

A derivative suit has just been filed against the company, its directors, and some officers. You were not involved in the underlying merger transaction, so no advice-of-counsel issues would be implicated by your representation of both the company and the individual defendants.¹ But the CEO says “Don’t turn this into the lawyer’s full employment act!” You get the picture. But can one law firm represent everybody? What are the risks?

Shareholder Derivative Lawsuits: Can You Ever Have Too Many Lawyers?

BY JOHN K. VILLA

Although representing both the corporation and individual directors and officers in shareholder derivative suits presents risk, it is permissible in some cases. We need to recognize first that because a derivative action is brought on behalf of the corporation, a nominal defendant, against the lawyers’ other clients—corporate directors and/or officers—there is always a potential conflict between the interests of the corporation and the interests of the individual defendants.² That risk increases if counsel learns of a confidential fact that raises serious questions as to the greater responsibility or liability of one or more of the defendant officers and directors, who were initially thought to be blameless, or the allegations involve serious misconduct, or the case survives a motion to dismiss.

In short, one rule does not fit all, and some courts have found that dual representation is permissible in certain circumstances.³ Before looking at these circumstances, let’s first examine the governing ethical rules.

Ethical Rules

Model Rule 1.13, which governs a lawyer’s relationship with an organizational client, generally permits the dual representation of the corporate client and one or more of its officers and directors,⁴ even in shareholder derivative actions. The pertinent commentary to this rule provides:

The question can arise whether counsel for the organization may defend [a derivative] action. The proposition that the organization is the lawyer’s client does not alone resolve the issue. Most derivative actions are a normal incident of an organization’s affairs, to be defended by the organization’s lawyer like any other suit.⁵

This rule, however, is subject to the conflict of interest provisions of Model Rule 1.7,⁶ when the derivative claim “involves serious charges of wrongdoing by those in control of the organization.”⁷ There, it is recognized, a conflict may exist “between the lawyer’s duty to the organization

and the lawyer’s relationship with the board,” thereby requiring the application of Model Rule 1.7 to determine who should represent the directors and the organization.⁸

As amended in 2002,⁹ Model Rule 1.7 applies when a lawyer is representing a client if the representation involves a concurrent conflict of interest—that is, if the representation of one client will be directly adverse to another client, or if there is a significant risk that that representation will be materially limited by the lawyer’s responsibility to another client.¹⁰

Despite the existence of a concurrent conflict of interest, representation may be permissible where:

- the lawyer reasonably believes that she will be able to provide competent and diligent representation;
- each affected client gives informed consent, confirmed in writing;
- the representation is not prohibited by law; and
- the representation does not involve the assertion of a claim by one client directly against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.¹¹

Prior to its amendment in 2002, Rule 1.7 similarly prohibited representations that were directly adverse to another client or that would materially be limited by the lawyer’s responsibility to another client.¹² The rule permitted such a representation, however, only upon a showing that: (1) the lawyer reasonably believed that the representation would not adversely affect the other representation; and (2) the client consented to the representation after consultation.¹³ Thus the last two limitations—“not prohibited by law” and the “assertion of a claim by one client directly against another client ... in the same litigation”—have



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been added. Some jurisdictions still adhere to the pre-2002 version of the rule.¹⁴ The reviser's explanation of the 2002 changes observes that no change in substance was intended, but only a clarification of the text "[to] better educate lawyers regarding the complex subject of conflict of interest."¹⁵

Under either version of the rule, therefore, dual representation in a derivative action is theoretically permissible—as long as each client gives the requisite consent. Since the consent must be obtained from the directors, some of whom may be defendants in the action with interests that could be adverse to the corporate defendant, the efficacy of the consent may be an issue. The company must identify a conflict-free corporate consent-giver—i.e., “other than the individual who is represented.” Model Rule 1.13(g).¹⁶

Case Law

Admittedly, most courts and commentators frown upon a lawyer's dual representation of the corporate entity and the individual corporate defendants in shareholder derivative litigation.¹⁷ Some ethics commissions even appear to espouse a *per se* rule against dual representation due to the “inherent” conflict.¹⁸ The jurisprudence, however, balances several factors in determining whether dual representation is permissible in a given case.

Many courts focus upon the nature of the allegations asserted by the shareholders against the individual defendants: Where the allegations are based on disagreements over business judgments, dual representation is ordinarily permitted, but where the suit is based on allegations of fraud or self-dealing, separate representation is usually required. An excellent illustration is *Bell Atlantic v. Bolger*,¹⁹ where the Third Circuit held that the trial court did not abuse its discretion in allowing the same lawyer to represent both the corporation and the defendant direc-

tors where the complaint only asserted a breach of the duty of care.²⁰ Relying on the commentary to Rule 1.13, which suggests that no conflict exists in the absence of serious charges of wrongdoing,²¹ the court stated:

*We believe serious charges of wrongdoing have not been leveled against the individual defendants. We say this because plaintiffs have alleged only mismanagement, a breach of the fiduciary duty of care. . . . But we do not understand plaintiffs to have accused defendants of breaching their duty of loyalty which requires a director to act in good faith and in the honest belief that the action taken is in the corporation's best interests. . . . There are no allegations of self-dealing, stealing, fraud, intentional misconduct, conflicts of interest, or usurpation of corporate opportunities by defendant directors.*²²

The court cautioned, however, that where a complaint alleges serious wrongdoing, such as fraud, intentional misconduct, or self-dealing, separate counsel would be required, unless the allegations are patently frivolous.²³

Most courts follow *Bell Atlantic's* distinction between allegations of serious and non-serious wrongdoing as the primary factor in determining the propriety of dual representation.²⁴ Some courts weigh additional factors, such as whether there was a good faith investigation into the shareholders' demands,²⁵ or whether the corporation intends to take an active role in the litigation.²⁶ Thus, whether dual representation will be permissible in a particular action ultimately involves a “highly fact-specific” inquiry.²⁷

Returning to the beginning hypothetical, counsel may have no apparent conflict in representing both the corporation and the individual defendants, if the wrongdoing alleged by the share-

holders is not serious in nature and it is unlikely that the corporation will actively participate in the litigation. Because the risk always exists for a conflict to appear as the case develops, it may be prudent to avoid this risk (and the consequences of any subsequently-filed motion to disqualify) by opting out of the dual representation at the outset or, as some jurisdictions permit, when a decision on the merits is reached on a motion to dismiss the derivative complaint.²⁸

So what to tell the CEO?

If the allegations only involve breach of duty of care, we can probably get by with one law firm providing:

- The motion to dismiss has not been denied;
- There is no clear evidence of liability of any individual to the company (i.e. liability is arguable); and
- The conflict is explained to and consented to by all defendants keeping in mind that the person giving consent for the company should not be a defendant herself. ❏

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NOTES

- 1 See generally J. Villa, *Corporate Counsel Guidelines* § 3:10 (ACC & Thomson/West 2005).
- 2 See *Ass'n of the Bar of New York Comm. on Ethics, Op. No. 842* (Jan. 4, 1960), 15 Record N.Y.C.B.A. 80 (1960) (noting that a conflict of interest is “inherent” in any derivative action in which relief is sought on behalf of a corporation against individual director-officer defendants).
- 3 See *Scott v. New Drug Servs., Inc.*, No. 11336, 1990 WL 135932, at *4 (Del. Ch. Sept. 6, 1990) (“While, in theory, separate representation may be the better practice . . . I am not persuaded that separate representation is mandated in all situations.”).
- 4 See *ABA Model Rules of Professional Conduct*, Rule 1.13(g) (2007) (“A lawyer representing an organization may also represent any of its directors, officers, employees, members, sharehold-

- ers, or other constituents, subject to the provisions of Rule 1.7.”).
- 5 *Id.*, Rule 1.13, cmt. 14.
 - 6 *See id.*, Rule 1.13(g), at n. 4, *supra*.
 - 7 *Id.*, Rule 1.13, cmt. 14; *see Bell Atlantic Corp. v. Bolger*, 2 F.3d 1304, 1316 (3d Cir. 1995) (finding that allegations in derivative complaint contained no serious charges of wrongdoing so as to preclude joint representation of corporation and defendant directors).
 - 8 *Id.*
 - 9 *See* ABA Ethics 2000 Commission, *Report on the Model Rules of Professional Conduct* (2002), available at www.abanet.org/cpr/e2k/e2k-report_home.html.
 - 10 *ABA Model Rules of Professional Conduct*, Rule 1.7(a) (2007).
 - 11 *Id.*, Rule 1.7(b).
 - 12 *See id.*, Rule 1.7 (2001).
 - 13 *Id.*
 - 14 *See* ABA Center for Professional Responsibility, *Charts Comparing Professional Conduct Rules As Adopted by States to ABA Model Rules*, available at www.abanet.org/cpr/jclr/charts.html.
 - 15 ABA Ethics 2000 Commission, *Rule 1.7: Reporter's Explanation Memo*, available at www.abanet.org/cpr/e2k/e2k-rule17rem.html.
 - 16 *See In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1189 (N.D. Cal. 1995) (noting that “[i]t is . . . clear that an inanimate corporate entity, which is run by directors who are themselves defendants in the derivative litigation, cannot effectively waive a conflict of interest as might an individual under applicable professional rules[.]”); *Cannon v. U.S. Acoustics Corp.*, 398 F. Supp. 209, 216 at n. 10 (N.D. Ill. 1975) (“This consent rationale seems peculiarly inapplicable to a derivative suit, because the corporation must consent through the directors, who, as in the present case, are the individual defendants”), *judgment aff'd in pertinent part*, 532 F.2d 1118 (7th Cir. 1976).
 - 17 *See Cannon*, 398 F. Supp. at 217 (noting that “the more recent trend is to require the corporation to obtain independent counsel” in derivative actions); *see also Restatement (Third) of the Law Governing Lawyers*, § 131, cmt. g (2000) (stating that in derivative actions, a lawyer for an organization ordinarily may not also represent the individual officers and directors, even with informed consent).
 - 18 *See* n. 2, *supra*.
 - 19 2 F.3d 1304 (3d Cir. 1993).
 - 20 *Id.* at 1316.
 - 21 *See* n. 7, *supra*.
 - 22 *Bell Atlantic*, 2 F.3d at 1316 (emphasis in original; citations omitted).
 - 23 *Id.* at 1317.
 - 24 *See Musheno v. Gensemer*, 897 F. Supp. 835 (M.D. Pa. 1995) (holding that counsel could not represent both the corporation and the defendant directors where derivative complaint alleged fraud and self-dealing); *Cannon*, 398 F.Supp. at 219 (disqualifying counsel representing both the corporation and the defendant directors where complaint alleged that the directors misappropriated corporate funds); *Campellone v. Cragan*, 910 So. 2d 363, 365 (Fla. App. 5th Dist. 2005) (disqualifying counsel from representing both the entity and majority shareholder in derivative action by minority shareholder alleging embezzlement, misappropriation of corporate assets, and breach of fiduciary duty on the part of the majority shareholder); *Forrest v. Baeza*, 58 Cal. App. 4th 65, 67 Cal. Rptr. 2d 857, 863 (1997) (allegations of embezzlement by defendant directors presented unwaivable conflict of interest precluding dual representation of directors and closely-held corporation); *see also Selama-Dindings Plantations, Ltd. v. Durham*, 216 F. Supp. 104, 115 (S.D. Ohio 1963), *aff'd sub nom. Selama-Dindings Plantations, Ltd. v. Cincinnati Union Stock Yard*, 337 F.2d 949 (6th Cir. 1964) (where there is no conflict of interest and no breach of confidence or trust, a law firm may represent both the corporate defendant and the individual directors in a shareholder derivative suit).
 - 25 *See Bell Atlantic*, 2 F.3d at 1316 (noting that although not dispositive and only significant in the absence of allegations of fraud, intentional misconduct, or self-dealing, the directors’ good faith investigation into the shareholders’ demands “suggests a relative (though not complete) convergence of individual and corporate interests in defending and settling the litigation.”); *accord. Musheno*, 897 F. Supp. at (relying on *Bell Atlantic* in holding that separate counsel was required: even though independent investigation into plaintiffs’ demands determined that corporation should not pursue legal action, complaint alleged fraud and self-dealing and, therefore, precluded dual representation); *see also Restatement (Third) of the Law Governing Lawyers*, *supra*, n. 18 (“If . . . the disinterested directors conclude that no basis exists for the claim that the defending officers and directors have acted against the interests of the organization, the lawyer may, with the effective consent of all clients, represent both the organization and the officers and directors in defending the suit.”).
 - 26 *Compare Messing v. FDI, Inc.*, 439 F. Supp. 776, 781 (D. N.J. 1977) (“[B]ecause in the instant case the directors have been accused of fraud and the corporation has elected to take an active stance in the litigation, it is enough for now to decide that, under these combined circumstances, the corporation must retain independent counsel.”), *with Scott*, 1990 WL 135932, at *4 (denying motion to disqualify defendants’ counsel where it did not appear that the corporation would be required or that it would be in its interest to take an active role in this litigation).
 - 27 *Scott*, 1990 WL 135932, at *4.
 - 28 *See Scattered Corp. v. Chicago Stock Exchange, Inc.*, 1997 WL 187316, at *6 (Del. Ch. 1997) (under Delaware practice, there is no conflict in having one firm represent both the corporation and individual defendants through the motion to dismiss stage of a derivative action); *see also Clark v. Lomas & Nettleton Fin. Corp.*, 79 F.R.D. 658, 661 (N.D. Tex. 1978) (there is no conflict of interest requiring disqualification when firm represents a derivatively sued corporation and its individually sued directors and files a motion to dismiss on behalf of its clients, since “[a]t 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, . . . the client’s right to select counsel of his choice outweighs any potential conflict of interest[;] [o]nce that determination is made, or once it becomes necessary for active participation in the defense of the directors, then new counsel must be sought[.]”).