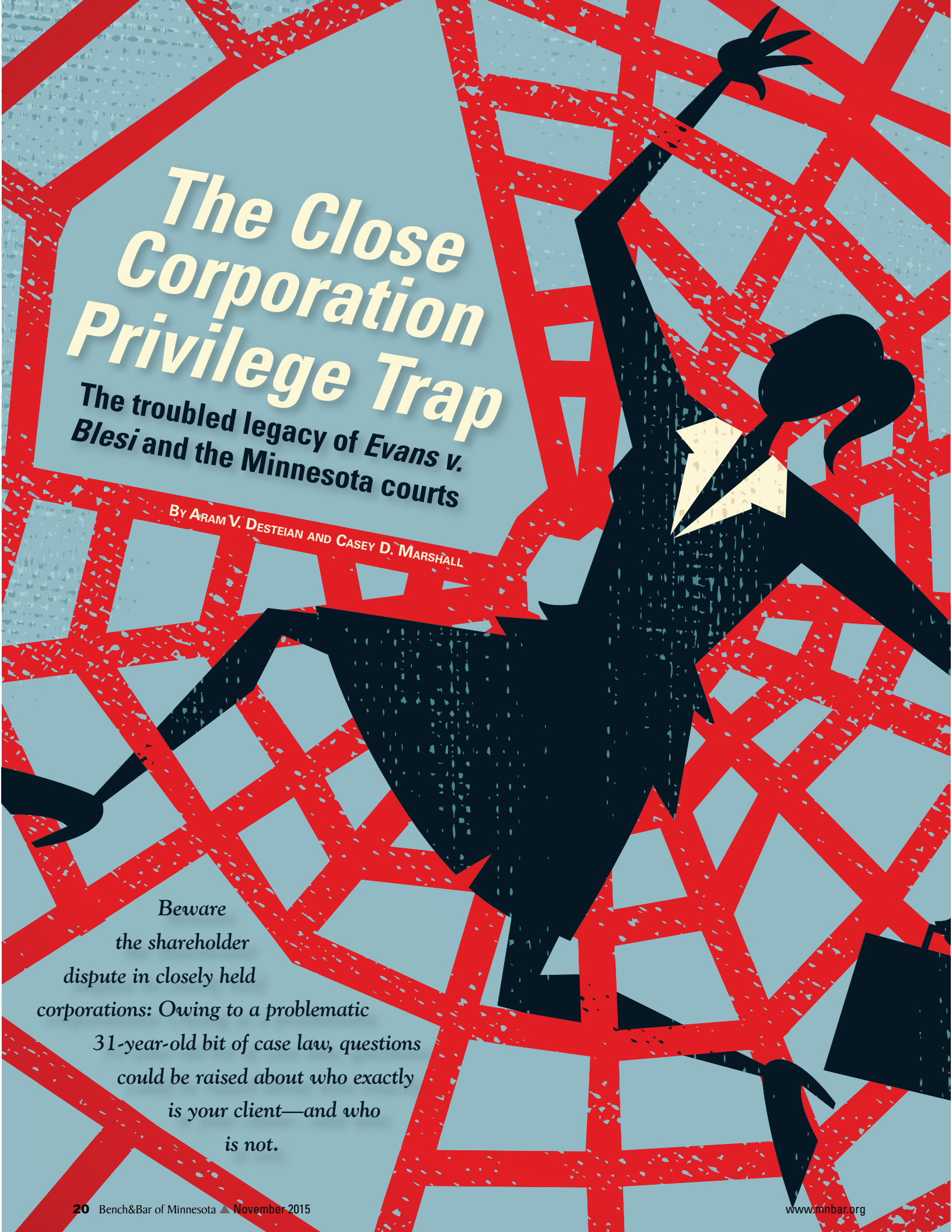
The Close Corporation Privilege Trap

The troubled legacy of *Evans v. Blesi* and the Minnesota courts

By Aram V. Desteian and Casey D. Marshall



Beware the shareholder dispute in closely held corporations: Owing to a problematic 31-year-old bit of case law, questions could be raised about who exactly is your client—and who is not.

Thirty-one years ago the Minnesota Court of Appeals issued its decision in *Evans v. Blesi*.[1] *Evans* quickly became a seminal case standing for the proposition that shareholders in closely held corporations owe each other a fiduciary duty. But often lost in that broader holding is that *Evans* also laid a trap for closely held corporations and their counsel. Hidden within two short paragraphs in the final portion of the court of appeals' decision is language that has been utilized to argue an exception to the corporation's ability to invoke its attorney-client privilege in disputes between shareholders of a closely held corporation. This article analyzes the policies underlying the *Evans* decision in the context of the greater corporate attorney-client privilege.

Imagine this: The president of XYZ Corporation calls and asks you to represent the company and its shareholders in connection with a dispute they are having with a minority shareholder. You run a conflicts check and, having found none, agree to the representation and draft a legal memo for your clients outlining the strengths, weaknesses and possible defenses to a potential suit. The minority shareholder files suit and litigation ensues. Your memo is protected by the attorney-client privilege, correct? Many attorneys would argue no, and in so arguing, rely on the trap laid by *Evans*.

The *Evans* opinion states that "by representing both the majority shareholder and the corporation, the lawyers were in a conflict of interest position and had a duty to advise [Plaintiff], the minority shareholder, of their advice regarding corporate matters."[2] As a result, *Evans* is often cited by attorneys representing minority shareholders for the broad proposition that the attorney-client privilege is vitiated with respect to minority shareholders when an attorney represents both a corporation and the majority shareholders against a minority shareholder.

At first look, it appears to make some sense that counsel representing a closely held corporation would have to inform minority shareholders of their advice regarding corporate matters. The minority shareholder is, after all, an owner of the company. On the other hand, doesn't this proposition essentially destroy the attorney-client privilege in the vast majority of shareholder disputes? And what happens when the minority shareholders are guaranteed access to information when their allegedly improper conduct is at issue, or their interests conflict with those of the company?

As these questions demonstrate, the long term effect of *Evans* on the attorney-client privilege in shareholder disputes is unclear. This is largely because the court of appeals issued its holding without citing any authority or clearly indicating any legal doctrine or theory under which the decision was made. In that sense, *Evans* appears to be a classic example of the maxim that "bad facts make bad law." But despite the uncertainties regarding the applicability of *Evans*, there is no question that without further clarity, privilege challenges will continue to arise in shareholder disputes where an attorney represents both the corporation and its majority shareholders.

The Holding in *Evans v. Blesi*

Evans is a classic case of breach of fiduciary duty between "partners." From 1955 through 1977, Evans and Blesi were the sole and equal shareholders of a closely held corporation.[3] Beginning in 1975, Evans began experiencing health problems, which led Blesi to begin making accusations that these health problems were negatively affecting Evans' job performance. Blesi became increasingly abusive towards Evans, including threatening to dissolve the company if Evans would not transfer him one share of stock in order to grant Blesi majority-shareholder status. As time progressed, Blesi continued his abusive behavior until Evans eventually acquiesced to the stock transfer, surrendering majority control to Blesi. Evans continued to work for the company after he gave Blesi majority control, and Blesi continued to make accusations of poor performance.[4]

Eventually, Blesi decided he no longer wanted to work with Evans and hired a law firm on behalf of the company to address the "problem." The firm advised Blesi to take a series of steps aimed at removing Evans, including: (1) eliminating cumulative voting, (2) lowering the vote required to amend the by-laws, (3) increasing authorized capital, and (4) calling a shareholders meeting for the purpose of removing Evans as an officer, director and employee if he refused to voluntarily resign.[5] In other words, many of the acts that allegedly breached Blesi's fiduciary duties to Evans were done at the direction of counsel from the company's law firm.

When Evans filed suit, Blesi retained the company's law firm to represent him individually, even though that firm had advised the company (through Blesi) on how to get rid of Evans. At trial, the district court called "as adverse witnesses, attorneys from the same law firm as appellants' trial counsel."[6] On appeal, Blesi and the company argued that the district court erred in permitting the attorneys to testify about privileged communications between counsel and Blesi. The court of appeals disagreed and affirmed the trial court, holding:

> 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 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 when calling them is not a mere stratagem by opposing counsel to seize unfair advantage.[7]

The court of appeals cited no case law and failed to identify the reasoning underlying its ruling. As a result, attorneys are left to guess whether it affirmed based on existing conflicts principles, on a fiduciary exception to the attorney-client privilege, or on some other unstated rationale or combination of legal theories. What is clear is that that by affirming the trial court's decision to vitiate the attorney-client privilege, the court of appeals opened the door for future challenges to the privilege in any case even tangentially resembling *Evans*.

The Fiduciary Exception and Closely Held Corporations

In the 31 years since *Evans* was decided, neither the Minnesota Supreme Court nor the court of appeals has cited *Evans* on the privilege issue. As a result, attorneys have been given little additional guidance regarding the applicability of *Evans* or the legal theories supporting it. However, in the single instance where this portion of *Evans* has been analyzed by a Minnesota court, it has discussed in relation to the so-called "fiduciary exception" to the attorney-client privilege.[8]

The "fiduciary exception" to the attorney-client privilege is premised on the idea that a communication that is otherwise protected by the attorney-client privilege is not protected against those to whom the client owes a fiduciary duty. In particular, under this theory the parties to a fiduciary relationship must disclose material facts to one another and may not prevent the opposing party's discovery of otherwise privileged communications that are linked to the workings of the partnership.[9]

In the single instance that *Evans* has been cited by a Minnesota court for its holding regarding the attorney-client privilege, it was explicitly rejected.

Subsequent Minnesota Law

In *Opus Corp. v. Int'l Bus. Machines Corp.*, the Minnesota District Court analyzed *Evans* and the fiduciary exception before rejecting the plaintiff's attempt to pierce the attorney-client privilege.

Opus involved a lawsuit between partners in a limited partnership between Opus and IBM. Opus brought suit against IBM alleging a breach of fiduciary duty.[10] The firm that was then Faegre & Benson represented both the partnership as well as IBM in its capacity as general partner. Opus sought to discover communications between IBM and Faegre arguing that "IBM may not, consistent with its fiduciary obligations as a general partner, withhold documents from it on the basis of an attorney-client privilege."[11]

Chief Magistrate Judge Raymond L. Erickson rejected this argument, reasoning that "we are unable to discern any inherent conflict between a general partner's fiduciary obligation to disclose material facts, and its privilege to refuse to disclose attorney-client communications, particularly as they relate to the general partner's private business affairs."[12] The court reasoned that "the purpose of the attorney-client privilege is not to thwart the disclosure of otherwise discoverable facts but, rather, to encourage clients to confide openly and fully with their attorneys."[13] Although Judge Erickson's analysis is a clear rejection of the fiduciary exception and its application under Minnesota law, he did not stop there. Rather, he explicitly criticized *Evans* as an outlier decision that fails to comport with Minnesota law, stating:

> As to the "fiduciary exception," we are mindful that, in *Evans v. Blesi*, [] the Court determined that, in the context of a closed corporation, a majority shareholder owed a fiduciary duty of disclosure to a minority shareholder, which precluded, under the facts there, an assertion of an attorney-client privilege when the attorney represented both the corporation and the majority shareholder. The Court did so, without citation of authority, because the "lawyers were in a conflict of interest position and had a duty to advise * * * the minority shareholder * * * of their advice regarding corporate matters." We can accept that, under Minnesota law, "the relationship among shareholders in closely held corporations is analogous to that of partners," but we are not aware of any authority which would allow a fiduciary relationship to trump the attorney-client privilege as a punishment for an attorney's representation of two or more clients. Notably, in the more than a decade since Evans was decided, its election to pierce the attorney-client privilege, on such tenuous legal grounds, has not been followed by any reported decision, and we decline to do so here.[14]

IBM has since been cited by the District of Minnesota for the proposition that "there is no partnership fiduciary exception to Minnesota's attorney-client privilege law."[15] Accordingly, in the single instance that *Evans* has been cited by a Minnesota court for its holding regarding the attorney-client privilege, it was explicitly rejected.

Interestingly, the fiduciary duty exception was also recently rejected by Minnesota state and federal trial courts in the context of an attorney's conversations with intra-firm ethics counsel regarding a potential legal malpractice claim.[16]

Foreign Jurisdictions and Their Responses to the Fiduciary Exception

Other jurisdictions have grappled with this same issue. The 5th Circuit's decision in *Garner v. Wolfinbarger*, 430 F.2d 1093, 1104 (5th Cir. 1970) is often cited for the proposition that the attorney-client privilege can be abrogated with respect to the corporation's shareholders, if the shareholders can show good cause.[17] There are a couple of common responses to the *Garner* holding. Many courts follow reasoning similar to that stated by Judge Erickson in *Opus* by noting that destroying privilege in shareholder disputes makes little practical sense. For example, in *Shirvani v. Cap. Inv. Corp.*, 112 F.R.D. 389, 391 (D. Conn. 1986), the court noted that:

> A hasty resort to *Garner* concepts will… ignore the genuine need of management in the ordinary course for confidential communications and advice. When the policy basis for attorney-client privilege is carefully considered, then although '[f]iduciary relationships may create special duties that require… unusual or special care', it is still the case that that is more, not less, reason to give fiduciaries full opportunity to consult openly with counsel.[18]

Similarly, in *Chambers v. Gold Medal Bakery*, 983 N.E.2d 683 (Mass. 2013), the Massachusetts Supreme Court dealt with an analogous situation and also rejected the fiduciary exception. In *Chambers*, plaintiffs, who were 50 percent shareholders and board members of a closely held corporation, brought direct and derivative claims against the corporation.[19] During the litigation, plaintiffs served a subpoena on the corporation's counsel, seeking to discover all communications between the firm and the corporation's president, who was also a board member and shareholder. The Court held that the plaintiffs could not discover the attorney-client privileged communications because "the plaintiffs' interests are adverse to [the corporation] for purposes of attorney-client privilege and work product protection as concerns documents generated in anticipation of or related to litigation."[20] In so holding, the court stated that "the principle that directors have a right of equal access to advice of corporate counsel provided to the corporation is based on the assumption that the interests of the directors are not adverse to the interests of the corporation on a given issue."[21] Therefore, because the plaintiffs had asserted direct claims against the corporation, the plaintiffs were clearly adverse to the corporation and should not be permitted access to privileged communication.[22]

Who May Assert or Waive the Privilege?

In addition to possible application of the "fiduciary exception," it also appears the *Evans* court relied, at least in part, on an argument that the plaintiff had a right to attorney-client communications because he, as a shareholder, was the client. *Evans* held that the attorneys representing the corporation "had a duty to advise [Plaintiff], the minority shareholder, of their advice regarding corporate matters."[23] Given this rationale, courts often address privilege questions in shareholder suits by asking: Who is the client and who holds (and thus may waive) the privilege?

Many (if not most) jurisdictions appear to apply the "entity rule" when discussing who "owns" the attorney-client privilege in the context of a corporation. Under this approach, the corporation as an entity "owns" the privilege, and therefore only the corporation, by and through its management, has the ability to assert or waive it.[24] This results from the fact that "[a]s an inanimate entity, a corporation must act through agents."[25] Therefore "the power to waive [or assert] the corporate attorney-client privilege rests with the corporation's management and is normally exercised by its officers and directors."[26]

An apparent minority of jurisdictions apply a different rule when analyzing who has the ability to waive a corporation's attorney-client privilege. Under this theory, often titled the "collective corporate client" or "joint client" exception, there is one corporate client that includes the corporation itself and each individual member of the board of directors, rather than just the corporation alone.[27] Courts applying this rule generally view the members of a board as "joint clients" of the attorney along with the corporation because the directors are the individuals who manage the company. This theory is almost entirely derived from *Kirby v. Kirby*, 1987 WL 14862 (Del. Ch. 1987) and has been applied in a minority of jurisdictions.[28]

Although there is no Minnesota case law explicitly adopting the "entity rule" regarding the corporate attorney-client privilege, the Minnesota Court of Appeals did favorably cite to *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343 (1985), an important "entity rule" case, regarding an exception to the attorney-client privilege.[29] In that case, the court of appeals cited *Weintraub* for the proposition that a former employee could not have waived a corporation's attorney-client privilege "because former employees cannot act for a corporation."[30] Although this is not an explicit adoption of the "entity rule," it does indicate that Minnesota courts may view the attorney-client privilege as being "owned" by the corporation rather than its individual employees, shareholders, or directors.

Conclusion

The mere fact that the Evans privilege decision appears to rest on tenuous legal grounds has not kept the opinion from being cited repeatedly by counsel as the basis for abrogating attorney-client privilege in disputes between shareholders of a closely held corporation. And despite the fact that arguments exist to combat such claims, *Evans* is the only precedential Minnesota appellate decision on the subject. As the only binding law, it will continue to present a trap to closely held corporations and their counsel until the courts or the Legislature provides additional guidance. As a result, *Evans* should be front-of-mind for attorneys deciding how to proceed with representation of both a closely held corporation and its majority shareholders. ▲

***ARAM DESTEIAN** is an attorney with Bassford Remele. He concentrates his practice in complex litigation, business litigation, and professional liability defense and legal ethics claims. He has co-authored several articles relating to legal ethics and professional responsibility.*

ADESTEIAN@BASSFORD.COM

***CASEY MARSHALL** is an attorney with Bassford Remele. Casey focuses his practice on business litigation and represents clients in shareholder, trust and and other commercial disputes.*

CMARSHALL@BASSFORD.COM

Notes

[1] *Evans v. Blesi*, 345 N.W.2d 775 (Minn. Ct. App. 1984)
[2] *Id.* at 780-81.
[3] *Id.* at 777.
[4] *Id.* at 778.
[5] *Id.*
[6] *Id.* at 780.
[7] *Id.* at 780-781.
[8] *Opus Corp. v. Int'l Bus. Machines Corp.*, 956 F. Supp. 1503 (D. Minn. 1996)
[9] *Id.* at 1509.
[10] *Id.* at 1505.
[11] *Id.* at 1509.
[12] *Id.* at 1510.
[13] *Id.*
[14] *Id.* at 1511 n. 9 (multiple internal citations omitted).
[15] *Bartholomew v. Avalon Cap. Grp., Inc.*, 278 F.R.D. 441, 448 (D. Minn. 2011).
[16] See *JJ Holand, Ltd. v. Fredrikson & Byron, P.A.*, Civ. No. 12-3064 ADM/TML (D. Minn. 7/17/2014) (order affirmed in *JJ Holand, Ltd. v. Fredrikson & Byron*, 2014 WL 5307606 (D. Minn. 10/16/2014)); *Coloplast A/S & Coloplast Corp., v. Spell Pless Sauro, P.C.*, Civ. No. 27-CV-12-12601 (Minn. Dist. Ct. 11/22/2013).
[17] The continuing validity of Garner has been called into question, including by the District of Minnesota in *Opus Corp. v. Int'l Bus. Machines Corp.*, 956 F . Supp. at 1511 n. 9 (citing *Milroy v. Hanson*, 875 F.Supp. 646, 651 (D. Neb. 1995).
[18] citing Saltzburg, "Corporate Attorney-Client Privilege in Shareholder and Similar Cases: Garner Revisited", 12 Hofstra L. Rev. 817, 847 (1984).
[19] *Chambers*, 983 N.E.2d at 687.
[20] *Id.* at 689.
[21] *Id.* at 693.
[22] *See also Milroy v. Hanson*, 875 F. Supp. 646 (D. Neb. 1995).
[23] *Evans*, 345 N.W.2d at 780-81.
[24] *See e.g. Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 348-49 (1985); *Montgomery v. eTreppid Tech., LLC*, 548 F. Supp. 2d 1175 (D. Nev. 2008); *Milroy v. Hanson*, 875 F. Supp. 646 (D. Neb. 1995); *Fouts v. Breezy Point Condo. Assoc.*, 851 N.W.2d 845, 496-97 (Wis. Ct. App. 2014).
[25] *Weintraub*, 471 U.S. at 348.
[26] *Id.* at 343.
[27] *See Las Vegas Sands v. Eight Jud. Dist. Ct.*, 331 P.3d 905, 910-11 (Nev. 2014) (discussing but ultimately rejecting the joint client exception).
[28] *See Gottlieb v. Wiles*, 143 F.R.D. 241 (D. Colo. 1992); *Harris v. Wells*, B-89-391, 1990 WL 150445 (D. Conn. 9/5/1990).
[29] *See Levin v. C.O.M.B. Co.*, 469 N.W.2d 512, 516 n.4 (Minn. Ct. App. 1991).
[30] *Id.*