by SA'ID VAKILI

CORPORATIONS IN CONFLICT

The potential for conflicts of interest in shareholder derivative lawsuits is high, leading to complex issue for courts and attorneys to resolve

SHAREHOLDER DERIVATIVE LAWSUITS have not diminished. Indeed, in industries such as finance and technology, the number of these lawsuits is growing.[1] A shareholder derivative suit is typically an action by one or more shareholders against some or all of the officers or directors of a corporation to redress corporate mismanagement. While the corporation itself is usually named as a defendant, its status as defendant is nominal. In practice, the interests of the shareholder and the corporation are considered aligned, and the plaintiff benefits only as a shareholder. Even through the shareholder may be the plaintiff named in the lawsuit, any recovery goes to the corporation rather than to the plaintiff-shareholder.[2] These dynamics give rise to significant conflicts of interest. Among the most important are the potential conflicts between the shareholder and the corporation, between the plaintiff shareholder and other shareholders, and between the corporation and its counsel. Some of these potential conflicts may also pose ethical challenges to the attorneys involved.

Although myriad acts can underlie a claim, shareholder derivative actions usually emerge as a result of breaches of fiduciary duties by officers or directors. These duties, long recognized at common law, have been codified in Corporations Code Section 309.[3] Pursuant to these authorities, each director owes a fiduciary duty of care to the corporation and its shareholders, and he or she must serve "in good faith in a manner such director believes to be in the best interest of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."[4] In addition to the duty of care, directors also owe a fiduciary duty of loyalty to the corporation they serve. "Loyalty" means placing corporate and shareholder interests ahead of any other business or personal interests.[5]

Discharging these obligations requires the exercise of sound business judgment. Courts

Sa'id Vakili is a partner with the Los Angeles firm of Vakili & Leus, LLP. His practice emphasizes business and employment litigation. He wrote this article in collaboration with Peter Zablotsky, Professor of Law at Touro College Jacob D. Fuchsberg Law Center in New York.

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have ruled that this obligation includes managing proactively: "A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment."[6] Similarly, "the [business judgment] rule does not immunize a director from liability in the case of his or her abdication of corporate responsibilities."[7]

Officers also have fiduciary duties to the corporation. These duties include a "duty, not only affirmatively to protect the interest of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation."[8] Here, the courts can impose a higher standard of care on an officer, as compared to a director, because officers are often more closely involved in running the corporation and have more direct responsibility for the preparation of "information, reports, or statements on corporate affairs."[9] Finally, an officer who participates in corporate management and who exercises some discretionary authority owes a fiduciary duty of loyalty to the corporation, even if the officer's authority falls short of having control over the corporation.[10]

In establishing what the appropriate exercise of these duties entails, courts have held, for example, that unreasonable salaries or other compensation paid to management may be challenged as a waste of corporate assets, and that, even when approved by a "disinterested" board, "unreasonably" large payments to officers and directors may constitute a "waste" of corporate assets and thus violate a director's fiduciary duties to the corporation.[11] It has also been held that directors or officers may not seize a corporate opportunity for themselves without first offering it to the corporation.[12] For example, a fiduciary may not acquire property in which the corporation has an interest or tangible expectancy when a proposed activity is reasonably incident to the corporation's present or prospective business and is one in which the corporation has the capacity to engage. Or, the purchase of corporate stock by one of its directors could be an appropriation of a corporate opportunity.[13] Pointedly, at least one court has held that a corporation's financial inability to take advantage of the opportunity is irrelevant if a shareholder-director diverted and concealed the opportunity without giving the corporation a chance at it.[14]

Conflicts between Plaintiff and Corporation

A derivative action commenced by a plaintiff shareholder against the officers and directors of the corporation does not give rise to a conflict between that plaintiff shareholder and the corporation. Viewed from another angle, the interests of the plaintiff shareholder and the corporation are considered aligned, and the shareholder only benefits through the corporation. As such, the primary mechanism for eliminating a conflict between the plaintiff and the corporation, despite the fact that the officers and directors of the corporation are being sued, is the straightforward requirement that the plaintiff be a shareholder.

Corporations Code Section 800(b)(1) sets the prerequisites for bringing a shareholder derivative action under California law.[15] A derivative plaintiff will qualify to initiate an action on a corporation's behalf if 1) the plaintiff is a shareholder of record, holder of a beneficial interest, or holder of a voting trust certificate, 2) the plaintiff was a shareholder when the wrong to the corporation that gave rise to the action took place (the contemporaneous-ownership rule), and 3) the plaintiff made a reasonable effort to inform the corporate directors about the action and induce them to commence suit against the responsible parties, unless such efforts would have been "useless" or "futile." Section 800(b)(1) also provides that the court has discretion to waive the contemporaneous ownership requirement if it finds that there is no one else to enforce the claim on the corporation's behalf and that defendants would otherwise retain the benefits derived from their willful breach of fiduciary duty unless the action is permitted to proceed.[16]

One federal court has permitted shareholders to act as plaintiffs in a derivative action despite positions adverse to the defendant directors in an earlier relationship. In *Tyco Laboratories, Inc. v. Kimball,*[17] the plaintiffs who brought the derivative action owned a substantial interest in the corporation and may previously have been in a position adversarial to the defendant directors regarding control of the corporation. But the court found that this did not disqualify the plaintiffs from representing the corporation's shareholders in a derivative action, because the plaintiffs were pursing common interest with the corporation by seeking redress for alleged breaches of fiduciary duties and other violations of state and federal laws on the corporation's behalf, and because any recovery would inure to the corporation's benefit and not to the plaintiffs in their individual capacities.[18]

Indeed, the conflict between the plaintiff shareholder and those charged with corporate governance generally emerges on a more practical level—over the scope and logistics of shareholder inspection rights. Perhaps the greatest need of the shareholder bringing the derivative suit is to inspect corporate records. Naturally, defendant officers and directors would prefer to minimize plaintiff shareholder access to information. This conflict appears to be resolved firmly in favor of the plaintiff shareholder.

Specifically, California law grants the right of inspection to shareholders unconditionally. The critical components of the right are statutory and are codified in Corporations Code Section 1601.[19] Subsection (a) provides, "The accounting books and records and minutes of proceedings of the shareholders and the board and committees of the board of any domestic corporation, and of any foreign corporation keeping any such records in this state or having its principal executive office is this state, shall be open to inspection upon the written demand of the corporation of any shareholder."[20] The statute goes on to grant the right of inspection "for a purpose reasonably related to such holder's interest as a shareholder."[21] Section 1601(b) provides that an attorney for the shareholder may be present during the inspection, and that "the right of inspection includes the right to copy and make extracts."[22]

Court interpretations of this section have affirmed the rights of shareholder inspection. Regarding the quality of the records made available for inspection, Section 1601 generally guarantees that the records provided be adequate and correct.[23] At least one court has held that an inspector's inability to make sense of the ledgers or financial statements due to the lack of any specifics in information was a failure to provide any meaningful inspection under Section 1602.[24]

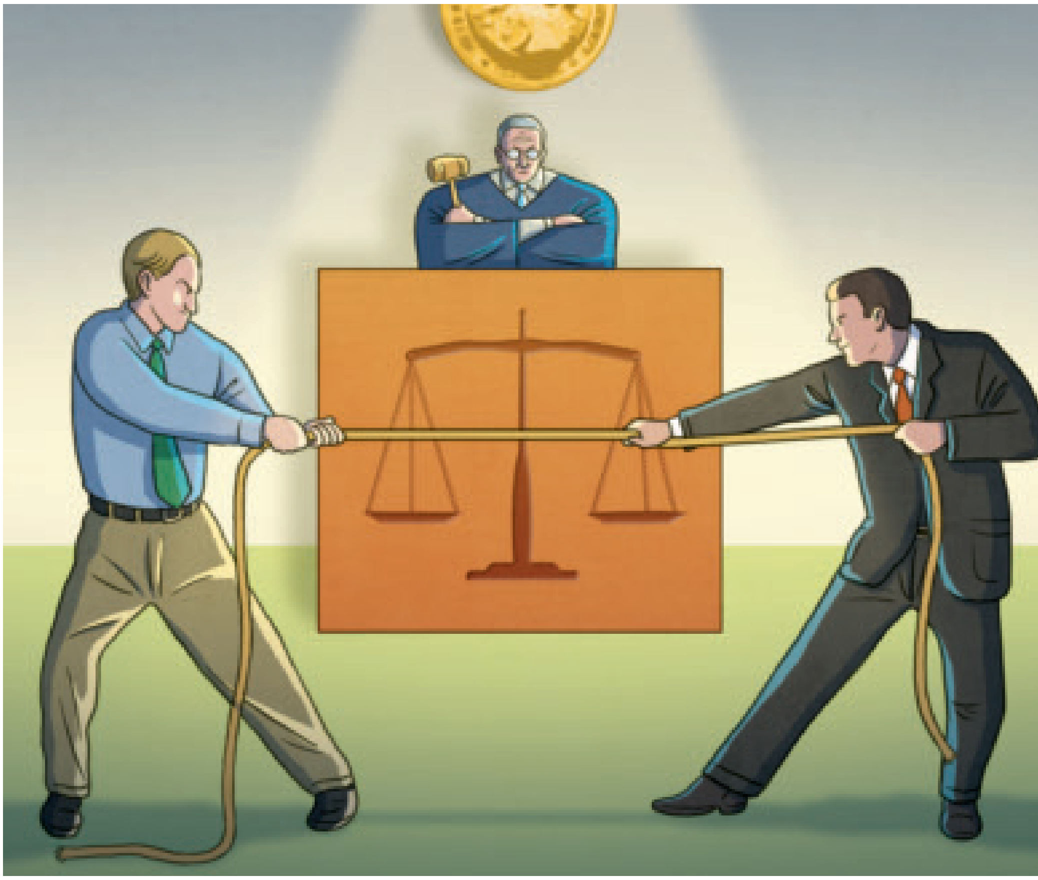
Courts have also held that a "reasonable" purpose for an examination includes investigating the disparity in value between the published report and market value of outstanding shares,[25] determining if the outstanding shares are held by an oligopoly of a shareholders who dictate the accounting policies,[26] and examining corporate assets to determine if they have been used in self-dealing.[27] Based upon these holdings, other reasonable interests would appear to include prosecuting a shareholder derivative complaint for the benefit of a nominal defendant corporation and its shareholders in order to recover monies converted by officers or directors, ascertaining whether assets are grossly undervalued, ascertaining whether transactions are tainted by director conflicts of interest, determining the fair value of the assets when interested directors fail to obtain a fairness opinion in violation of Corporations Code Section 1203(a), and remedying other breaches of fiduciary duties by officers or directors.[28]

Courts have also held that shareholder inspection of foreign corporations is governed under California law regardless of where the company is incorporated. In *Valtz v. Penta Investment Corporation,*[29] a 5 percent shareholder in a Delaware corporation invoked his absolute right to inspect under California law. The corporation argued that because of its place of incorporation, the more limited Delaware law, which allows inspection only for a proper, investment-related purpose, should be applied. The court found, however, that by locating a principal executive office in California and keeping its books and records here, a corporation brings disputes regarding inspection of the records into California courts and renders California public policy applicable. The court reasoned that full faith and credit need not be given under the laws of another state when doing so would violate California public policy. Moreover, the court in *Valtz* held that California places no proper-purpose restriction on a shareholder's right of inspection, and that the California courts must enforce that policy despite the fact that the corporation was incorporated in Delaware.[30]

These rules also apply to a "nominally foreign corporation." Pursuant to the Corporations Code, a "nominally foreign corporation" is any foreign corporation doing intrastate business in California if, during the previous year, 1) the average of what is termed the "property factor," the "payroll factor," and the "sales factor" within California is more than 50 percent, and 2) more than half of its voting securities are held by persons with California addresses as shown by the corporation's books.[31] In short, California law applies if the corporation conducts more than 50 percent of its business in California, and if California residents own most of the stock. At least one California court has relied upon the U.S. Supreme Court to interpret this statute. In *Wilson v. Louisiana-Pacific Resources,*[32] the Third Appellate Department wrote, "Every state is entitled to enforce in its own court its own statutes, lawfully enacted. One who challenges that right, because of the force given to a conflicting statute of another state by the full faith and credit clause, assumes the burden of showing, upon some rational basis, that of the conflicting interests involved those of the foreign state are superior to those of the forum."[33]

The Corporations Code does not specify the number of past years for which records must be made available.[34] However, Section 17058 requires limited liability companies (LLCs) to maintain all tax returns and financial statements of the past six years, and books and records related to internal affairs of the LLC for at least the past four years.[35]

Finally, if a corporation refuses to honor the lawful demand of a shareholder to inspect the records, and if good cause can be shown, Section 1603 vests courts with the authority to appoint an independent inspector or accountant "to audit the books and records kept in this state and investigate the property, funds and affairs of any domestic corporation or any foreign corporation keeping records in this state."[36] When appointed, inspectors have much broader rights than shareholders, as they are able to inspect all books and records of a company, without limitation to the time and types of records. While the shareholder typically pays the costs of the court-ordered inspection, courts do additionally have the power to appoint costs of the audit against the corporation by writ of execution.[37]



Conflicts between the Plaintiff and Remaining Shareholders

In order to avoid conflicts between the plaintiff shareholder and other shareholders, the federal counterpart to Corporations Code Section 800 provides an additional requirement—that a "derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association."[38] This suggests that there can be disqualifying conflicts between a plaintiff shareholder and other shareholders. While California's Section 800(b)[39] contains no such requirement, given the nature of a shareholder derivative suit, a conflict arguably arises between a plaintiff shareholder in a derivative action and the other shareholders when the plaintiff shareholder simultaneously brings a direct claim against a corporation.

Even in this context, however, California courts have held that a shareholder may maintain separate direct and derivative actions and that nothing in California state law prohibits a shareholder from initiating a derivative lawsuit if he or she also happens to be wronged in an individual capacity.[40] Moreover, in the case of closely held corporations with a small number of shareholders, the distinction between direct and derivative actions may blur if the acts of one or a few officer/shareholders directly affects both the corporation and the other shareholders. The fact that shareholders may also have other individual claims does not preclude them from bringing a derivative action.[41]

By contrast, at least under federal law, cases of clear conflict between a direct and a derivative action brought by the same shareholder can be problematic. For example, in *Zarowitz v. Bank America Corporation*,[42] the plaintiff, a former bank employee, was fired after the bank attributed substantial investment losses to decisions made by the plaintiff and other employees. Two sets of litigation ensued: The bank sought damages against the plaintiff and other former employees for its losses, and the plaintiff sued individually for wrongful termination and defamation. Meanwhile, a series of four class actions and a dozen derivative actions were filed against the bank's officers and directors. With the single exception of this plaintiff, all the other plaintiffs reached a comprehensive settlement agreement with the bank's insurers. The plaintiff attempted to block two of the settlements, however, because he thought they would have an adverse effect on his damage action for wrongful termination. Under these facts, the court agreed that the plaintiff had a conflict of interest with the other shareholders and thus had no standing to object to the settlement of the derivative action.[43]

Conflicts in Legal Representation

While the typical shareholder derivative action is brought against the officers and directors of a corporation, it also names the corporation as a defendant. As such, the question arises as to whether an attorney can simultaneously represent the officers and directors on one hand and the corporation on the other. If the case involves allegations of wrongdoing against the officers or directors, the answer is an emphatic no. Indeed, both general principles of legal ethics and established California precedent appear to require per se disqualification if a lawyer attempts to represent both the company and its individual officers and directors in a derivative action.

Every relevant codification of rules of legal ethics—the Model Rules of Professional Responsibility, the Model Code of Professional Responsibility, and the California Rules of Professional Conduct—prohibit the simultaneous representation of conflicting interests or concurrent adverse representation.[44] In applying this prohibition to shareholder derivative actions alleging misconduct by corporate officers or directors, a leading treatise on corporations states, "Dual representation of the corporation and individual defendants in a derivative proceeding which asserts a claim of serious wrongdoing by those in control of the corporation is considered improper because a potential conflict of interest exists between counsel's duty to the corporate entity and counsel's relationship with the individual defendants."[45] The treatise advises that the corporation retain independent counsel whenever the corporation decides to take an active role in the litigation. He concludes that, except in patently frivolous cases, allegations of fraud, intentional misconduct, or self-dealing by officers or directors require separate counsel.[46] Other commentators have been arriving at similar conclusions for decades, with one stating that the possibility for conflicts of interest in shareholder derivative actions is "universally recognized."[47]

In California, Rule 3-310 of the Rules of Professional Conduct expressly prohibits conflicts of interest.[48] Section 3-310(C) provides that a lawyer shall not, without the informed written consent of each client, "[a]ccept representation of more than one client in a matter in which the interests of the clients potentially conflict, or "[a]ccept or continue representation of more than one client in a matter in which the interest of the clients actually conflict."[49]

The seminal California case addressing Rule 3-310(C) in a shareholder derivative action is *Forrest v. Baeza.*[50] In *Forrest,* a lawyer was simultaneously representing both several corporations and their corporate directors who were accused of embezzling from, and subjecting the corporations to, penalties for tax fraud. The court reasoned that, in such suits, the corporation, while nominally a defendant, is actually a plaintiff; if the allegations are proved, the corporation stands to benefit from recovery for the wrongful actions of the directors.

The court then reviewed California precedent and held, "Current case law clearly forbids dual representation of a corporation and directors in a shareholder derivative suit, at least where the directors are alleged to have committed fraud."[51] The *Forrest* court concluded, "In all but a few instances, the rule of disqualification in simultaneous representation cases is a *per se* or 'automatic' one."[52] Many subsequent cases have cited *Forrest.* For example, in *La Jolla Cove Motel and Hotel Apartments, Inc. v. Superior Court*, the court wrote that "where a shareholder has filed an action questioning its management or the actions of individual officers or directors, such as in a shareholder derivative action, corporate counsel cannot represent both the corporation and the officers, directors or shareholders with which the corporation has a conflict of interest."[53]

Moreover, the conflict of interest cannot be covered by the traditional means of written consent or partial withdrawal, because the exception cannot be applied when there is no disinterested party that can provide the consent. That is precisely the situation in most shareholder derivative actions, because, typically, all the directors and officers of the corporation are named as individual defendants.

Indeed, Rule 3-600(E) specifically recognizes this eventuality.[54] It allows a lawyer to represent a company and its officers and directors subject to the requirement of informed, written consent found in Rule 3-310(C) but goes on to state unequivocally, "If the organization's consent to the dual representation is required by rule 3-310, the consent shall be given by an appropriate constituent of the organization other than the individual or constituent who is to be represented, or by the shareholder(s) or organization members."[55] In other words, the officers and directors named as individual defendants cannot give valid consent on behalf of the corporation for their own lawyer to represent the corporation.[56]

The court of appeal in *Forrest* also addressed this issue and held that the officers and directors could not give valid consent to have counsel represent both them and the company in a derivative action. The court described reliance on consent as "ill founded" in the context of derivative litigation. The court reasoned, "This consent rationale seems peculiarly inapplicable in a derivative suit, because the corporation must consent through its directors, who are the individual defendants."[57] The court concluded that "it would be meaningless in derivative litigation to allow the consent of the parties defendant to exculpate the practice of dual representation, for most often it would be the defendant directors and officers who would force the corporation's consent."[58]

Nor does partial withdrawal seem to be a viable strategy. It is well established that a law firm may not play "hot potato" with its clients to avoid disqualification for concurrent adverse representation. In *Truck Insurance Exchange v. Fireman's Fund Insurance Company,*[59] a law firm was counsel of record for the plaintiff, Truck Insurance Exchange, while at the same time representing the defendant, Fireman's Fund Insurance Company, in another, unrelated action. The law firm sought to avoid disqualification in the case involving Truck Insurance by withdrawing as counsel in the unrelated case involving the defendant. The court held that a law firm could not avoid disqualification by withdrawing from the representation of the less favored client before a hearing on a motion for disqualification.

In reaching this decision, the court cited a series of cases for the proposition that an attorney who is simultaneously representing one client against the interest of another client should not be able to avoid the rule of per se disqualification by simply dropping one of the clients when a disqualification motion is filed. The court stated that it saw no reason to depart from the "well-established principle requiring automatic disqualification" when a law firm seeks to avoid disqualification simply by dropping one client like a hot potato. If this were not the case, the court noted, a law firm could always convert a present client into a former client when faced with disqualification.[60] The same policies and rationale would appear applicable in shareholder derivative cases and operate to prevent a lawyer from curing this conflict by simply withdrawing as counsel for the corporation.

The very nature of the shareholder derivative action engenders conflict between the shareholders and the corporation, among shareholders, and for the attorneys involved. Some of these conflicts are proving intractable. Future courts will likely be called upon in the continuing effort to reach ultimate resolutions. ■

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[1] Zurich American Insurance Company, Recent Developments in Shareholder Derivative Suits 2 (Advisen MSC Ad., 2009).
[2] Counseling California Corporations §3A.17, at 474.18 (CEB 3d ed. 2011).
[3] Corp. Code §309.
[4] Corp. Code §309(a); Lebman v. Superior Court, 145 Cal. App. 4th 109, 121 (2006).
[5] 1 Cal. Practice Guide: Corporations 91 6:252 (Rutter 2010).
[6] Burt v. Irving Co., 237 Cal. App. 2d 828, 853 (1965).
[7] Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1263 (1989).
[8] Bancroft-Whitney Co. v. Glen, 64 Cal. 2d 327, 345 (1966).
[9] 1 Ballentine & Sterling, California Corporation Law §102.02 (4th ed. 2010).
[10] GAB Business Servs., Inc. v. Lindsey & Newsom Claim Servs., Inc., 83 Cal. App. 4th 409, 420-21 (2000), *disapproved on other grounds*, Reeves v. Honlon, 33 Cal. 4th 1140, 1154 (2004).
[11] 1 Cal. Practice Guide: Corporations, *supra* note 5, ¶6:421.
[12] Industrial Indem. Co. v. Golden State Co., 117 Cal. App. 2d 519, 533 (1953).
[13] Kelegion v. Mgrdichian, 33 Cal. App. 4th 982, 988 (1955).
[14] Klinicki v. Lundgren, 695 P. 2d 906, 920 (Or. 1985).
[15] Corp. Code §800(b)(1).
[16] *Id.*
[17] Tyco Labs., Inc. v. Kimball, 444 F. Supp. 292 (E.D. Pa. 1977).
[18] *Id.* at 299.
[19] Corp. Code §1601.
[20] Corp. Code §1601(a).
[21] *Id.*
[22] Corp. Code §1601(b).
[23] Corp. Code §1601.
[24] Schnabel v. Superior Court, 5 Cal. 4th 704 (1993).
[25] Homestake Mining Co. v. Superior Court, 11 Cal. App. 2d 488 (1936).
[26] *Id.*
[27] Capron v. Pacific Sw. Discount Corp., 6 Cal. App. 2d 436 (1935).
[28] *Id.*; Homestake Mining Co., 11 Cal. App. 2d 488; Corp. Code §§1600 *et seq.*
[29] Valtz v. Penta Inv. Corp., 139 Cal. App. 3d 803 (1983).
[30] *Id.* at 808.
[31] Corp. Code §2115.
[32] Wilson v. Louisiana-Pacific Res., 138 Cal. App. 3d 216 (1982).
[33] *Id.* at 222 (quoting Alaska Packers Assoc. v. Industrial Accident Comm'n, 294 U.S. 532 (1935) (holding that California laws that mandate cumulative voting are not preempted by Utah laws that only provide for straight voting unless otherwise stated)).
[34] Corp. Code §§1500 *et seq.*; Corp. Code §§1600 *et seq.*
[35] Corp. Code §17058.
[36] Corp. Code §1603.
[37] Koshaba v. Koshaba, 56 Cal. App. 2d 302 (1942).
[38] Fed. R. Civ. P. 23.1.
[39] Corp. Code §800(b).
[40] Denevi v. LGCC, 121 Cal. App. 4th 1211, 1221-22 (2004).
[41] Jara v. Suprema Meats, Inc., 121 Cal. App. 4th 1238, 1253-60 (2004).
[42] Zarowitz v. BankAmerica Corp., 866 F. 2d 1164 (9th Cir. 1989).
[43] *Id.* at 1166.
[44] Model Rules of Prof'l Conduct R. 1.7; Model Code of Prof'l Responsibility DR 5-105.
[45] 13 Fletcher, Cycopedia of Corporations §6025.
[46] *Id.*
[47] *See Developments in the Law–Conflicts of Interest in the Legal Profession*, 94 Harv. L. Rev. 1244, 1339-40 (1981). *See also* 1 Witkin, Cal. Proc. 4th, Attorneys, §13, at 182 (1997) (noting that "the later cases tend to bar dual representation in all derivative actions").
[48] Cal. Rules of Prof'l Conduct R. 3-310.
[49] Cal. Rules of Prof'l Conduct R. 3-310(C).
[50] Forrest v. Baeza, 58 Cal. App. 4th 65 (1997).
[51] *Id.* at 74.
[52] *Id.*
[53] *See*, *e.g.*, La Jolla Cove Motel and Hotel Apartments, Inc. v. Superior Court, 121 Cal. App. 4th 773, 785-86 (2004) (citing Friedman, Cal. Practice Guide: Corporations ¶6:612).
[54] Cal. Rules of Prof'l Conduct R. 3-600(E).
[55] *Id.*
[56] *See, e.g.,* Pringle v. La Chapelle, 73 Cal. App. 4th 1000, 1006 (1999).
[57] Forrest v. Baeza, 58 Cal. App. 4th 65, 76 (1997).
[58] *Id.* (quoting Comment, *Independent Representation for Corporate Defendants in Derivative Suits*, 74 Yale L.J. 524, 528 (1965)). *See also Developments in the Law*, *supra* note 47, at 1341.
[59] Truck Ins. Exch. v. Fireman's Fund Ins. Co., 6 Cal. App. 4th 1050 (1992).
[60] *Id.* at 1054-58.