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COMMENTARY

New Support for Joint Representation of Company and Directors in Derivative Litigation

When a shareholder seeks, by derivative litigation, to hold a corporation's officers or directors liable to the company, one of the first questions that arises for company counsel is whether the company and the individual defendants need separate counsel. A recent opinion from the Northern District of California confirms that, at least at the outset, the company and the individual defendants may be jointly represented. The decision in *Voss v. Sutardja*[1] shines a welcome ray of light into an otherwise murky area and provides useful guidance to company counsel.

At first blush, the answer to the question might seem straightforward. Since the complaint seeks to have the company serve as a plaintiff and recover damages from the individuals, the interests of the company and the individuals seem unalterably opposed. Many reported decisions reflexively suggest that separate representation is required. In one notable case, a federal district court, citing "a substantial body of authority proscribing dual representation of corporate and individual defendants in a derivative action," refused to approve the settlement of a derivative case—even though plaintiffs' and defendants' counsel both supported it—because the company was not represented by counsel independent of the attorneys for the individual defendants.[2] In a leading case in California, the court upheld the disqualification of an attorney from representing a closely held corporation in derivative litigation in which the attorney was also representing the directors, who had been accused of embezzlement.[3] The court expressed the view that this result was required in cases where directors were accused of fraud, and it also held that the conflict of interest could not be waived by the corporation, because the corporation could give consent only through the defendant directors.[4]

The problem with requiring separate representation at all stages of all cases, however, is that it ignores some important practical considerations of derivative litigation. These considerations suggest that, at least at the outset of some cases, the interests of the company and the defendant directors or officers may very well be aligned. If this is so, it ought to be permissible for one attorney to represent both sets of clients jointly.

From the point of view of the company's internal or external counsel, the first step in analyzing the representation issue is to look at the interests of the respective parties. The individual defendants will, of course, be opposed to the litigation and in favor of obtaining a dismissal as promptly as possible. But what about

the company? It turns out that the company may well have entirely defensible reasons to oppose the litigation as well.

By definition, derivative litigation seeks to force a company to do two things that it may not want to do: sue its own officers or directors, and turn the control of that suit over to an attorney over whom the company has no control. A corporation's board normally enjoys the power to decide whether to assert claims on behalf of the company against those, including the company's own officers and directors, who may have harmed the company; the derivative case seeks to wrest this power from the board. Delaware and many other jurisdictions protect this power by requiring that before a shareholder can sue in the company's name, he or she must make a formal demand on the board to initiate the action itself. Presentation of the demand gives the board the opportunity to investigate the alleged claim and to make a decision as to whether or not the company should seek relief on its own, permit the shareholder to pursue the action on behalf of the company, or decline to take action. If the board's decision is later challenged in court, the court will often review the board's action under the relatively deferential "business judgment rule" standard.

A shareholder can circumvent the demand requirement by establishing that demand would be futile because the board is incapable of objectively evaluating whether to sue its own members or company management. To demonstrate "demand futility," the shareholder plaintiff must plead specific facts that tend to demonstrate the inability of a majority of the board to consider the action impartially. Simply alleging that "the board cannot be expected to sue itself" is generally not enough.

The company may have good reason to decide that suing its own officers or directors is not in the company's best interest. The board may conclude that the proposed action is a meritless "strike suit," or perhaps that, even if the claim has some merit, there are sound business reasons why asserting it is would not be advantageous. At a practical level, the company may want to insist on its right to decide for itself whether a suit should be filed. It may also believe that the claim of "demand futility" is not legally sufficient. Under these and other circumstances, the company may decide to fight an allegation of demand futility on purely procedural grounds, arguing that the plaintiff has not met the requirement to plead specific facts. (If a dismissal is granted for the plaintiff's failure to demonstrate demand futility, the plaintiff may still be able to make demand on the board.)

The interests of the company and the director defendants may, therefore, be aligned, at least at the outset of the case. The individuals desire to defeat the claims against them, and the company wishes to oppose the shareholder's attempt to circumvent the board's authority to control purported claims belonging to the company. Under these circumstances, it should be permissible for the same counsel to advocate dismissal on behalf of both sets of parties. The Delaware Chancery Court, recognizing this reality, has approved the practice of permitting one firm to jointly represent the company and the individual defendants at the motion to dismiss stage.[5] California courts, by contrast, have not expressly approved this practice.[6]

Under this analysis, the type of misconduct alleged against the directors should not matter. What matters is that if a shareholder has sought to circumvent the board's authority to institute and control litigation, the corporation should have the ability to argue, by motion to dismiss, that the shareholder's suit is procedurally improper. Thus, it should not be automatically assumed that just because a shareholder is seeking to have the company sue its officers or directors, the company and the individuals need separate counsel from the outset.

The court in *Voss* recognized this reality. The case involves a company that in prior litigation was found to have engaged in willful patent infringement and was ordered to pay more than $1 billion in damages. The plaintiff shareholders alleged that the company's directors and officers had engaged in fraud and had breached their fiduciary duties by permitting the company to engage in the infringement and failing to disclose it in periodic reports. The company and the individual defendants, represented by a single law firm, moved to dismiss the complaint, with the individuals arguing that the plaintiffs had failed to state a cause of action and the company arguing that demand futility had not been sufficiently alleged. Although the plaintiffs did not seek to disqualify defense counsel, they argued that the company's argument in favor of dismissal should not be considered by the court because it was being advanced by conflicted counsel.

The court dismissed the complaint with leave to amend and specifically addressed plaintiffs' argument concerning the role of defense counsel. After reviewing the case law, the court concluded that "at this stage of the litigation … any potential conflict which may exist has no bearing on the Court's conclusion that, as a matter of law, the Plaintiffs' claims must be dismissed." The court also observed that if the case proceeded beyond the motion to dismiss, the company "would be advised to obtain independent counsel in the future."[7]

The *Voss* decision provides support to defendant companies and individuals who conclude, after careful consideration, that joint representation at the outset of derivative litigation is consistent with their respective interests. Counsel embarking on such joint representation must, of course, proceed in a manner consistent with applicable rules of professional conduct.

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Endnotes

1 2015 U.S. Dist. LEXIS 8795 (N.D. Cal., Jan. 16, 2015).

2 *In re Oracle Sec. Litig.,* 829 F. Supp. 1176, 1188 (N.D. Cal. 1993).

3 *Forrest v. Baeza,* 58 Cal. App. 4th 65 (1997).

4 *Id.,* 58 Cal.App. 4th at 76.

5 *Scattered Cos. v. Chi. Stock Exch., Inc.,* 1997 WL 187316, at *6-8 & n. 4 (Del. Ch. Apr. 7, 1997), aff'd on other grounds, 701 A.2d 70 (Del. 1997), overruled on other grounds by *Brehm v. Eisner,* 746 A.2d 244 (Del. 2000) (citing cases); *Respler v. Evans,* 17 F.Supp. 3d 418, 421 (D. Del. 2014).

6 A California case approving joint representation in a different context, *Jacuzzi v. Jacuzzi Bros., Inc.* 243 Cal. App. 2d 1, 36 (1966), was disapproved in *Oracle* (note 2 *supra*) and *Forrest* (note 3 *supra*).

7 *Voss, supra* note 1, at *38.