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Attorneys Beware: Federal Court Reinstates Aiding and Abetting Breach of Fiduciary Duty Claim Against Law Firm

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Attorneys who advise a distressed company usually work very closely with members of the board of directors. A recent opinion from the United States District Court for the Western District of Texas provides a cautionary reminder to such attorneys not to lose sight of the fact that, notwithstanding that the company acts through its board, the attorneys' duties are to the company and not to the individual board members. And, losing focus on the source of the attorneys' duties may result in exposure to significant liability.

A. The Underlying Dispute, Bankruptcy, and Dismissal of Adversary Proceeding

The dispute in *Milligan v. Salamone* first arose when the founder of Westech Capital Corp. ("Westech") filed a shareholder derivative suit in the Delaware Chancery Court to remove two board members, one of whom (Halder) counter-sued to remain on the board. One law firm (the "Law Firm") represented the company before and during the litigation over control of the company's board. The Delaware court eventually held that Halder was properly removed from the board, and on the same day, the Law Firm took it upon itself to prepare an agreement to cancel Halder's employment contract, release him from non-competition obligations, and commit the company to pay certain accrued obligations to Halder (the "Cancellation Agreement"). The Cancellation Agreement was signed by Halder and another board member to bind the company.

Westech subsequently filed a Chapter 7 bankruptcy in the Western District of Texas. The Chapter 7 trustee filed an adversary proceeding against the Law Firm alleging that the Cancellation Agreement that the Law Firm drafted went against Westech's pecuniary interests because Westech would have been better off if it had simply allowed Halder's employment agreement to expire. The trustee alleged that the Law Firm's actions constituted (1) breach of its fiduciary duties to Westech, (2) malpractice, and (3) aiding and abetting breach of Halder's fiduciary duties to the company. The Bankruptcy Court granted the Law Firm's motion to dismiss all of the trustee's claims against it.

B. Appeal to the District Court

On appeal, the District Court upheld the Bankruptcy Court's dismissal of the breach of fiduciary duty and malpractice claims, but overturned dismissal of the claim for aiding and abetting Halder's (and another director's) breaches of fiduciary duty.

With regard to the breach of fiduciary duty claim, the trustee first argued that the Law Firm "chose sides" in the Delaware lawsuit and "aligned itself with Halder" and another director because Halder and the other director were responsible for authorizing payment of the Law Firm's fees for representing Westech. The District Court rejected this argument because it could find no fault in the Law Firm "aligning itself" with the board members of the company it represented while they were on the board. There was no allegation that the Law Firm represented Halder, or any other directors, individually during the Delaware lawsuit, and the company could not act except through its directors. Therefore, the Law Firm's alignment with those directors in the context of representing Westech was insufficient to support a breach of fiduciary duty claim.

The trustee also argued that the Law Firm failed to push for enforcement of Halder's non-compete agreements after Halder was removed from the board and that this failure was in breach of the Law Firm's fiduciary duties. This claim failed, the District Court reasoned, because the trustee did not allege that the Law Firm had acted in its own pecuniary interest over Westech's, but rather, that it had acted in "conscious disregard" for Westech's interest. In rejecting the trustee's argument, the District Court explained that the trustee's allegations in this regard sounded in malpractice—not breach of fiduciary duty.

Moving on to the malpractice claim, the trustee argued that the Law Firm was negligent by drafting and pursuing execution of the Cancellation Agreement by which Halder was released from his non-competition obligations and was paid money that he may not otherwise have obtained if Westech had simply not renewed his employment contract. The trustee also alleged that, after Halder was terminated, it was negligent for the Law Firm not to advise Westech to sue Halder for self-dealing, for advocating for Westech to pay Halder and others commissions and bonuses, and for seeking appointment of a custodian over the company on behalf of Halder and others in a separate pre-bankruptcy lawsuit. The District Court first acknowledged that, after the Delaware court ordered Halder removed from Westech's board, the Law Firm breached its duty of care by (1) failing to advise Westech to sue Halder, (2) representing Halder in the subsequent lawsuit seeking a custodian over the company, and (3) opposing a non-compete provision in a related lawsuit in which a *status quo* order was sought. By that point, the District Court reasoned, Halder was adverse to Westech because he was both suing Westech and working for a competitor. Nonetheless, the District Court upheld dismissal of the malpractice claim because the trustee failed to plead a plausible theory of damages caused by those breaches.

Unfortunately for the Law Firm, the District Court overturned the Bankruptcy Court's dismissal of the trustee's aiding and abetting breach of fiduciary duty claim—or a "knowing participation" claim under Texas law. That claim was also premised upon the Law Firm's drafting the Cancellation Agreement, which the trustee alleged gave Halder benefits he was not entitled to under his employment agreement and the execution of which by Westech's directors was not properly authorized. The Bankruptcy Court had dismissed the claim because it held the complaint did not plausibly allege that the Law Firm knew it was participating in the directors' breaches of duty. The District Court disagreed, and held that a factfinder could infer that, as counsel for Westech, the Law Firm knew that the Cancellation Agreement was a violation of Halder's fiduciary duties and was knowingly helping Halder self-deal on his way out of the company. Similarly, the District Court held that the Law Firm may have known that Westech was not in breach of Halder's employment agreement. If Westech was not in breach, it would have owed Halder substantially less money if it had instead simply not renewed that employment agreement, and the Law Firm would then also have known that Westech received nothing in exchange for releasing Halder from the restrictive covenants in his employment agreement. Finally, the District Court held that the fact that the Law Firm prepared the Cancellation Agreement on its own suggested that the Law Firm knew the purposes behind it at the time. The District Court remanded the case so that the trustee could continue pursuing the claim before the Bankruptcy Court.

C. The Take-Away

While the District Court's analysis on appeal focused on Texas law, that analysis and the Court's decision serve as an important reminder to attorneys to carefully evaluate their allegiances, particularly when they consider representing individual board members of a company that is itself a client. Building trust and closely working with board members is an essential foundation for an attorney to effectively represent a company. And, the relationships built upon that foundation often evolve into life-long friendships. However, practitioners must always be mindful of their professional obligations to the company they represent and avoid allowing their relationships with individual board members to cloud their judgment and take actions in dereliction of those obligations.

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