette Mohr formed a limited liability called Purposeful Press to market a guidebook Sprengel had written about the side effects of chemotherapy. Each was a 50% shareholder in the LLC, but Mohr was the sole manager of Purposeful Press and served without salary for two years, during which time the entity successfully marketed the book, licensed rights, and even added a second book. But after that, Mohr demanded a salary going forward, and in response Sprengel offered to take over the management duties. Sprengel then also accused Mohr of using corporate funds for personal expenses.

While the dispute was ongoing, Mohr hired two sets of lawyers: Gregory Zbylut to prepare corporate tax filings and Vincent Cox and his firm Leopold Petrich & Smith (collectively Cox) to provide advice regarding the entity's intellectual property rights. Cox thereafter sent a letter to Sprengel's personal attorney stating that he represented Purposeful Press, recognized the principals were in dispute, and asserted that the company had the right to continue to market the intellectual property. On hearing that Mohr had hired lawyers for the LLC, Sprengel withdrew $162,000 from the corporate checking account and put the funds in trust with her personal attorney. Sprengel also revoked in writing "any implied copyright license she had granted" to the LLC. In response, Cox assisted Mohr in preparing a copyright registration that listed Purposeful Press as well as both owners individually as claimants. Sprengel then filed an involuntary dissolution action and also a federal copyright lawsuit. After these suits were filed, Cox amended his retainer agreement to include pursuing a declaratory relief action and related claims on behalf of the company against Sprengel. Ultimately the federal district court ruled that Sprengel had in fact granted Purposeful Press "an implied license to exploit those copyrights, which provided a complete defense to Sprengel's infringement claims."

So of course after losing, Sprengel sued all the lawyers for malpractice — because it's got to be their fault. She sought both reimbursement of any fees paid by Purposeful Press to Zbylut and Cox and also sought reimbursement of her own fees. As to the reimbursement to the corporation, Sprengel's claim was rejected since she was required to bring such an action as a derivative suit. But Sprengel also sought an award in her individual capacity and contended that "by undertaking representation of a corporate entity comprised of two 50 percent owners, the defendants necessarily entered into an *implied* attorney-client relationship with each of the owners in their individual capacity." (Emphasis added.) Simply put, if the court had accepted this argument, it would have put all attorneys who represent small companies at risk whenever there is an internal dispute, so thankfully the court also rejected this overreaching argument.

But the current law still puts lawyers at risk, since it allows a court to find an "implied" attorney client relationship with the individual principals based on "the totality of the circumstances." Despite the general rule that a corporation's lawyer owes no duty to individual shareholders, an entity's lawyer may still be deemed to take on fiduciary obligations to the individual owners based on the lawyer's conduct. Justice Zelon summarizes the non-exhaustive list of factors for a court to consider developed from prior law: (1) the type and size of the client entity; (2) the nature and scope of the engagement; (3) the kind and extent of contacts by the lawyer with the individual owner; and (4) the attorney's access to financial information relating to the specific individual's interests. Frankly, that is scary law, since there is no clear test regarding when a corporate lawyer has crossed the unseen line into "implied" representation. Justice Zelon does provide some helpful guidance, explaining that the key issue is "whether the parties conducted themselves in a way that would reasonably cause a shareholder to believe the attorney would protect the shareholder's individual interest." Obviously in

Sprengel, both sets of lawyers were hired after there was a dispute, and Cox was adverse to Sprengel's contentions from the outset. Indeed, neither lawyer had ever spoken to Sprengel, and Sprengel actually depleted the corporate account so that the lawyers would not be paid. Thus, the "adversarial nature of their relationship was clear from the time they were retained," so Sprengel could never have reasonably believed that the lawyers were looking out for her individual interests.

While *Sprengel* is properly decided on its facts, it leaves open many questions for lawyers representing close corporations or partnerships. It simply is not unusual for two principals to have a dispute, often after the entity has been operating for an extended period, and unlike in *Sprengel*, corporate/partnership counsel are often providing services well beforehand. Since it is the job of a corporate lawyer to protect the assets of the entity, it would sometimes be reasonable for a principal to believe that the lawyer is also acting in the principal's personal interest. Using the factors the opinion identifies, when a lawyer represents a two person entity, that lawyer frequently has lots of direct contact with both principals. Moreover, a lawyer for a company typically has access to extensive personal financial information, and frequently the retention is not limited as it was here. And after all, lawyers do try to be nice to their client's principals — responding to questions and developing a positive dynamic — basic client relations. So taking account of these factors alone, most lawyers may run the risk of a claim of an implied attorney client relationship.

Perhaps the best way to address this risk is in the initial retention. In *Sprengel*, the existence of the dispute and the limited scope of the representation was critical in demonstrating that Sprengel could not have relied on Cox; but where there is no existing dispute, lawyers could include a term in their retainer agreement expressly denoting that they will not and do not intend to give any individual principal any personal advice and that the scope of their representation is expressly limited to representing the entity. And in a small two or three person company, there is nothing wrong with having each principal initial such a paragraph, or alternatively sending each owner a short letter specifically indicating to them as much and urging them to retain and consult separate counsel for any personal legal advice. An ounce of prevention is worth a pound of cure! ■

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