

Ethical Traps in Shareholder Litigation

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I. Conflicts When Representing the Corporation

A. Dual representation of the corporation and management in derivative suits

A cause of action against one who has injured a corporation belongs to the corporation and not to the shareholders.¹ A corporate stockholder cannot recover damages personally for a wrong done solely to the corporation, even though he may be injured by that wrong.² A cause of action for injury to the property of a corporation or for impairment or destruction of its business is vested in the corporation, as distinguished from its shareholders, even though the harm may result indirectly in the loss of earnings to the shareholders.³ The individual shareholders have no separate and independent right of action for wrongs to the corporation that merely results in depreciation in the value of their stock.⁴ As a result, to recover for wrongs done to the corporation, the shareholder must bring the suit derivatively in the name of the corporation so that each shareholder will be made whole if the corporation obtains compensation from the wrongdoer.⁵

When a shareholder brings an derivative action on behalf of the corporation, it is well-established in Texas that the corporation is not only a proper party to a derivative claim, but is an indispensable party to a shareholder's lawsuit.⁶ Ordinarily, the plaintiff is required to name the corporation as a "nominal" defendant, notwithstanding the fact that the plaintiff shareholder purports to represent the interests of the corporation.⁷ "In a derivative action, a plaintiff

¹ Swank v. Cunningham, 258 S.W.3d 647, 661 (Tex. App.—Eastland 2008, no pet.).

² Wingate v. Hajdik, 795 S.W.2d 717, 719 (Tex.1990).

³ Redmon v. Griffith, 202 S.W.3d 225, 233 (Tex.App.—Tyler 2006, pet. denied).

⁴ Id.

⁵ Swank v. Cunningham, 258 S.W.3d at 661; Redmon v. Griffith, 202 S.W.3d at 234.

⁶ See Barthold v. Thomas, 210 S.W. 506, 507-08 (Tex. Comm'n App. 1919, jmt adopted); Providential Inv. Corp. v. Dibrell, 320 S.W.2d 415, 418 (Tex. Civ. App.—Houston 1959, no writ). Accord In re Marriage of Scott, 117 S.W.3d 580, 583 (Tex. App.—Amarillo 2003, no pet.); DeBord v. Circle Y of Yoakum, Inc., 951 S.W.2d 127, 134 (Tex. App.—Corpus Christi 1997), rev'd on other grounds, Stary v. DeBord, 967 S.W.2d 352 (Tex. 1998); Texas Soc. V. Fort Bend Chapter, 590 S.W.2d 156, 160 (Tex. Civ. App.—Texarkana 1979, writ ref'd n.r.e.); Motorola, Inc. v. Chapman, 761 F. Supp. 458 (S.D. Tex. 1991).

⁷ See Meyer v. Fleming, 327 U.S. 161, 168 (1946); Bell Atlantic Corp. v. Bolger, 2 F.3d 1304, 1315 (3d Cir. 1993).

shareholder is a nominal plaintiff and the corporation on behalf of which the action is brought is merely a nominal defendant.”⁸ As the Court stated in *Miller v. American Telephone and Telegraph Co.*, “(a)lthough . . . any corporation involved in a stockholders' derivative action . . . is properly made a nominal defendant, it must realistically be considered to be the complainant in the action.”⁹

The usual situation in a shareholder derivative suit is that the shareholder is bringing a claim against those in control of the corporation (officers, directors and/or controlling shareholders) for damage done to the corporation through a breach of their fiduciary duties, such as looting the corporation’s assets through excessive compensation. Because the defendants being accused of harming the corporation also control the corporation, the paradox almost invariably arises that the “corporation” thinks the lawsuit brought on its behalf is a very bad idea and actively opposes the effort. Because the plaintiff shareholder is required to join the corporation as a “nominal” defendant (even though it is the real plaintiff in interest), very frequently the corporation’s regular counsel, paid by the corporation, undertakes the joint representation of the corporation and of the individual defendants in opposition to the plaintiff’s derivative claim. Therefore, the defendants’ attorney, at least theoretically, is in the awkward position of representing the corporation in trying to prevent the corporation from obtaining damages from individuals accused of looting the corporation. This situation presents a very real conflict of interest. As the United States District Court for the Northern District of Texas wrote in *Clark v. Lomas & Nettleton Fin. Corp.*:

In fact, the corporation is the real plaintiff and any finding of liability would redound to its benefit, not to its detriment. And, obviously, in this action any finding of liability on the part of the ‘inside’ directors, controlling stockholder and the controlled corporations would result in a recovery for Booth, Inc. The interests of Booth, Inc. and the other Director defendants are clearly adverse, and the representation by one law firm of Booth, Inc. and the Directors, except under very limited circumstances, would be improper under the Canons of Ethics.¹⁰

1. Dual representation is usually a conflict of interest.

Although no Texas court has addressed the issue, a many decisions in other jurisdictions have held that, in general, the same attorney may not represent both the corporation and the individual defendants accused of serious breach of fiduciary

⁸ *Clark v. Lomas & Nettleton Fin. Corp.*, 79 F.R.D. 658, 659 (N.D. Tex. 1978).

⁹ 394 F.Supp. 58, 65 (E.D.Pa.1975), *aff'd* 530 F.2d 964 (3rd Cir. 1976),

¹⁰ *Clark v. Lomas & Nettleton Fin. Corp.*, 79 F.R.D. at 659-60.

duties to that corporation. The first case to seriously address the issue was *Lewis v. Shaffer Stores Co.*,¹¹ which held:

[t]he interests of the officer, director and majority stockholder defendants in this action are clearly adverse, on the face of the complaint, to the interests of the stockholders of [the corporation] other than defendants. I have no doubt that [the attorneys] believe in good faith that there is no merit to this action. Plaintiff, of course, vigorously contends to the contrary. The court cannot and should not attempt to pass upon the merits at this stage. Under all the circumstances, including the nature of the charges, and the vigor with which they are apparently being pressed and defended, I believe that it would be wise for the corporation to retain independent counsel, who have had no previous connection with the corporation, to advise it as to the position it should take in this controversy.¹²

In *Cannon v. U.S. Acoustics Corp.*,¹³ the court disqualified a law firm from representing a corporation and its board of directors in a derivative action, where the complaint alleged a misappropriation of corporate funds by the Directors.¹⁴ The court reached its decision based upon both the conflict of interest between the corporation and its directors, and the possibility that confidences obtained from one client during the course of representation might be used to the detriment of the other.¹⁵ Many other courts have reached the same result.¹⁶ The same rule applies in a dissolution case (and therefore presumably in a shareholder oppression case).¹⁷

¹¹ 218 F.Supp. 238 (S.D.N.Y.1963),

¹² Id. at 239-40.

¹³ 398 F.Supp. 209 (N.D.Ill.1975), aff'd in relevant part per curiam, 532 F.2d 1118, 1119 (7th Cir.1976),

¹⁴ Id. at 218-19.

¹⁵ Id.

¹⁶ See *Messing v. FDI, Inc.*, 439 F.Supp. 776 (D.N.J.1977); *In re Oracle Securities Litigation*, 829 F.Supp. 1176, 1188-89 (N.D.Cal.1993); *Musheno v. Gensemer*, 897 F.Supp. 833, 838 (M.D.Pa. 1995) ("Rather, in cases such as this, where the potential for conflict is great, the better approach is to require the corporation to obtain independent counsel."); *Forrest v. Baeza*, 67 Cal. Rptr. 2d 857, 863 (Cal. App. 1st Dist. 1997); *Rowen v. LeMars Mut. Ins. Co. of Iowa*, 230 N.W.2d 905, 915 (Iowa 1975); *Horowitz v. Horowitz*, 151 A.D.2d 646, 542 N.Y.S.2d 708 (1989); *Tydings v. Berk Enter.*, 80 Md.App. 634, 565 A.2d 390, 393 (1989); *Elberta Oil Co. v. Superior Court of Kings County*, 108 Cal App 344, 291 P 668; *Camp v. Chase*, 39 Conn Supp 264, 476 A2d 1087; *Essential Enterprises Corp. v. Dorsey Corp.*, 40 Del Ch 343, 182 A2d 647.; *Murphy v. Washington American League Base Ball Club*, 324 F2d 394; *Milone v. English*, 306 F2d 814; *Langer v. Garay*, 30 AD2d 942, 293 NYS2d 78; *Garlen v. Green Mansions*, 9 App Div 760, 193 NYS2d 116; *In re Conduct of Kinsey*, 294 Ore 544, 660 P2d 660. see also *Bell Atlantic Corp. v. Bolger*, 2 F.3d at 1316 ("We have no hesitation in holding that--except in patently frivolous cases--allegations of directors' fraud, intentional misconduct, or self-dealing require separate counsel.").

¹⁷ See *La Jolla Cove Motel and Hotel Apts. Inc. v. Superior Court*, 17 Cal.Rptr.3d 467, 476 (Cal. App. 4th Dist. 2004).

2. Exceptions

Most courts have applied the conflict rule only in cases involving allegations of serious misconduct by the individual defendants. The Third Circuit held that where the claims against the individuals were merely negligence or mismanagement, that is breaches of the duty of care rather than the duty of loyalty, then disqualification was not required.¹⁸ Also courts do not apply the rule in derivative cases that are “patently frivolous.”¹⁹

Some courts have held that the early and limited representation of the individual defendants by the corporation’s counsel does not present a serious conflict, such as when the corporation’s attorneys file an answer or a motion to dismiss on behalf of the individual defendants but then withdraw. In *Clark v. Lomas & Nettleton Fin. Corp.*,²⁰ the court held that

there is no conflict of interest requiring disqualification in the narrow instance when one law firm represents a derivatively sued corporation and its individually sued directors and the law firm initially files a motion to dismiss on behalf of its clients, does not otherwise participate in the lawsuit, and withdraws from representation of either the corporation or the individual directors when either the motions are overruled or when it becomes necessary to participate in the defense of the corporation and the individual directors. At this stage of the proceedings, when the court must make a determination on whether as a matter of law the defendants should be in the lawsuit, unless it can be shown that an actual conflict exists or that certain confidences are being jeopardized, I think the client's right to select the counsel of his choice outweighs any potential conflict of interest. Once that determination is made, or once it becomes necessary for active participation in the defense of the directors, then new counsel must be sought, because the potential for conflict has increased to the point where it outweighs the rights of the individual directors to select counsel.²¹

However, other courts, although acknowledging that no real conflict exists at the outset of the lawsuit and that the defendants might be burdened by having to locate

¹⁸ *Bell Atlantic Corp. v. Bolger*, 2 F.3d at 1317 (but noting that “in cases where the line is blurred between duties of care and loyalty, the better practice is to obtain separate counsel”).

¹⁹ *Id.*

²⁰ 79 F.R.D. 658 (N.D.Tex.1978),

²¹ *Id.* at 661.

two different law firms from the outset, nevertheless held that even this limited joint representation was not permitted.²²

The district court in *Clark v. Loman & Nettleton Fin. Corp.* also suggested, but did not actually consider, that it might be possible for the court to allow the corporation to waive the conflict.²³ One rather odd Louisiana opinion recognizes the considerable authority holding that there is a conflict in dual representation when the individuals are accused of serious misconduct, but holds that disqualification is not appropriate.

Although the corporation appears as a party on both sides of the lawsuit, its true interest lies with the plaintiff shareholder; it is only nominally a defendant. Therefore, [the law firm] represents only the interests of the individual directors who have allegedly harmed the corporation, and the plaintiff's counsel actually represents the interests of the corporation, to which any recovery will be returned. [The law firm] is not representing adverse interests because the corporation has no interest as a defendant; it is merely required to be named as one.²⁴

Therefore, the court reasoned, there is no conflict because the defendants' lawyers are not really representing the corporation – which raises an interesting question of whether the corporation is paying their legal fees and why.

3. Retaining independent counsel.

Generally, the choice of independent counsel belongs to the corporation, not to the court.²⁵ However, merely requiring the defendants to associate a second law firm does not really solve the problem. If the individual defendants control the corporation, hire counsel who take their orders from the individual defendants (even if not technically representing them), and actively engage in a joint defense with the individual defendants' counsel, then the situation with the separate counsel continues the same evils that the disqualification sought to remedy—confidential information belonging to the corporation may still be used against the best interests of the corporation, the attorneys for the corporation are still actively opposing the interests of the corporation. Therefore, courts have been careful to exercise some supervision over the selection and conduct of the new independent counsel.

In this derivative action the officers and directors who are accused of harming the interests of the policyholders will choose counsel to

²² See *Musheno v. Gensemer*, 897 F.Supp. at 838.

²³ 79 F.R.D. at 661.

²⁴ *Robinson v. Snell's Limbs and Braces of New Orleans, Inc.*, 538 So.2d 1045, 1048-49 (La. App. 1989).

²⁵ See *Tydings v. Berk Enterprises*, 80 Md App 634, 565 A2d 390 (1989).

represent the policyholders regarding those charges unless the court does so. The issue is equitable. We can exercise our discretion to permit the corporations to choose independent counsel to represent them, or we or the trial court can select the independent counsel. ... While the first alternative would respect corporate autonomy and remove the outward appearance of dual representation, it would not eliminate the substance of the problem sought to be avoided. Counsel for the corporation would be subject to the control of those accused of wrongdoing.²⁶

Some courts have ruled that the lawyer who has been engaging in the dual representation may continue to represent the corporation, while independent counsel is retained for the individuals. Defendants often favor this approach as it simplifies having the corporation pay the entire cost of the defense. However, most courts have required the corporation to retain new, independent counsel.²⁷

In *Lewis v. Shaffer Stores, Co.*, the district court ordered the corporation to obtain separate, independent counsel, "who have had no previous connection with the corporation," and who were to file an answer on behalf of the corporation after their own investigation of the facts. However, the court did not find the fact the independent counsel for the corporation would be selected by the same officers and directors who had been sued to "present any insuperable difficulty."²⁸ The court in *Messing v. FDI, Inc.*,²⁹ faced with a similar situation, held that the corporation was required to obtain independent counsel, "unshackled by any ties to the directors", to advise it of its most favorable course of action.³⁰

In *Rowen v. LeMars Mut. Ins. Co. of Iowa*, the Iowa Supreme Court ordered the trial court to appoint independent counsel for the corporation.³¹ The Second Circuit acknowledged the court's power to do so.³² However, a Maryland court of appeals

²⁶ *Rowen v. LeMars Mut. Ins. Co. of Iowa*, 230 N.W.2d at 916.

²⁷ See *Stepak v. Addison*, 20 F.3d 398, 404 (11th Cir. 1994); see, e.g., *Cannon v. U.S. Acoustics Corp.*, 398 F.Supp. 209, 220 (N.D.Ill.1975) (rejecting potentially conflicted counsel's offer to withdraw from representation of individual defendants but requiring the corporation to obtain independent counsel), *aff'd* in relevant part, 532 F.2d 1118, 1119 (7th Cir.1976) (per curiam); *Lewis v. Shaffer Stores Co.*, 218 F.Supp. 238, 240 (S.D.N.Y.1963) (requiring corporation to obtain independent counsel when corporation's general counsel had also represented the insider defendants and when the interests of the corporation and the insiders were clearly adverse on the face of the complaint).

²⁸ 228 F.Supp. at 240,

²⁹ 439 F.Supp. 776 (D.N.J.1977),

³⁰ *Id.* at 782. See also *Garlen v. Green Mansions, Inc.*, 9 A.D.2d 760, 193 N.Y.S.2d 116, 117 (1959) (appearance by a corporation in a derivative suit "must be by independent counsel whose interests will not conflict with those of the individual defendant")

³¹ 230 N.W.2d at 916.

³² *Levine v. American Export Indus., Inc.*, 473 F.2d 1008, 1009 (2nd Cir. 1973).

rejected this approach.³³ In *Messing v. FDI, Inc.*,³⁴ the federal district court declined to appoint independent counsel for the corporation as this would “prospectively pass” on the director’s willingness to comply with the court’s order to associate truly independent counsel. However, the court left the door open to its future appointment of counsel if the directors requested that the court do so or if the directors failed to comply with the order. “It is the duty of the directors, in this as in other matters, to act in the corporation’s best interest. If they are disqualified from acting on this or on any other matter, then it is for them, in the first instance, to devise a method to accommodate the need to continue the corporate enterprise while refraining from participating in any corporate decision in which they might have a personal interest. They act, or fail to act, at their peril.”³⁵

B. The corporation’s position in derivative suits.

A related issue is whether the corporation, regardless of who represents it, may actively defend its management in a derivative suit. Even if the corporation and the management are represented by different lawyers, the management still control the corporation and hire, pay and direct the activities of the corporation’s lawyer. If the management is being sued for damaging the corporation, then the management will be eager to have the corporation through its counsel take a position in defense of the management. The corporation, after all, is not its management, and the true interests of the corporation are not necessarily aligned with the desire of management—particularly if the management is really looting the corporation. The attorney for the corporation must be aware that the inherent conflict of interest among the management can become the attorney’s conflict if he is directed to conduct the litigation so as to favor the management at the expense of the true interests of the corporation. If there are outside, disinterested directors, or a disinterested litigation committee, then the corporate attorney’s job is much simpler because he can take his direction from directors who have no personal interest in the decision, although the attorney must be aware of whether the disinterested directors are exercising their valid business judgment—fully informed, independent of domination by the self-interested directors.

The overwhelming authority is that the corporation must remain neutral unless the derivative action directly threatens corporate interests (independent of whether it threatens corporate management).³⁶ Therefore, if disinterested directors or a

³³ Tydings v. Berk Enterp., 565 A.2d at 396.

³⁴ 439 F.Supp. 776, 784 (D.N.J. 1977),

³⁵ Id. at 783-84.

³⁶ See *Patrick v. Alacer Corp.*, 167 Cal.App.4th 995, 84 Cal.Rptr.3d 642 (2008); *Sobba v. Elmen*, 462 F.Supp.2d 944, 950 (E.D. Ark. 2006); *Int’l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Hoffa*, 242 F.Supp. 246, 253 (D.D.C.1965); *Alleghany Corp. v. Kirby*, 218 F.Supp. 164, 186 (S.D.N.Y.1963) (“New York allows a corporation to expend funds in defense of a derivative action presumptively brought in its behalf when some

disinterested special committee determine that the derivative litigation is not in the best interest of the corporation, then the corporation's attorney can and should pursue a dismissal under TBCA 5.14(H). If the litigation threatens a legitimate corporate interest, then the corporation's attorney may defend against the derivative suit. However, the interests that justify the corporation's active participation in the defense must be interests of the corporation, not the interests of the corporation's management. If the litigation will result in exposing the corporation to liability to a third party or will result in making public confidential information, then the corporation may oppose the lawsuit or seek relief from the court necessary to protect the corporate interests. However, the fact that litigation against the management will be distracting and expensive and will otherwise inconvenience the officers and directors who are being sued should not justify active participation in the defense by the corporation.

C. Adverse directors

A very difficult situation is presented to a corporation's lawyer when the dispute is between or among directors of a corporation, as often happens in oppression disputes in small closely-held corporations where all the shareholders are also on

interest of the corporation is threatened."); *Fuller v. Am. Mach. & Foundry Co.*, 91 F.Supp. 710, 711 (S.D.N.Y.1950) ("The corporation can actively defend where the interests of the corporation are threatened with injury by the relief sought in the complaint."); *Leven v. Birrell*, 92 F.Supp. 436, 444 (S.D.N.Y.1949); *Otis & Co. v. Penn. R.R. Co.*, 57 F.Supp. 680, 682 (E.D.Pa.1944) (holding that corporation can file an answer when the plaintiff's "cause of action is such as to endanger rather than advance corporate interests," but not where the cause of action is fraud against the corporate directors); *Esposito v. Riverside Sand & Gravel Co.*, 287 Mass. 185, 191 N.E. 363 (1934); *Meyers v. Smith*, 190 Minn. 157, 159, 251 N.W. 20, 21 (1933) (striking the corporation's answer where defendants who controlled the corporation sought "to impose on the corporation the burden of fighting their battle"); *Slutzker v. Rieber*, 132 N.J.Eq. 412, 415-16, 28 A.2d 528, 530 (N.J.Ch.1942) (granting motion to strike the corporation's answer that controverted the merits of the complaint's claims); *Solimine v. Hollander*, 129 N.J.Eq. 264, 266-68, 19 A.2d 344, 345-46 (N.J.Ch.1941); *Chaplin v. Selznick*, 186 Misc. 66, 58 N.Y.S.2d 453, 455 (Sp. Term 1945) ("The corporation itself can take no position in a derivative stockholder's suit which is fundamentally antagonistic to the claim asserted on its behalf. That is the whole theory which is behind a derivative stockholders' action."); *Kirby v. Schenck*, 25 N.Y.S.2d 431, 432-33 (Sp. Term 1941) (allowing corporation to defend action where plaintiff sought to enjoin corporation from carrying out personal service contracts because "interests of the corporation [were] injuriously threatened" by plaintiff's suit); *Godley v. Crandall & Godley Co.*, 181 A.D. 75, 78, 168 N.Y.S. 251 (N.Y.App.Div.1917); *Swenson v. Thibaut*, 39 N.C.App. 77, 101, 250 S.E.2d 279, 294 (1978); *Nat'l Bankers Life Ins. Co. v. Adler*, 324 S.W.2d 35, 37 (Tex.Civ.App.1959) ("If the derivative action threatens rather than advances the corporate interests, the corporation may actually defend the action."); see also *Corey v. Indep. Ice Co.*, 226 Mass. 391, 115 N.E. 488 (1917) (holding that corporation was allowed to defend suit challenging corporate reorganization); *Apfel v. Auditore*, 223 A.D. 457, 458, 228 N.Y.S. 489 (N.Y.App.Div.1928) ("We regard it as inequitable that the corporations should be called upon to pay for the defense of this action brought for their benefit and resulting in a judgment in favor of the plaintiff as a representative of the corporate interests."); cf. *Lewis v. Shaffer Stores Co.*, 218 F.Supp. 238 (S.D.N.Y.1963) (striking corporation's answer where it was represented by same counsel representing the defendant directors and officers of the corporation); *Weiland v. N.W. Distilleries*, 203 Minn. 600, 281 N.W. 364 (1938) (finding that corporation could defend suit where plaintiff's suit sought the corporation to cancel and void 375 shares of stock); *McHarg v. Commonwealth Fin. Corp.*, 44 S.D. 144, 182 N.W. 705 (1921) (finding that corporation could challenge venue where plaintiff sought the appointment of a receivership).

the board of directors. The board of directors of a corporation are charged with its management,³⁷ but the board's authority must be exercised as a group—individual directors have no authority apart from the board. When a shareholder fight involves two directors, the corporation's lawyer is faced with a real dilemma. The lawyer's duty is to the corporation, not to the individual shareholders, directors, or officers. But who is the corporation in this situation? The natural inclination is to side with the directors who represent the controlling interest and to shun the dissident director who represents a minority interest, but this can be a terrible mistake. The dissident director remains a director, is entitled to the rights and powers of a director, and the board of directors can take no action legally without notice to (and the knowledge of) the dissident director.

One of the thorniest issues that arises is whether information or communications between the other directors and the corporation's lawyers can be withheld from the dissident director on the grounds of attorney-client privilege. Texas has not addressed this issue head-on, but the law is clear that the right of a director of a Texas corporation to inspect the corporate books and records is absolute.³⁸ Because directors of a corporation are charged with managing the business and affairs of the corporation, "it would seem to be axiomatic that the individual director cannot make his full contribution to the management of the corporate business unless given access to the corporation's books and records. The information therein contained is ordinarily requisite to the exercise of the judgment required of directors in the performance of their fiduciary duty so much so that the directors' right of inspection has been termed absolute, during their continuance in office at all reasonable times."³⁹ Even before the Texas Business Corporation Act specifically conferred upon directors the right to inspect the corporate books, Texas courts held that this right existed by common law.⁴⁰ The current TBCA and BOC specifically provide directors the right of inspection and a remedy for violation of that right.⁴¹ The director does not have to have a "proper" purpose to inspect, so long as his purpose is "reasonably related to his service as a director": however, the director is not required to state his purpose or even to make a written demand.

A recent California appellate court decision grappled with this exact issue.⁴² Under California law, corporate directors also have an "absolute right" to inspect and copy

³⁷ BOC §21.401; TBCA art. 2.31

³⁸ *Chavco Investment Company, Inc. v. Pybus*, 613 S.W.2d 806, 810 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.).

³⁹ *Chavco Inv. Co., Inc. v. Pybus*, 613 S.W.2d at 810 (quoting : Fletcher, *Cyclopedia of the Law of Private Corporations* s 2235)

⁴⁰ *Id.*

⁴¹ TBCA art. 2.44(B). BOC §3.152(a).

⁴² *Tritek Telecom v. Superior Court*, 169 Cal.App.4th 1385, 87 Cal.Rptr.3d 455 (Jan. 7, 2009).

all corporate “books, records and documents of every kind.”⁴³ This “absolute right” normally extends to documents otherwise subject to the attorney client privilege.⁴⁴ In *Tritek Telecom v. Superior Court*, California Fourth Court of Appeals dealt with a shareholder dispute involving two equal shareholders of a closely-held corporation, both of whom were directors. A third non-shareholder director apparently aligned with one of the shareholders thus giving that shareholder effective control. The controlling shareholder then proceeded to lock out the other shareholder, stop paying his salary, and misappropriate assets. The ousted shareholder sued the other two directors and the corporation alleging various causes of action and seeking the return of the shareholder’s investment. Initially, corporation’s lawyer represented both corporation and the individuals in the litigation. The trial court correctly disqualified corporation’s lawyer from the dual representation and required new and separate counsel for both the corporation and the individual defendants.⁴⁵

Thereafter, the plaintiff sought to inspect the documents and communications generated by corporation’s attorney during the time of the dual representation. The defendants resisted the inspection on the grounds of attorney-client privilege. The trial court ordered the inspection. The appellate court reversed, holding that the plaintiff shareholder/director had no right to inspect attorney-client privileged documents that were generated in defense of the plaintiff’s lawsuit filed against the corporation.⁴⁶

In reaching its conclusion the Court of Appeals acknowledged that the director’s rights to access to corporate records is absolute, but then paradoxically noted that there are exceptions to its absoluteness. One California Court of Appeals had previously noted hypothetically that a director’s absolute right of inspection might be denied where a disgruntled director announces his or her intention to violate his or her fiduciary duties to the corporation, such as by using inspection rights to learn trade secrets to compete with the corporation.⁴⁷ That court had held that the director was entitled to inspection but had ruled that §1603(a) of the Cal. Corp. Code, which provides that a court may enforce the right of inspection “with just and proper conditions,” permits a court to grant a corporation a protective order denying or limiting a director’s inspection, but only if the corporation demonstrates by an evidentiary showing that the protective order is necessary to prevent a tort from being committed against the corporation by the director.⁴⁸ The *Tritek* court⁴⁹

⁴³ Cal. Corp. Code § 1602.

⁴⁴ 169 Cal.App.4th at 1387.

⁴⁵ See, e.g., *Bell Atlantic Corp. v. Bolger*, 2 F.3d 1304 (3rd Cir. 1993); *Clark v. Lomas & Nettleton Fin. Corp.*, 79 F.R.D. 658 (N.D. Tex. 1978); *Cannon v. U.S. Acoustics Corp.*, 398 F.Supp. 209 (N.D. Ill. 1975), *aff’d* 532 F.2d 1118 (7th Cir. 1976); *Messing v. FDI, Inc.*, 439 F.Supp. 776, 781-82 (D.N.J. 1977).

⁴⁶ 169 Cal.App.4th at 1392.

⁴⁷ *Havlicek v. Coast- to-Coast Analytical Services, Inc.*, 39 Cal.App.4th 1844, 1855 (1995).

⁴⁸ *Id.* at 1856.

also cited *La Jolla Cove Motel and Hotel Apts. Inc. v. Superior Court*,⁵⁰ for the proposition that corporate counsel has no duty to disclose privileged information to a dissident director with which the corporation has a dispute.⁵¹

In *Tritek*, the Court held that the dissident director's "absolute right" to access to corporate records did not extend to privileged communications generated in defense of each suit that the director had filed against the corporation because the interests of the director were adverse to those of the corporation and because such access would violate the privilege between the controlling shareholder and the corporation's lawyer during the time that the corporation's lawyer represented the individual shareholder.

The Court's reasoning is very troubling on a number of levels. First, the Court fails to consider whether the attorney-client privilege ever existed in the first place. A communication is subject to the attorney-client privilege only if the communication is made with the expectation of confidentiality.⁵² The attorney-client privilege may be held jointly by two or more persons, and the assertion or waiver by one of the joint holders does not affect the others.⁵³ The very nature of the corporation is that it is controlled and managed by its board of directors. The directors exercise their power and authority over the corporation only as a group, not individually. Therefore, while the corporation is the holder of the attorney-client privilege with its corporate counsel, the privilege is exercised by and through the directors, and no one director has any more claim to access to privileged communications than any other. Therefore, communications between a corporation and its corporate counsel cannot be made with the expectation that they will be kept confidential from any member of the Board of Directors. Therefore the question arises, as to the sitting members of the Board of Directors, what attorney-client privilege can be asserted against them? One previous California case held that meetings with corporate

⁴⁹ 169 Cal.App.4th at 1391.

⁵⁰ 121 Cal.App.4th 773, 787-88, 17 Cal.Rptr.3d 467 (2004),

⁵¹ Actually, the court in *La Jolla Cove Motel and Hotel Apts. Inc. v. Superior Court* had dealt with a very different issue. In that case, non-director minority shareholders had brought suit against the majority shareholders. The minority shareholders had elected two directors to represent their interests, and those directors were aligned with the minority shareholders in the dispute. During the litigation, the majority shareholders moved to have the minority shareholders' lawyer disqualified or disciplined for contacting and taking statements from the minority-aligned directors without the permission of the corporation's counsel. The Court held that the corporation's lawyer could not be deemed the lawyer of the minority-aligned directors because there was an actual dispute among the shareholders and directors which would have precluded the corporation's lawyer from representing the dissident directors against the corporation. The court also noted, in passing, that the corporation's lawyer was free to use communications by the dissident directors prior to the dispute to further the interests of the corporation, even if those interests were adverse to the dissident directors. This is not the same thing as holding that the dissident directors are not entitled to access to privileged communications between the corporation and its counsel to which the directors aligned with the controlling shareholders would have had access.

⁵² Cal. Evid. Code §952.

⁵³ Cal. Evid. Code §912.

counsel by one group of shareholders in a closely-held corporation could be withheld from another group of shareholders on the grounds of attorney-client privilege, where the evidence showed that the meeting had served a corporate purpose.⁵⁴ However, that court neatly side-stepped the difficult issue posed by the fact that one of the dissident group of shareholders was also a director by noting that the lawsuit had been brought in director's capacity as a shareholder, not a director.⁵⁵

The Delaware courts have also addressed this issue, and their conclusions have been markedly different from that reached in the *Tritek* case. Under Delaware law, when a corporation employs legal counsel, each of the members of the board of directors has a status co-equal with the corporation as "client." "The issue is not whether the documents are privileged or whether plaintiffs have shown sufficient cause to override the privilege. Rather, the issue is whether the directors, collectively, were the client at the time the legal advice was given. Defendants offer no basis on which to find otherwise, and I am aware of none. The directors are all responsible for the proper management of the corporation, and it seems consistent with their joint obligations that they be treated as the 'joint client' when legal advice is rendered to the corporation through one of its officers or directors."⁵⁶ Therefore, communications with corporate counsel during a director's tenure on the board cannot be privileged as to her because, as a matter of law, such communications could not legally have been intended to be kept confidential from her. "Absent a governance agreement to the contrary, each director is entitled to receive the same information furnished to his or her fellow board members."⁵⁷ In fact, Delaware corporate law is clear that attorney-client communications to which a director should have had access during her tenure continue to be available to her after she ceases to be a director. In *Kirby v. Kirby*,⁵⁸ the Delaware Chancellor held that, as to attorney-client communications that occurred during the tenure of former directors, it is not possible for any privilege to have been created for those communications, and therefore, there is no basis for the invocation of the attorney-client privilege at a later date. Independently, under Delaware corporate law, the corporation is prohibited from asserting the attorney-client privilege as to information to which a director is entitled. A corporation may not "assert the privilege to deny a director access to legal advice furnished to the board during the director's tenure."⁵⁹

Perhaps more troubling are the explicit reasons for the *Tritek* court's holding, that the plaintiff is adverse to the corporation and that access to privileged

⁵⁴ *Holles v. Superior Court*, 157 Cal.App.3d 1192, 1200, 204 Cal.Rptr. 111 (1984).

⁵⁵ *Id.* at 1202

⁵⁶ *Kirby v. Kirby*, 1987 WL 14862 (Del. Ch. 1987).

⁵⁷ *Intrieri v. Avatex*, 1998 WL 326608 (Del. Ch. 1998).

⁵⁸ 1987 WL 14862 (Del. Ch. 1987),

⁵⁹ *Moore Business Forms, Inc. v. Cordant Holdings Corp.*, 1996 WL 307444 (Del. Ch. 1996).

communications would violate a privilege held independently by the controlling shareholder. The opinion does not give great detail about the exact procedural posture of the case and the exact causes of action asserted by the plaintiff. If the plaintiff asserted a cause of action against the controlling shareholder for breach of fiduciary duties as a result of misappropriation of corporate assets, then this claim must almost certainly have been brought as a derivative claim, in which case the plaintiff would have been asserting claims on behalf of the corporation rather than against it. In almost every lawsuit between a controlling shareholder and a non-controlling shareholder for wrongdoing done by the controlling shareholder, the law governing standing and capacity will almost always require that some of the claims be brought against the corporation. This very often results in the strange situation in which a plaintiff is both suing and representing the interests of the corporation in the same lawsuit. Courts, however, generally view the situation as a matter of substance over form. The true dispute is between the shareholders, and regardless of how the complaint is stated, the gravamen of the complaint is the manner in which the controlling shareholder has exercised his power over the Corporation. There is absolutely no reason for a court to assume that the party that controls the corporation is therefore acting in the interests of the corporation. If the claims made by the plaintiff in Tritex are true, then the plaintiff was acting on behalf of the corporation, and the controlling shareholder was adverse to the corporation.

There can be little justification for protecting the confidentiality of communications between the corporation's lawyer and the controlling shareholder/director as against another director when the very act of establishing the attorney client relationship between the corporation's lawyer and the controlling shareholder was a breach of both of their duties to the corporation "[A]s attorneys for [a] corporation, counsel's first duty is to [the corporation]."⁶⁰ "These cases make clear that corporate counsel's direct duty is to the client corporation, not to the shareholders individually, even though the legal advice rendered to the corporation may affect the shareholders."⁶¹ A corporation's attorney is not permitted, either during or after that engagement, to represent any shareholder or director against the corporation (or the other shareholders when that would entail acting contrary to his prior representation of the interests of all the shareholders).⁶² Moreover, a corporation is not permitted to defend a derivative action on the merits,⁶³ and the corporation's lawyer has a duty to refrain from taking part in any controversies or factional differences among shareholders as to control of the corporation, so that he or she can advise the corporation without bias or prejudice.⁶⁴ As for the controlling

⁶⁰ Meehan v. Hopps 144 Cal.App.2d 284, 293, 301 P.2d 10 (1956).

⁶¹ Skarbrevik v. Cohen, England & Whitfield 231 Cal.App.3d 692, 704, 282 Cal.Rptr. 627 (1991).

⁶² See Metro-Goldwin Mayer, Inc. v. Tracinda Corp., 36 Cal.App.4th 1832, 1845, 43 Cal.Rptr.2d 327 (1995); Goldstein v. Lees, supra, 46 Cal.App.3d 614, 622, 120 Cal.Rptr. 253 (1975).

⁶³ Patrick v. Alacer Corp., 167 Cal.App.4th 995, 84 Cal.Rptr.3d 642 (2008),

⁶⁴ See Goldstein v. Lees 46 Cal.App.3d at 622

shareholder who elected to use the corporation's lawyer to defend claims brought against him personally based on his individual breach of duties to the corporation and to the other shareholder, the controlling shareholder has misappropriated corporate assets (the services and independence of the corporation's lawyer, not to mention the fees incurred by the corporation) for his individual benefit, and has directed the corporation's lawyer to violate his duties to the corporation and to cause the corporation to take a position that it is not legally permitted to take. It is very difficult to understand why the *Tritek* court believed that this was a valid exercise of the attorney-client privilege worthy of the court's protection, and the opinion does not address the issue.

Of course, if a dispute arises between a two groups of shareholders or between the corporation and one of its directors, the corporation may very easily preserve the attorney-client privilege and the integrity and confidentiality of the legal advice from the corporation's lawyer by establishing an independent litigation committee to consult with corporate counsel. As the Chancellor held in *Moore Business Forms, Inc. v. Cordant Holdings Corp.*:

Holdings had alternative means to enable its directors (other than Mr. Rogers) to receive confidential attorney advice not discoverable by Moore. Holdings could have bargained for such protections in the Stockholders Agreement. Alternatively, and independent of the Stockholders Agreement, the Holdings board could have acted, pursuant to 8 Del.C. § 141(c) and openly with the knowledge of Moore and Rogers, to appoint a special committee empowered to address in confidence those same matters. Under either scenario the special committee would have been free to retain separate legal counsel, and its communications with that counsel would have been properly protected from disclosure to Moore and its director designee. Neither approach was followed here.⁶⁵

Of course, this approach assumes that there are independent directors and that the corporation (as apart from the shareholders involved in the lawsuit) has some legitimate, independent reason for legal advice. This alternative would not have been possible in the *Tritek* case, where there were only two shareholders, no independent directors, and no reason for the corporation or the corporation's lawyer to be actively involved in defending one or the other shareholder.

⁶⁵ 1996 WL 307444 (Del. Ch. 1996)

II. Conflicts When Representing the shareholders in a derivative action

Attorneys representing plaintiff shareholders in litigation must also be aware of potential conflicts of interest because these attorneys will owe duties both to their individual client and to the corporation on whose behalf the lawsuit was brought. These interests are not always perfectly aligned.

A. Joining individual and derivative claims

Very frequently, the shareholder will have individual claims, such as shareholder oppression, that arise out of or relate to the transactions and occurrences that gave rise to the derivative claims, and which are properly brought in the same lawsuit. At a very theoretical level, there is some conflict of interest inherent in the simultaneous pursuit of individual and derivative claims.⁶⁶ In bringing the derivative claims on behalf of the corporation, the plaintiff and his attorney are acting in a representative capacity and owe the corporation fiduciary duties of loyalty. If the plaintiff shareholder is also suing on individual claims, then that plaintiff and his attorney might be tempted to devote greater resources and attention to the individual claims or to favor the individual claims in settlement negotiations. Courts have recognized that the conflict between a plaintiff's derivative and individual claims is more "theoretical than real."⁶⁷ In assessing this "theoretical" conflict, courts look beyond the "surface duality" and determine whether an actual conflict exists.⁶⁸ Notwithstanding this theoretical possibility of a conflict (and bearing in mind that the court must pass on the fairness and adequacy of the settlement), courts have almost universally held that it is permissible for a plaintiff shareholder to join individual and derivative claims.⁶⁹

⁶⁶ See *Tuscano v. Tuscano*, 403 F.Supp.2d 214, 223 (E.D.N.Y. 2005) ("Any individual claims raised by a shareholder in a derivative action present an impermissible conflict of interest.").

⁶⁷ *First American Bank & Trust v. Frogel*, 726F.Supp. 1292, 1298 (S.D. Fla. 1989) (denying a motion to dismiss derivative claims on the basis of Rule 23.1 where the plaintiff was bringing a derivative claim to recover money for the corporation, while at the same time bringing a class action to obtain monetary damages against the same corporation).

⁶⁸ *Id.*; *Keyser v. Commonwealth Nat'l Fin. Corp.*, 120 F.R.D. 489, 492 (M.D. Pa 1988); see *Jordan v. Bowman Apple Products Co.*, 728 F.Supp. at 413 (denying a motion to dismiss derivative claims on the basis of Rule 23.1 where the plaintiff was also suing for the dissolution of the corporation); see also *Shoberg v. Clearmediaone, Inc.*, 2006 WL 2709269, at *4 (S.D. Tex. Sept. 20, 2006) (rejecting defendants' argument that plaintiff's simultaneous class, derivative and individual claims created a conflict).

⁶⁹ See *Moffatt Enterprises, Inc. v. Borden, Inc.*, 807 F.2d 1169, 1176 (3rd Cir. 1986) (noting that this proposition is "hornbook law"). Nor does it matter that the derivative and individual claims arise from the same facts. See *G.A. Enterprises, Inc. v. Leisure Living Communities, Inc.*, 517 F.2d 24, 27 (1st Cir. 1975); *Ohio-Seally Mattress Mfg. Co. v. Kaplan*, 90 F.R.D. 21, 25 (N.D. Ill. 1980); *Robinson v. Computer Servicenters, Inc.*, 75 F.R.D. 637, 643 (N.D. Ala. 1976).

B. Suing the corporation

A much more difficult issue is presented when an attorney represents a plaintiff shareholder that joins claims against the corporation with derivative claims on behalf of the corporation. Take a fairly typical shareholder oppression scenario. The controlling shareholder initiates a campaign to squeeze out a minority shareholder. This campaign involves looting the corporation, misappropriating assets, excessive compensation, firing the plaintiff, and causing the corporation to withhold compensation due to the plaintiff under a contract. While all of this conduct is supports a claim of oppressive conduct against the controlling shareholder, claims for damages resulting from the looting, misappropriation, and excessive compensation can only be asserted as derivative claims. Joining these derivative claims against the controlling shareholder with a shareholder oppression claim against the same defendant arising in part from the same conduct should not present a problem; however, the claim for damages from withholding compensation can only be asserted against the corporation. The reason that the corporation breached the contract was that the controlling shareholder caused the corporation to do so as part of a campaign of oppression, but because the party to the contract is the corporation and not the controlling shareholder, the claim must be brought only against the corporation. There is no logical inconsistency and no actual conflict of interest, but the plaintiff and his attorney are, in fact, suing the corporation at the same time as they are supposed to be representing it. In derivative suit, the corporation is the real plaintiff.⁷⁰

Whether this is a matter of form over substance or not, simultaneously suing and representing the same party is an ethical issue that the law takes very seriously.⁷¹ The issue of whether a lawyer may be disqualified from representing a plaintiff on both her derivative claims on behalf of the corporation and on her individual claims against the corporation has come up very few times in reported case law. However, in the context of determining the suitability of lead counsel in class action lawsuits, the issue arises fairly frequently. These cases typically involve class action claims for security fraud against a corporation in which derivative claims against the officers and directors arising out of the same facts are also pending. In determining the suitability of class counsel in such situations, courts have taken a very dim view of any lawyer seeking to represent the class of defrauded investors against the

⁷⁰ Clark v. Lomas & Nettleton Fin. Corp., 79 F.R.D. 658, 659 (N.D. Tex. 1978).

⁷¹ Texas Disciplinary Rule of Professional Conduct 1.06 plainly states that a “lawyer shall not represent opposing parties to the same litigation.” TEX. DISCIPLINARY R. OF PROF’L CONDUCT 1.06(a) (1990), reprinted in TEX. GOV’T CODE ANN. tit. 2, subtit. G, app., Art. 10 § 9A (Vernon 2005). The term “opposing parties” contemplates the situation where a judgment favorable to one party will have a direct negative impact on the other. Id. cmt. 2. “Unquestionably, the national standards of attorney conduct forbid a lawyer from bringing a suit against a current client without the consent of both clients.” In re Dresser Indus., Inc., 972 F.2d 540, 545 (5th Cir. 1992) (granting disqualification motion barring counsel from suing client in concurrent litigation).

company when that lawyer also owes a duty of loyalty to the corporation and its current shareholders as a result of prosecuting a derivative claim. The procedural issue is really not the same as the one we are considering here, but the same interests are at stake, and the dicta in opinions dealing with this situation clearly argues for the existence of an impermissible conflict of interest. In *Hawk Indus., Inc. v. Bausch & Lomb, Inc.*,⁷² the district court disqualified plaintiffs' co-lead counsel in a federal securities class action suit (a direct action) against Bausch & Lomb because the same lawyers represented the plaintiff in a derivative suit brought on behalf of Bausch & Lomb in state court litigation. The court held that this presented a conflict because

co-counsel is bound to pursue two actions to the best of his ability and as vigorously as possible. If both are successful, one action would result in a recovery for the corporation; the other would result in a detriment to the corporation. It is difficult to see how counsel could retain his independence of professional judgment and loyalty to his clients and their interests in both suits. While [the firm] is counsel for a plaintiff suing derivatively on behalf of Bausch & Lomb in the state court, it cannot furnish adequate representation to the plaintiff class here. It is, therefore, estopped from acting as co-lead counsel in this case.⁷³

The rationale of *Hawk Industries* is consistent with one of the basic tenets on which attorney client relationships are based, namely that the attorney owes his client an undivided duty of loyalty.

A lawyer owes his current litigation client a duty of zealous advocacy. . . . Indeed, an attorney "should not put himself in a position where, even unconsciously, he will be tempted to 'soft pedal' his zeal in furthering the interests of one client in order to avoid an obvious clash with those of another."⁷⁴

⁷² 59 F.R.D. 619 (S.D.N.Y. 1973),

⁷³ Id. at 624; accord, *Ruggiero v. American Bioculture, Inc.*, 56 F.R.D. 93 (S.D.N.Y. 1972) (refusing to permit attorneys in derivative action on behalf of corporation to serve as lead counsel in class action against corporation because of conflict between recovery "for" and "against" the corporation). See also *Int'l. Bus. Mach. Corp. v. Levin*, 579 F.2d 271 (3d Cir. 1978) (antitrust plaintiff firm disqualified from representing a party adverse to a client who had firm on retainer); *Cinema 5, Ltd. v. Cinerama, Inc.* 528 F.2d 1384, 1387 (2d Cir. 1976) (prima facie improper for attorney to simultaneously represent a client and another party with interests directly adverse to client).

⁷⁴ *Selby v. Revlon Consumer Prod. Corp.*, 6 F. Supp. 2d 577, 581 n.5 (N.D. Tex. 1997) (citing ABA Comm. on Ethics and Prof. Responsibility, Formal Op. 92-367 (1992)).

Other courts considering this issue have taken a more flexible approach,⁷⁵ noting the “surface appeal” of the argument but rejecting it as elevating form over substance.⁷⁶ In the case of *In re Dayco Corporation Derivative Securities Lit*,⁷⁷ the court actually dealt with a motion to disqualify plaintiff’s lawyer due to the alleged conflict between suing a corporation and bringing a derivative claim. The court agreed with the plaintiffs that the “case law is virtually unanimous in holding that one counsel can represent a stockholder bringing both an individual and a derivative action.”⁷⁸ The Court noted that “theoretical conflict of interest” was “not rooted in the realities of most individual and derivative suits.”⁷⁹ The Court in *Dayco* held that no per se rule of disqualification existed, and then did a factual analysis of the circumstances of the representation holding that “the asserted conflict of interest is not so apparent so as to justify, at least at this time, disqualification.”⁸⁰

In *Gonzalez v. Chillura*,⁸¹ a Florida Court of Appeals overturned a trial court’s disqualification of the plaintiff-shareholder’s lawyer that had been based on a conflict between suing a corporation and bringing a derivative claim on its behalf. The Court held that there is no attorney-client relationship between the corporation and the plaintiff’s counsel even though the plaintiff and her counsel technically represent the corporation on the derivative claim.⁸² “If the mere fact of pursuing a derivative claim that belongs to a corporation, but which the corporation has refused to bring, were enough to establish an attorney-client relationship between the corporation and the lawyer for the derivative plaintiff, there would be no way for the derivative plaintiff to ever have conflict-free counsel.”⁸³

⁷⁵ See *In re Dayco Derivative Securities Litigation*, 102 F.R.D. at 630-31; *In re TransOcean Tender Offer Securities Litigation*, 455 F.Supp. 999, 1014 (N.D. Ill. 1978); *Kane Assoc. v. Clifford*, 80 F.R.D. 402, 407-408 (E.D.N.Y. 1978); *Bertozzi v. King Louie Int’l, Inc.*, 420 F.Supp. at 1179-80; *Miller v. Fisco, Inc.*, 63 F.R.D. 132, 134 (E.D. Pa. 1974); *Heilbrunn v. Hanover Equities Corp.*, 259 F.Supp. 936, 939 (S.D.N.Y. 1966).

⁷⁶ See *In re Dayco Corporation Derivative Securities Lit*, 102 F.R.D. 624, 630 (S.D. Ohio 1984).

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.* at 631.

⁸¹ 892 So.2d 1075 (Fla. App. 2004),

⁸² *Id.* at 1077-78.

⁸³ *Id.* at 1078.