

The Perils of Elma Fudd, Esq. – Malpractice Risks in Business Formations

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Nothing is as easy as it seems anymore, as the following tale illustrates. Attorney Elma Fudd is hired to form a new Internet business, ACMEChemical.com, which will sell stink bombs, explosives, and do-it-yourself-rockets online. The principal owners of the new business will be long-time friends and business acquaintances Babs Bunny, Daphnia Duck, and Wylie Coyote. Although the Fudd Law Office has served as Babs' legal counsel for years, including preparation of Babs' estate plan, it has never previously represented Daphnia or Wylie.

Babs is the technowiz behind the new entity and will hold the top position at ACME. Wylie, who has extensive experience in the use of incendiary devices, will be in charge of product selection. Daphnia has joined the venture principally as an investor and has brought her accountant, Porkington Pig, into the deal. Babs, Daphnia, and Wylie will all be contributing toward the start-up capital, but in varying amounts.

It's a common scenario - a small group of individuals seek the assistance of a lawyer in forming a closely held business entity. It's also a potentially dangerous situation that presents numerous ethical conundrums and malpractice traps for lawyers. Among them are conflicts-of-interest allegations, scope-of-representation disputes, and questions regarding clients' informed consent to major decisions.

Conflicts conundrums (or "Who's the client here?")

Attorney Fudd's conflicts of interest dilemma began the moment she picked up the telephone to discuss the forma-



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tion of ACME with Babs. Who was Fudd's client? Was it exclusively Babs? Babs, Daphnia, and Wylie collectively? The new entity itself? All of the above?

Lawyers frequently respond to this question by stating that they're representing the fledgling business enterprise rather than any one individual—which raises more questions. How can your client be an entity that does not exist? What individual has the authority to act on behalf of the yet-to-be-formed entity that has no corporate officers or partners in place?

Okay, so let's assume that Ms. Fudd is representing Babs, Daphnia and Wylie as well as the new venture. Don't be lulled into a false sense of security by the apparent unity of co-clients at the outset of the representa-

tion. Representing multiple clients is tricky business that rarely ends as benignly as it begins and requires a thorough analysis.

For example, Daphnia and Wylie might subsequently allege that Fudd drafted change-in-ownership and succession provisions in the manner that best served Babs' overall estate-planning goals and her desire to leave the business to Bugs Jr. Alternatively, Babs could argue that Fudd should have negoti-

ated a five-year employment contract for her as part of the deal. After all, Babs quit her former position as CEO of Warner Sisters Corp. to launch ACME Chemical.com.

There is also the issue of the participants' disparate investments and what those investments mean as far as ownership and control. Even if Babs, Daphnia and Wylie had invested equally in ACME, however, one or more of them could later maintain that he or she were entitled to a greater piece of the pie because of his/her extraordinary individual contribution to the enterprise (e.g., Babs' technology know-how or Wylie's extensive knowledge of munitions.) While a thoughtfully drafted conflicts-of-interest disclosure and waiver can alleviate some conflicts issues, in other cases the multiple representation will continue to raise serious conflict concerns throughout the engagement.

Choice-of-organization enigmas

After Elma takes a few aspirin to stop the pounding in her head, her next challenge will be to ensure that Babs, Daphnia and Wylie have been thoroughly briefed on their choice-of-business-entity options. Will ACME be

formed as a general partnership, a regular “c” corporation, an “s” corporation, a limited partnership, or a limited liability company, to name a few. If the group selects a corporate form, will ACME be incorporated in Illinois, Delaware, or some other jurisdiction?

As Professor Philip Hablutzel of Chicago-Kent College of Law recently noted, there are three primary factors to consider when selecting the type of business entity best suited to the client’s needs: tax consequences, management and control issues, and liability implications. In most situations, these factors will not be weighed equally by the original participants—which leads us back to the conflicts-of-interest thicket.

Wylie, for example, has virtually no personal assets to speak of and therefore is less concerned with limiting his personal liability than Babs and Daphnia. Babs, on the other hand, is focused on management dynamics and succession issues. That leaves Daphnia, whose primary consideration is the impact of the ACME investment on her personal tax situation.

Regardless of the decision made by Fudd’s clients, whoever they may be, it

is recommended that Fudd document in writing that the clients were apprised of the advantages and disadvantages of each business type, the decision made by the client or clients, and the reasons for that decision. A detailed confirmation letter to the clients restating the decision-making process would accomplish the goal.

Another method would be to prepare a flow chart or diagram explaining the pros and cons of each business entity and to have the clients circle their priorities and sign off on the entity of choice. (We’ll assume that Elma has previously clarified in writing whether the unanimous consent of all clients is necessary for action or the direction of one or more designated clients is sufficient.)

Scope-of-representation riddles

As if that weren’t enough, Fudd could find herself on the wrong end of a malpractice suit if she doesn’t discuss the scope of her representation with her clients and then document it. Is Attorney Fudd’s role limited to drafting specific documents based upon terms previously agreed to by all parties, or is she responsible for the whole enchilada?

What is Fudd’s role, if any, with respect to the tax and financial aspects of the business formation? While Attorney Fudd may assume that Porkington is providing tax advice to the group and filing any necessary tax forms, that assumption should be confirmed in writing.

The formation of ACME may involve intellectual property issues as well. If Elma won’t be providing advice on these matters, she should either enlist the assistance of an intellectual property practitioner or instruct the clients in writing to seek other counsel immediately for all intellectual property questions. Or she could simply pack it in, move to Montana, and take up animal rights law.

Disclosure and documentation

Forming a new business enterprise in the 21st century requires a careful conflict-of-interest analysis, consensus on the scope of the representation, full disclosure of the options available to the client, and detailed documentation throughout. A sense of humor, while not required, is also helpful. ■