Disqualification of Corporate Counsel in Derivative Actions: Jacuzzi and the Inadequacy of Dual Representation

S. Kendall Patton
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By S. Kendall Patton*

Placing justifiable limits on dual representation in shareholder derivative suits requires an analysis of the fundamental question of the extent to which a court, in light of the legal ethics of an attorney representing potentially conflicting interests, should interfere with a litigant's right to be represented by counsel of its own choosing. Recent federal cases have disallowed dual representation in derivative actions where only a potential conflict of interest exists between the corporation and its officers or directors who are named as individual defend-

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1. “Dual representation” as used throughout this Note refers to an attorney representing, or attempting to represent, both the defendant corporation and the individual director and/or officer defendants in a shareholder derivative suit.

2. “Attorney” as used throughout this Note refers to both the attorney individually and the law firm with which he or she is associated.


4. “Conflict of interest” is not expressly defined in the American Bar Association Canons of Professional Ethics, but a situation of conflicting interests is described in Canon 6: “A lawyer represents conflicting interests when, in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose.” ABA CANONS OF PROFESSIONAL ETHICS No. 6.

The Canons of Professional Ethics of the American Bar Association were in effect between 1908 and 1969. These original Canons were replaced in 1970 by the American Bar Association Code of Professional Responsibility (CPR). Although they have been superseded, the original Canons still provide ethical maxims and standards of professional conduct which the legal profession should strive to maintain.

The CPR is divided into three separate but interrelated parts: Canons, Ethical Considerations, and Disciplinary Rules.

“The Canons are statements of axiomatic norms, expressing in general terms the standards of professional conduct expected of lawyers in their relationships with the public, with the legal system, and with the legal profession. They embody the general concepts from which the Ethical Considerations and the Disciplinary Rules are derived.

“The Ethical Considerations are aspirational in character and represent the objectives toward which every member of the profession should strive. They constitute a body of principles upon which the lawyer can rely for guidance in many specific situations.

“The Disciplinary Rules, unlike the Ethical Considerations, are mandatory in character. The Disciplinary Rules state the minimum level of conduct below which no lawyer can
California, however, presently allows the same attorney to represent both the corporation and the individual insider defendants prior to an adjudication that a conflict actually exists.  

The problem of dual representation arises from peculiarities in American shareholder derivative suit procedure. In legal effect, a shareholder derivative suit is an action brought by the corporation but conducted by the shareholders. The corporation, although formally aligned as a party defendant, is the real party in interest and the beneficiary of any recovery resulting from successful prosecution of the suit. The shareholder is only a nominal plaintiff. Thus, while on a superficial level no conflict of interest appears when one attorney represents the corporation and its director, both named defendants, an inherent potential conflict is always present, and an actual conflict must exist if the shareholder suit has merit. In such a case the attorney is incapable of fulfilling his or her fiduciary duty of undivided loyalty to either client.

A myriad of problems arise if dual representation is permitted in a derivative action where directors and/or officers are named as defendants. If the shareholder allegations have merit, not only will the attorney be in the untenable position of asserting a cause on behalf of one fall without being subject to disciplinary action.” Preamble and Preliminary Statement to ABA Code of Professional Responsibility.


client that is antagonistic to the interests of the other client, but fair inquiry into the merits of the shareholder claim also may be prevented, distorting the future posture taken by the corporation in litigation or settlement negotiations. Furthermore, dual representation may jeopardize confidences and secrets obtained from each client, and may subject the corporation to great hardship if corporate counsel is forced to withdraw midstream from the litigation due to an actual conflict. Finally, dual representation may easily cause an appearance of impropriety, damaging not only to the attorney but to the legal profession as a whole.

This Note proposes that the federal rule requiring counsel representing both the corporate and individual insider defendants in a derivative action to withdraw as counsel for the corporation in all cases where a potential conflict appears on the face of plaintiff's complaint be adopted in California. In light of this position, the California Court of Appeal decision in Jacuzzi v. Jacuzzi Brothers should be overruled.

11. Weaver v. UMWA, 492 F.2d 580, 584 (D.C. Cir. 1973); Appointment of Independent Counsel, supra note 10. An attorney attempting to represent two clients with conflicting interests in litigation is placed in the untenable position of breaching the fiduciary duty of undivided loyalty to each client and is unable to deal competently with either client's case because of the conflicting interests.


14. If an attorney accepted employment from multiple clients whose interests did become conflicting, he or she would have to withdraw from employment, with the likelihood of resulting hardship to his or her clients. In such a case it is preferable that the attorney refuse the employment initially. ABA Code of Professional Responsibility Ethical Consideration 5-15.

15. See ABA Code of Professional Responsibility Ethical Consideration 9-6. An attorney not only should avoid impropriety but should avoid the appearance of impropriety. Id. (citing State ex rel Nebraska State Bar Ass'n v. Richards, 165 Neb 80, 93, 84 N.W.2d 136,145 (1957); Schlotter v. Railoc of Indiana, Inc., 546 F.2d 706, 709 (7th Cir. 1976) (where the court, construing the combined effect of Canons 4 and 9 of the Code of Professional Responsibility, held that "an attorney may be required to withdraw from a case where there exists even an appearance of a conflict of interest"). See also Comden v. Superior Court, 20 Cal. 3d 906, 576 F.2d 971, 145 Cal. Rptr. 9 (1978) (where the California Supreme Court required the firm of Loeb & Loeb to withdraw from their representation of petitioners Doris Day Comden and Barry Comden where it appeared that an attorney from Loeb & Loeb would be called as a witness for petitioners).

16. 243 Cal. App. 2d 1, 52 Cal. Rptr. 147 (1966). In a 1963 opinion in the same case, Jacuzzi v. Jacuzzi Bros., 218 Cal. App. 2d 24, 32 Cal. Rptr. 188 (1963), the court denied the director defendants' motion to enjoin one of plaintiffs' attorneys from representing the plaintiff shareholders on the ground of breach of confidence where the attorney had previously represented the corporation. The court held that there was no breach of confidence because the attorney had withdrawn from representing the corporation prior to the occurrence of the transactions that were the subject of the lawsuit.
insofar as it permits dual representation when only a potential conflict of interest exists.

In developing this argument, this Note considers federal cases from Otis & Co. v. Pennsylvania Railroad Co.\textsuperscript{17} to Messing v. FDI, Inc.,\textsuperscript{18} analyzing the later cases in relation to the American Bar Association Code of Professional Responsibility (CPR). Analogous cases forbidding dual representation in actions brought under section 501 of the Labor-Management Reporting and Disclosure Act,\textsuperscript{19} permitting union members to assert derivative actions against union officers, also are examined. Against this background, and in light of the Rules of Professional Conduct of the State Bar of California\textsuperscript{20} and cases interpreting those rules,\textsuperscript{21} the error of the Jacuzzi court in permitting dual representation of potentially conflicting interests in shareholder derivative actions will be readily apparent.

The Need for Independent Corporate Counsel

Dual representation has occurred frequently in the past,\textsuperscript{22} partially because directors and officers, who are charged with the responsibility of selecting corporate counsel in spite of the fact that some or all of them may be named as individual defendants, often designate the same counsel to represent themselves and the corporation.\textsuperscript{23} Allowing dual representation creates several practical problems which can impair the corporation's ability to effect a recovery from its directors or officers. The corporation usually is only a nominal party in a derivative action and not permitted to actively defend on the merits.\textsuperscript{24} As a nominal or neutral party, however, the corporation may set up certain procedural defenses which can greatly prejudice the plaintiff shareholders' chances

\textsuperscript{17} 57 F. Supp. 68 (E.D. Pa. 1944), aff'd per curiam, 155 F.2d 522 (3d Cir. 1946).
\textsuperscript{19} 29 U.S.C. § 501(b) (1976) provides, \textit{inter alia}: “When any officer, agent, shop steward, or representative of any labor organization is alleged to have violated the duties declared in subsection (a) of this section and the labor organization or its governing board or officers refuse or fail to sue or recover damages or secure an accounting or other appropriate relief within a reasonable time after being requested to do so by any member of the labor organization, such member may sue such officer, agent, shop steward, or representative in any district court of the United States or in any State court of competent jurisdiction to recover damages or secure an accounting or other appropriate relief for the benefit of the labor organization.”
\textsuperscript{21} See notes 116-20 & accompanying text \textit{infra}.
\textsuperscript{22} \textit{Independent Representation}, supra note 9, at 524.
\textsuperscript{23} \textit{Id.}; \textit{Appointment of Independent Counsel}, supra note 10, at 176.
\textsuperscript{24} H. Henn, \textit{Corporations} § 371 (2d ed. 1970).
of success in the litigation. Dual representation enables the director and officer defendants, acting through counsel shared with the corporation, to raise procedural defenses early in the proceeding which may prevent fair inquiry into the merits of the shareholder claim and possibly defeat a corporate recovery.

In certain limited situations in which the corporation is a real defendant to some issue in the case—for example, where the shareholder complaint prays for the appointment of a receiver, seeks to interfere with a corporate reorganization, or attacks a long-standing corporate policy—the corporation may be allowed to answer and actively defend on the merits. In this instance, the need to ensure the active corporate litigant a full and fair defense to the plaintiffs’ allegations should necessitate the appointment of independent counsel.

The need for independent corporate counsel is also crucial during settlement negotiations. Plaintiff shareholders’ counsel may not press for the largest possible corporate recovery because, past a certain point, increases in the settlement fund recovered by the corporation may not significantly increase the fees awarded shareholders’ counsel. Therefore, the individual defendants, as well as plaintiffs’ counsel, both may desire quick termination of settlement negotiations. If dual representation is permitted in this situation, the interests of the corporation are likely to receive insufficient protection. The interests of the corporation can best be served in such a circumstance by separate corporate counsel exercising independent judgment on behalf of the corporation.

The Trend in Other Jurisdictions

The practical considerations outlined above have been reflected in recent court decisions. Although two federal cases, Otis & Co. v. Pennsylvania Railroad Co. and Selama-Dindings Plantation, Ltd. v. Durham, remain on the books as support for the propriety of dual representation, the distinct trend in the federal courts and in state juris-

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25. Id. The procedural defenses which the corporation may assert include alleging that demand on the directors or shareholders to bring suit was not made, objecting to lack of proper service, claiming that the plaintiff shareholder has not met the contemporaneous ownership requirement, or moving that the plaintiff be required to post security for expenses.


29. Independent Representation, supra note 9, at 532.

30. Id.


dictions outside California has been to disallow dual representation in shareholder derivative suits.

In the *Otis* case, plaintiff alleged in its derivative action that the defendant officers of the Pennsylvania Railroad Company and the Pennsylvania, Ohio & Detroit Railroad Company had breached their fiduciary duty to the corporations by negligently failing to "shop around" for the "best obtainable price" on a new bond issue.\(^{33}\) The Pennsylvania district court concluded that because no fraud had been alleged and because the plaintiff was attacking long-established corporate policy reflecting on the good faith and good will of the corporations,\(^ {34}\) the corporations could file an answer and actively defend on the merits. In denying plaintiff's motion to disqualify counsel from representing both the corporations and the insider defendants, the court stated:

>[T]here is no reason to require removal of counsel as petitioned. The corporation, as an interested party having a right to appear and defend, may select such counsel as it chooses. Moreover, there is no allegation of any breach of confidence or trust of which either the corporations or the individual defendants complain. . . . Moreover, there are many stockholders' suits on record in which the same counsel represented both the individual and corporate defendants.\(^ {35}\)

The second federal case permitting dual representation was *Selama-Dindings Plantation, Ltd. v. Durham*.\(^ {36}\) Plaintiff alleged that the insider defendants had failed to obtain the best possible price on the sale of certain corporate real estate and that defendants had spent corporate funds improperly for the ultimate purpose of keeping themselves in office. The Ohio district court held, without discussion, that it was not improper or illegal for a law firm to represent the corporate defendant and individual director defendants when there was no existing conflict of interest and no breach of confidence or trust.\(^ {37}\) The *Selama* court cited *Otis* and *Marco v. Dulles*\(^ {38}\) as the sole bases for this conclusion. The court's reliance on the *Marco* opinion was inappropriate, however, for at no point in the *Marco* litigation had the same law firm simultaneously represented the individual and corporate defendants. Furthermore, the *Marco* court never stated that the corporation

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\(^{33}\) 57 F. Supp. at 681.

\(^{34}\) *Id.* at 684.

\(^{35}\) *Id.*


\(^{37}\) *Id.* at 115. As pointed out in *Cannon v. U.S. Acoustics Corp.*, 398 F. Supp. 209 (N.D. Ill. 1975), *aff'd in part, rev'd in part*, 532 F.2d 1118 (7th Cir. 1976), while *Selama* stands for the proposition that dual representation is permissible in the absence of actual conflict, the Court of Appeals for the Sixth Circuit did not discuss the dual representation issue in its affirmance, and the district court's opinion has never been cited for such proposition. *Id.* at 218.

and the individual defendants could properly be represented by the same law firm in a derivative suit. Given the weakness of the Selama decision as precedent, Otis stands as the only federal case in the past thirty-five years providing support for the propriety of dual representation in derivative suits.

The trend over the past twenty years in both federal and state courts other than in California has moved away from Otis and has disallowed dual representation where a potential conflict exists between the corporate and individual director and officer defendants. The 1959 opinion of the New York Appellate Division in Garlen v. Green Mansions, Inc. was the forerunner of this trend. In Garlen, the court required that the corporation be represented by independent counsel when it took an active stance and filed an answer. Three years later the Delaware Chancery Court expanded this trend and required that corporate and individual defendants be represented by separate counsel in derivative litigation involving a potential conflict.

The lead taken by the New York and Delaware courts was followed by a New York district court in 1963 in Lewis v. Shaffer Stores Co. Lewis was a derivative action brought by a shareholder of the R.C. Williams Company against the officers, directors, and a majority shareholder of the corporation to recover short swing profits allegedly made by the insider defendants in the purchase and sale of corporate securities, and to recover losses allegedly caused the corporation by certain transactions initiated by the defendants. The same law firm appeared for both the corporate and insider defendants and plaintiff moved to strike the appearance of the law firm as counsel for the corporation.

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42. 218 F. Supp. at 239. See Independent Representation, supra note 9, at 525.
tion of potentially conflicting interests improper. The court ordered the corporation to retain independent counsel having no previous connection with the corporation to advise on the stance the corporation should take in the litigation.

Twelve years later, a strong and well-reasoned indictment of dual representation was delivered in Cannon v. U.S. Acoustics Corp., a 1975 decision by Judge Marshall of the District Court for the Northern District of Illinois. Cannon was a shareholder derivative action brought against four officer-directors and two corporations. Plaintiffs' six count complaint alleged misappropriation of corporate funds and violation of state and federal securities laws. Shortly after the attorneys filed an appearance on behalf of both the corporate and individual defendants, plaintiffs moved to disqualify them from representing the corporate defendants, alleging that the dual representation created a conflict of interest. Plaintiffs requested that the court appoint independent counsel for the corporation.

The Cannon court, in considering "whether the same counsel can represent both the individual and corporate defendants in a derivative shareholders suit consistent with the ethical standards promulgated by the American Bar Association and adopted by this court," stressed that resolution of this issue required an examination of "fundamental questions of legal ethics and the extent to which a court should interfere with the right of any litigant to be represented by counsel of his own choosing." After extensive discussion of relevant case law and the CPR, the court held that the same counsel could not represent both the individual and corporate defendants when a conflict of interest appeared on the face of plaintiffs' complaint, and directed the corporate defendants to select independent counsel to represent their interests.

43. 218 F. Supp. at 240. Although the Lewis court did not rely on the now-superseded Canons of Professional Ethics of the American Bar Association, its disqualification of counsel conformed with old Canons 6 and 37. Those canons provided that an attorney should not represent clients with adverse or conflicting interests, nor compromise confidences of present or former clients.

44. Id.


46. Id.

47. Id.

48. Id. The District Court for the Northern District of Illinois has adopted the CPR as the ethical standard governing the conduct of attorneys practicing before its bar. Northern Dist. of Ill. Gen. R. 8(a) & (d).

Although the court in Cannon v. U.S. Acoustics Corp., 398 F. Supp. 209 (N.D. Ill. 1975), aff'd in part, rev'd in part, 532 F.2d 1118 (7th Cir. 1976), relied on and has adopted the rules of the CPR, these rules, like the original and now superseded Canons of Professional Ethics, have no statutory force. The rules and maxims contained in the CPR and the Canons of Professional Ethics do, however, reflect the attitude of the legal profession as a
Although the CPR, adopted at least in part by every state except California, does not expressly address the problem of the conflict of interest in dual representation, several of the Ethical Considerations (EC) of Canon 5 of the CPR, taken together, do demonstrate the ethical problems involved in dual representation. Canon 5 of the CPR, which concerns representation of multiple clients, provides that a lawyer should exercise independent professional judgment on behalf of a client. EC 5-1 sets the tone of Canon 5 of the CPR: "The professional judgment of a lawyer should be exercised... solely for the benefit of his client and free of compromising influences and loyalties. Neither his personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute his loyalty to his client." Other Ethical Considerations deal more specifically with representation of multiple clients. EC 5-15 provides in part that "[a] lawyer should never represent in litigation multiple clients with differing interests; and there are few situations in which he would be justified in representing in litigation multiple clients with potentially differing interests." EC 5-18 goes one step further: "A lawyer employed or retained by a corporation or similar entity owes his allegiance to the entity and not to a stockholder, director, officer... or other person connected with the entity." As the Cannon opinion points out, although EC 5-18 focuses on the problem of corporate counsel representing corporate officials when the corporation itself is not involved in litigation, it clearly demonstrates that the interests of the corporate client are paramount and must not be compromised by conflicting loyalties to corporate officials. When EC 5-15 and EC 5-18 are read together, they clearly es-


49. Forty-one states had adopted the CPR by the end of 1972. SPECIAL COMMITTEE TO SECURE ADOPTION OF THE CODE OF PROFESSIONAL RESPONSIBILITY, REPORT, in AMERICAN BAR ASSOCIATION, 97 ANNUAL REPORT 268 (1972). Since 1972, eight additional states, but not California, have adopted the CPR as the ethical standard governing lawyers practicing before their bars.

50. ABA CODE OF PROFESSIONAL RESPONSIBILITY Ethical Consideration 5-1.

51. ABA CODE OF PROFESSIONAL RESPONSIBILITY Ethical Consideration 5-15 (emphasis added).

52. ABA CODE OF PROFESSIONAL RESPONSIBILITY Ethical Consideration 5-18 (emphasis added).

establish that the more ethical course in a derivative suit is for the corporate defendant to be represented by independent counsel from the outset.

Although no one CPR Ethical Consideration deals specifically with shareholder derivative actions, the influential Committee on Professional Ethics of the Association of the Bar of New York has addressed the issue directly:

[A] conflict of interests is inherent in any [derivative] action wherever relief is sought on behalf of the corporation against the individual director-officer defendants, and . . . in such cases Canon 6 [of the old American Bar Association Canons of Professional Ethics] precludes one firm from representing both the corporation and the individual director-officer defendants except in unusual circumstances stemming from particular facts in a given case.54

In addition to the above-mentioned cases and the views expressed in the CPR and the New York Bar Committee on Professional Ethics, the rule against dual representation has also been reflected in suits brought under section 501 of the Labor-Management Reporting and Disclosure Act.55 Under section 501, union members may sue the union and its officers for breach of fiduciary duty in a derivative action, with any recovery going to the union.56 The derivative union actions brought under section 501 have uniformly required that independent counsel be appointed for the union when there is a potential conflict of interest between the union and the individual officer defendants.57

As indicated by the above discussion, the federal courts and several state courts have developed a strong policy of forbidding dual representation in derivative actions brought by shareholders against the corporation and its directors. Such a policy is both ethically sound and equitable to all the parties concerned: the attorney will not be put in the unethical position of representing conflicting interests; the corporation, and hence its shareholders, will obtain fair inquiry into the merits of the action at the outset of the suit; unwarranted procedural defenses will not be interposed; and the corporation will be adequately represented in any settlement negotiations. Furthermore, where independent counsel is appointed at the outset of the proceeding, the corporation


cannot be subjected to the hardship of having its counsel forced to withdraw from litigation midstream if an actual conflict materializes.

Continuing Areas of Controversy

Despite the soundness of a general rule that prohibits dual representation in shareholder derivative suits, an examination of federal and state cases shows that certain areas of debate remain. The first of these, whether potential conflict requires disqualification, has been settled in nearly all jurisdictions—potential, no less than adjudicated conflict, demands independent representation for the corporate defendant. Counsel attempting to represent both the corporate and individual defendants will often contend, in good faith, that there is no merit to the plaintiff's complaint and that in the event that an actual conflict materializes they will immediately withdraw from representing the corporation. Invariably, counsel will claim that plaintiff's motion to disqualify, when based merely on a potential conflict, is premature. This argument finds support in the fact that strike suits are still frequently brought despite security for costs statutes which now exist in many jurisdictions. Furthermore, the corporation is usually only a nominal party in a derivative action and corporate counsel may argue that to require separate counsel for the corporation is unreasonable and wastefully expensive when the action may lack merit. This argument, however, fails to appreciate that independent counsel must be appointed at the outset of the lawsuit to protect the interests of the corporation and its shareholders, because by the time an actual conflict is determined by the court the merits of the case have been decided. It is then too late to have independent counsel serve any purpose. The Iowa Supreme Court, in *Rowen v. LeMars Mutual Insurance Co.*, forcefully stated this position:

> There is considerable force to the law firm's argument that disqualification should await some inquiry into the merits of the action. The court is faced with a dilemma. If the action is without merit, the expense of independent counsel for the corporation is unjustified.

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59. *Independent Representation, supra* note 9, at 530 nn.29-31.

60. *Id.* at 530.

61. 230 N.W.2d 905 (Iowa 1975). *See* notes 94-95 & accompanying text *infra*. 
This is an expense the [shareholders] ultimately would bear. Yet, if the action has merit, the expense is justified and necessary. Since the officers and directors control the management of the corporation, fair inquiry into the merits of the claim may itself be prevented unless the corporation is represented at the outset by independent counsel. Fair inquiry into the merits is in the interests of the [shareholders]. Thus, the [shareholders] must either pay the price of independent counsel or risk loss of what might otherwise be a successful case. The Iowa court, finding a potential conflict between the corporate and insider defendants, required independent counsel, stressing that the "benefit justifies the cost."  

Federal courts have stressed the impropriety of a judicial inquiry into the merits of a case in its early stage and, when presented with a timely motion to disqualify, have ordered the corporation to retain independent counsel in cases where directors or officers are named as individual defendants, creating an inherent potential conflict. This policy is consistent with CPR Ethical Consideration 5-15.

A second area of debate involves representation on behalf of a passive or nominal corporate defendant. The state and federal courts have not uniformly insisted upon independent representation if the corporation is only a passive party. In Garlen v. Green Mansions, Inc., for example, the New York appellate court required the corporation to retain independent counsel when the corporation actively appeared and answered. Subsequent New York cases have followed the Garlen rule, inferentially allowing dual representation when the corporation is only an inactive defendant. This distinction between the active and passive corporate litigant was reflected in the voting on Opinion 842 of the New York City Bar Association Committee on Professional Ethics. While the committee unanimously agreed that when the corpora-

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62. 230 N.W.2d at 915.
63. Id.
65. For a discussion of the distinction between an active and passive corporate litigant, see notes 24-28 & accompanying text supra.
67. Russo v. Zaharko, 53 App. Div. 2d 663, 385 N.Y.S.2d 105 (1976); Langer v. Garay, 30 App. Div. 2d 942, 293 N.Y.S.2d 783 (1968); Kelley v. 74 & 76 West Tremont Ave. Corp., 24 Misc. 2d 370, 198 N.Y.S.2d 721 (Sup. Ct. 1960). The holding in these cases, that where the corporation takes an active stance in litigation it should be represented by independent counsel, seems to permit dual representation where the corporation assumes only a passive role in the litigation.
68. 15 RECORD OF N.Y.C.B.A. 80, supra note 54. In contrast, commentators have taken the broader view that the corporation should always be separately represented in a
tion takes an active stance in the litigation, independent counsel must be obtained, only a majority of the committee required independent counsel regardless of the corporation's stance.69

The New Jersey district court addressed the active-passive issue in *Messing v. FDI, Inc.* 70 In that case shareholders of FDI, Inc., alleged that the directors of FDI had violated provisions of the 1934 Federal Securities Act, and attached pendant state claims of fraud and negligence to their complaint. The corporation chose to take an active stance in the litigation. The court stated in dicta that the need for independent counsel for the corporate defendant should not depend on whether the corporation had elected to pursue an active or passive stance in the litigation, "for that very election may have already been tainted by conflict." 71 The court, however, expressly limited its holding to the controversy before it and required independent counsel only when the corporation has elected to take an active stance in the litigation.

The distinction between the passive and active litigant is improper, for, regardless of the corporation's stance, whenever the plaintiff's claim has merit the interests of the corporate and individual defendants must conflict. Allowing dual representation in the case of a passive corporate defendant could cause the attorney to violate Canons 4 and 5 of the CPR by compromising the confidences and secrets of his or her clients and breaching his or her fiduciary duty of undivided loyalty. Further, the nominal corporate defendant is able to interpose procedural defenses which may well defeat the shareholders' claim, and hence the corporation's recovery. Dual representation provides the opportunity, intentionally or otherwise, to persuade counsel shared with the insider defendants to interpose these defenses in instances which are not in the corporation's best interests. The sounder course is to require independent counsel for the corporation, regardless of the corporation's stance in the litigation.

Another problem concerning dual representation is the applicability of the consent provisions of the CPR to derivative actions. CPR Ethical Consideration 5-16 provides that in some circumstances representation of potentially conflicting multiple interests may be permissible if both clients are fully informed of the conflict and the parties expressly consent to such representation. 72 Literal application of this

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69. 15 RECORD OF N.Y.C.B.A. 80, supra note 54.
71. Id. at 782.
72. ABA CODE OF PROFESSIONAL RESPONSIBILITY Ethical Consideration 5-16. See also STATE BAR OF CALIFORNIA, RULES OF PROFESSIONAL CONDUCT Rule 5-102.
consent rationale to dual representation is overly simplistic and inappropriate because the corporation may only consent through its directors, who are themselves defendants in the litigation.\textsuperscript{73} This inherent problem was recognized by the New York City Bar Association Committee on Professional Ethics in Opinion 842, where the committee warned that “the unique relationship existing between the corporation and its directors is such that extreme caution should be exercised in resorting to the ‘consent’ provisions of Canon 6 [of the American Bar Association Canons of Professional Ethics] as justification for such dual representation.”\textsuperscript{74} The only justifiable course is for the courts to refuse to allow the officers and directors of the corporation to consent to dual representation.

A fourth area of controversy concerns distinctions drawn between allegations of fraud and negligence in a derivative suit. The court in \textit{Otis & Co. v. Pennsylvania Railroad Co.}\textsuperscript{75} inferred a distinction between derivative actions involving fraud and those actions involving negligence, stating that dual representation was proper in the absence of any allegation of breach of confidence or trust by the director or officer defendants.\textsuperscript{76} The distinct federal trend, however, has been to require independent counsel regardless of the nature of the allegations in the complaint, in recognition of the fact that the problems of dual representation impact the entire litigation process, whether the allegations are based on fraud or negligence.

In \textit{Messing v. FDI, Inc.}\textsuperscript{77} the court, in dicta, realized the fallacy of distinguishing fraud from negligence:

This court perceives no basis for relying upon the nature of the charges against the directors for purposes of determining whether they may share counsel with the corporation. Irrespective of the nature of the charges against the directors—whether it be fraud or negligence—the interests of the two groups will almost always be diverse.\textsuperscript{78}

Despite this accurate statement, the court limited its holding to the facts before it and stated only that where “the directors have been accused of


\textsuperscript{74} 15 RECORD OF N.Y.C.B.A. 80, supra note 54.


\textsuperscript{76} 57 F. Supp. at 684. The \textit{Otis} court distinguished Elberta Oil Co. v. Superior Court, 108 Cal. App. 344, 291 P. 668 (1930), an early California decision requiring that the corporation be represented by independent counsel when fraud was alleged against the corporation’s directors. See notes 112-13 & accompanying text infra for a full discussion of the \textit{Elberta} opinion.


\textsuperscript{78} Id. at 782.
fraud and the corporation has elected to take an active stance in the litigation they must the corporation retain independent counsel. Under this restrictive holding, *Otis* remains the law in the Third Circuit, allowing dual representation when negligence alone is alleged, despite the fact that, regardless of the nature of the allegations, recovery will be had by the corporation if the plaintiff's claim has merit. The fallacy of the *Otis* rule is obvious; when interests are adverse or potentially adverse, separate counsel should be obtained, without regard to the nature of the charges.

Another ethical concern involved in dual representation is the possibility that the attorney's ability to preserve the confidences and secrets of one client while representing another may be jeopardized. Although this possibility may present a serious problem with individual clients, the potential for harm is not as serious in a derivative suit because the confidences of the corporation already are totally accessible to the director and officer defendants.

The timeliness of plaintiff's motion to disqualify corporate counsel is yet another area of discussion. When the plaintiff has raised the objection to dual representation late in the proceedings, the courts have been reluctant to grant the motion, insisting that a motion for independent counsel be timely posed and where the plaintiff shareholders have voiced no objection to dual representation, the courts have not yet demonstrated a willingness to require independent counsel.

79. *Id.*

80. *See ABA CODE OF PROFESSIONAL RESPONSIBILITY* Canon 4 (A Lawyer Should Preserve the Confidences and Secrets of a Client). *ABA CANONS OF PROFESSIONAL ETHICS* No. 37 provided in part: "It is the duty of a lawyer to preserve his client's confidences . . . . [A lawyer should not] accept employment which involves or may involve the disclosure or use of these confidences . . . . A lawyer should not continue employment when he discovers that his obligation prevents the performance of his full duty to his former or to his new client." *See also CAL. BUS. & PROF. CODE § 6068(e)* (West 1974).


83. Marco v. Dulles, 169 F. Supp. 622 (S.D.N.Y. 1959), *appeal dismissed*, 268 F.2d 192 (2nd Cir. 1959) (motion to disqualify submitted nineteen years after the litigation had been initiated in state courts). The court in *Marco* stated that "[a] motion to disqualify [counsel] is of an equitable nature. A party making such a motion should do so with reasonable diligence and promptness after the facts have become known to it." *Id.* at 632. *See Milone v. English, 306 F.2d 814, 818 (D.C. Cir. 1962)* (motion to disqualify considered "of an equitable nature and should be made with promptness and diligence after the facts are known").
sua sponte. In light of the strong interests considered in this Note, it seems proper for the courts to require independent corporate counsel with or without plaintiff's motion. Until such point is reached, however, it is incumbent on the plaintiff to file a timely motion to disqualify.

The last major area of debate in requiring independent counsel for the corporation is the question of who should have the power to appoint new counsel. Those cases requiring separate representation have uniformly required that the corporation, rather than the individual defendants, obtain independent counsel. The logic of this rule is clear: if the corporation kept its original counsel and the insider defendants secured new counsel, no real assurance could be had that corporate counsel would be free of bias toward the directors and officers with whom counsel formerly had close association. Implicit in the independent counsel requirement, then, is the requirement that the newly-retained attorney or law firm have had no prior dealings with the corporation or the insider defendants.

The problem of who should appoint new counsel remains. Lewis v. Shaffer Stores Co., a 1963 New York district court case, first addressed this problem. Plaintiffs there had filed a motion to disqualify corporate counsel and requested that the court appoint independent counsel. The court ordered 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 [the] controversy." Similarly, an Illinois district court in Cannon v. U.S. Acoustics Corp., rely-

84. Murphy v. Washington American League Base Ball Club, Inc., 324 F.2d 394 (D.C. Cir. 1963). Although the court in Murphy found that in cases of dual representation the defendant corporation and the individual defendants should be separately represented, the court refused to enjoin corporate counsel from further representing the insider defendants where all the insider defendants but one were not served in the litigation and the plaintiffs did not object to that one defendant being represented by counsel for the corporation. Id. at 397.


86. Independent Representation, supra note 9, at 533.

87. Id. at 536.


89. 218 F. Supp. at 240.

ing on Lewis, allowed the defendant corporations to appoint their own independent counsel, rejecting plaintiffs' request that the court itself appoint counsel as being without precedent.91

Permitting the corporation to appoint independent counsel means in effect that the board of directors will select such counsel.92 The board may appoint partisan counsel and thereby circumvent the entire purpose behind the independent counsel requirement, as the newly-appointed counsel may be prone to safeguard the interests of the insider defendants at the expense of the corporation.93 This fear was addressed in Rowen v. LeMars Mutual Insurance Co.,94 a 1975 Iowa Supreme Court decision. The court found a potential conflict of interest in a derivative action brought by the policyholders of the defendant insurance companies sufficient to warrant disqualification of corporate counsel, and took the unprecedented step of appointing counsel for the corporations. The court reasoned that while allowing the corporations (in essence the boards of directors) to appoint independent counsel would "respect corporate autonomy and remove the 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."95 On this basis, the court found judicial appointment of counsel preferable.

The federal courts have not sanctioned court-appointment of counsel for the corporation. In Messing v. FDI, Inc.,96 the New Jersey district court, after commenting on the Rowen solution, declined to appoint counsel, stating that it remained the directors' duty, acting in the corporation's best interest, to appoint independent counsel.97

In considering the appointment of counsel problem, the right of the shareholders and employees of the corporation to have truly independent counsel who will fully safeguard the corporation's interests and facilitate the greatest corporate recovery must be balanced against the countervailing right of the corporate entity to be represented by counsel of its own choosing.98 A strong argument in favor of board appointment is that such a course would respect the integrity of the corporation as a self-governing entity.99 Allowing the court to appoint counsel for the corporate litigant seems a harsh denial of a party's right

91. 398 F. Supp. at 220.
92. See Appointment of Independent Counsel, supra note 10, at 176.
93. Id. at 184.
94. 230 N.W.2d 905 (Iowa 1975).
95. Id. at 916.
97. 439 F. Supp. at 783.
98. Independent Representation, supra note 9, at 534-35.
99. Id. at 535.
to counsel of its own choosing. Whether a court is competent to substitute its judgment regarding the selection of counsel for that of the corporation's directors and officers is questionable.\textsuperscript{100} Furthermore, a forceful argument can be made that the directors should be permitted to exercise their business judgment in appointing independent counsel until such time as the allegations against the directors are proven.\textsuperscript{101} These considerations must be balanced against the likelihood that board-appointed counsel may be biased in favor of the insider defendants.\textsuperscript{102}

Several intermediary solutions to the appointment of counsel would be less drastic than completely denying the corporation the right to counsel of its own choosing, and could still ensure the shareholders that their economic interests would be adequately protected in litigation or settlement negotiations. First, if not all directors are named defendants, a committee of disinterested directors could appoint independent counsel, subject to court approval, and thus preserve the corporation's autonomy of action. When virtually all board members are parties to the suit, the board could draw up a list of acceptable counsel from which the court could select, or the court could appoint counsel after extensive consultation with the board.\textsuperscript{103} Either of these alternatives would respect the autonomy of the corporation as an entity while protecting shareholder rights through close court supervision.

A third alternative solution would be to permit the shareholders to appoint independent counsel. This solution might well be viable in a small, closely-held corporation, if the shareholders are not themselves the officers and directors named in the complaint. Such a solution is not practical, however, in a large corporation because such shareholder action would require a proxy solicitation entailing enormous procedural costs, and would allow the board to continue to exercise its powers and exert its biases through the proxy machinery.\textsuperscript{104}

Whatever method of appointing counsel is adopted, the court clearly should continue to supervise the board's power to dismiss newly-appointed independent counsel.\textsuperscript{105} Absent this supervision, the insider defendants could dismiss the new counsel and appoint an attorney or firm predisposed to serve their interests. Dismissal should not be sanctioned by the court unless such action is in the corporation's, not the insider defendant's, best interests. Continuing court supervision

\textsuperscript{100.} Independent Representation, supra note 9, at 535. See also Appointment of Independent Counsel, supra note 10, at 183.

\textsuperscript{101.} Independent Representation, supra note 9, at 535; Appointment of Independent Counsel, supra note 10, at 182.

\textsuperscript{102.} See notes 92-93 & accompanying text supra.

\textsuperscript{103.} Independent Representation, supra note 9, at 536.

\textsuperscript{104.} Appointment of Independent Counsel, supra note 10, at 185.

\textsuperscript{105.} Independent Representation, supra note 9, at 536.
should shield independent corporate counsel from the pressures an unfavorable board might try to exert.\textsuperscript{106}

The above discussion clearly demonstrates that an attorney who attempts to represent both corporate and insider defendants in a derivative suit should be required to withdraw from representing the corporate defendant, regardless of the allegations brought in the complaint, the posture of the corporation in the litigation, or the attorney's good faith claim that he or she will withdraw if an actual conflict is found in fact to exist. Furthermore, appointment of independent counsel need not infringe substantially on the corporation's right to counsel of its own choosing. Thus, the protection of the corporation's rights in litigation and settlement proceedings gained by requiring independent corporate counsel justifies the expense incurred.

**The California Position**

The current California position on dual representation was enunciated in *Jacuzzi v. Jacuzzi Brothers*,\textsuperscript{107} a 1966 decision by the First District Court of Appeal. In that case a derivative action was brought by plaintiff shareholders of the defendant corporation, Jacuzzi Brothers, against five individual directors and officers of the defendant corporation, and against Jacbros, S.A., a Swiss corporation. The complaint sought rescission of a sale by Jacuzzi Brothers of its foreign holdings to Jacbros and an accounting on the principal ground of inadequate consideration.\textsuperscript{108} The court, in denying plaintiffs' motion to disqualify the same counsel from representing both the corporate and individual defendants, held that generally, "prior to an adjudication that the corporation is entitled to relief against its officers and directors, the same attorney may represent both."\textsuperscript{109} The *Jacuzzi* court noted the rule laid down in an earlier California case, *Elberta Oil Co. v. Superior Court*,\textsuperscript{110} disallowing dual representation, but instead relied on the federal decision in *Otis & Co. v. Pennsylvania Railroad Co.*\textsuperscript{111} for its conclusion that dual representation was proper. This reliance on *Otis* was misplaced in view of the strong arguments against dual representation prevailing in the federal courts and other state jurisdictions at that time and which currently prevail outside of California.

\textsuperscript{106} Id.

\textsuperscript{107} 243 Cal. App. 2d 1, 52 Cal. Rptr. 147 (1966).

\textsuperscript{108} Id. at 4, 52 Cal. Rptr. at 150. Three other causes of action were dismissed by the court.

\textsuperscript{109} Id. at 36, 52 Cal. Rptr. at 171.

\textsuperscript{110} 108 Cal. App. 344, 291 P. 668 (1930). See note 76 \textit{supra} and notes 112-13 & accompanying text infra.

The Jacuzzi court gave scant discussion of, and no explanation for, its rule condoning dual representation. The Elberta court was, in contrast, specific in its reasoning requiring independent counsel. In Elberta, plaintiffs brought their action against the corporation and its officers and directors, alleging that the officers and directors had fraudulently used inside information to acquire oil rich land for themselves to the exclusion of the corporation. Plaintiffs sought, *inter alia*, to have the individual defendants convey the property to defendant Elberta Oil Company and to quiet title to the property in the corporation. One of the individual defendants filed a cross-complaint against plaintiffs and the defendant corporation. The court stated that if the plaintiffs’ allegations were proved true the corporation would be entitled to recover from the defendants, that in advance of trial it was impossible to determine whether the interests of the cross-complainant and the corporation were adverse, and that such a potential conflict required that the corporation be represented by independent counsel. The Elberta decision subsequently has been relied upon as authority by the federal courts.

The Jacuzzi court may have distinguished Elberta, albeit without discussion, because the cross-complaint in Elberta necessarily indicated a conflict between the corporation and the director defendants, and because in Elberta specific allegations of fraud and misappropriation were made. The previous discussion, however, has shown the weakness of such distinctions and the patent unfairness to shareholders whose interests are at stake when the same attorney is permitted to represent potentially conflicting interests. From an ethical standpoint, Elberta, and not Jacuzzi, states the sounder position, which California courts should adopt.

The Elberta position also is supported by proper interpretation of Rule 5-102 of the Rules of Professional Conduct of the State Bar of California, which states:

(A) A member of the State Bar shall not accept professional employment without first disclosing his relation, if any, with the adverse party, and his interest, if any, in the subject matter of the employment. A member of the State Bar who accepts employment under this rule shall first obtain the client’s written consent to such employment.

(B) A member of the State Bar shall not represent conflicting interests, except with the express consent of all parties concerned.

113. *Id.* at 348, 291 P. at 669-70.
In properly interpreting Rule 5-102, the lack of California opinions addressing dual representation in derivative actions necessitates examination of other cases involving representation of multiple interests. California cases interpreting the Rules of Professional Conduct of the State Bar of California, when applied to other instances of potential conflict in representing multiple interests such as are encountered in divorce and insurance actions, have split on the propriety of multiple representation. One line of cases permits an attorney to represent litigants whose interests potentially conflict provided that the attorney has made a full disclosure to all the litigants and the litigants consent to the common representation.\textsuperscript{116} In \textit{Lysick v. Walcom},\textsuperscript{117} for instance, the same attorney had represented both the insurer and insured at trial. The court of appeal there stated: "In California, an attorney may usually, under minimum standards of professional ethics, represent dual interests as long as full consent and full disclosure occur."\textsuperscript{118} This rule is not an adequate standard in derivative actions for two reasons. First, attorneys should not strive merely to meet \textit{minimum} ethical standards, but rather should represent their client with full and undivided loyalty, and avoid not only professional impropriety but the appearance of impropriety. This is impossible where an attorney attempts to represent conflicting interests. Second, as noted earlier,\textsuperscript{119} the consent doctrine is particularly inappropriate in a shareholder derivative action, because the individual director and officer defendants themselves grant the consent.

The second line of cases interpreting the California Rules of Professional Conduct have held that counsel representing multiple inter-

\textsuperscript{5-102} became effective January 1, 1975, replacing former Rules 6 and 7 which were in effect in 1966 when \textit{Jacuzzi} was decided. Former Rules 6 and 7 were identical to present Rule 5-102, except that the former rules did not have the written consent requirement which is now part of Rule 5-102(A).

The Rules of Professional Conduct are binding upon all members of the California Bar. \textit{STATE BAR OF CALIFORNIA, RULES OF PROFESSIONAL CONDUCT} Rule 1-100; \textit{CAL. BUS. \\& PROF. CODE} § 6077 (West 1974). Willful breach of these rules empowers the Board of Governors of the State Bar of California to discipline the attorney, and to recommend that the California Supreme Court disbar or suspend the attorney from practice. \textit{CAL. BUS. \\& PROF. CODE} §§ 6077, 6078 (West 1974).


\textsuperscript{117} \textit{Id} at 147, 65 Cal. Rptr. at 413-14 (interpreting old Rules 6 and 7).

\textsuperscript{118} \textit{Id} at 147, 65 Cal. Rptr. at 413-14 (interpreting old Rules 6 and 7).

\textsuperscript{119} \textit{See} notes 72-74 & accompanying text \textit{supra}.
ests should terminate the attorney-client relationship when the discharge of a duty to one client conflicts with the attorney's duty to another client.\textsuperscript{120} Such an interpretation is more in keeping with the spirit of the California Rules of Professional Conduct and the CPR. Although these cases dealt with actual conflict, their rationale is equally applicable to the potential conflict inherent in derivative actions.\textsuperscript{121} This rule will ensure that the corporation receives a full and fair investigation into the merits of the complaint and has the benefit of full loyalty from counsel with no duty to opposing parties.

Applying the California Rules of Professional Conduct, while recognizing the inapplicability of the consent provisions therein to derivative actions, should produce the same result in California as in the federal courts: independent counsel should be required to represent the corporation in derivative litigation whenever directors and/or officers of the corporation are named as individual defendants. Thus the Jacuzzi opinion, relying as it does on the outdated rationale of Otis, should be overruled insofar as it allows dual representation of potentially conflicting interests.

\textbf{Conclusion}

The present view in the federal courts is that counsel who represent both the corporate and insider defendants in derivative litigation are not able to guide the litigation in the corporation's best interest because of the potential conflict of interest inherent in the derivative action. Clearly, an attorney who undertakes dual representation violates the mandates of the CPR and Canon 6 of the American Bar Association Canons of Professional Ethics because "in behalf of one client it is his duty to contend for that which his duty to another client requires him to oppose."\textsuperscript{122} Following the dictates and ethical wisdom of the CPR, the federal courts have developed a strong policy of disallowing dual representation in derivative actions. This position is equitable toward all persons affected by the action. The rule against dual represen-

\textsuperscript{120} See Dettamanti v. Lompoc Union School Dist., 143 Cal. App. 2d 715, 723, 300 P.2d 78, 83-84 (1956) (district attorney representing both school district and child injured on school property in personal injury action); Hammert v. McIntyre, 114 Cal. App. 2d 148, 153-54, 249 P.2d 885, 888 (1952) (attorney representing both insurance company and insured); Pennix v. Winton, 61 Cal. App. 2d 761, 773, 143 P.2d 940, 946 (1944) (attorney acting as counsel for defendant in automobile guest action in good faith charged collusion between plaintiff and defendant). See also Anderson v. Eaton, 211 Cal. 113, 293 P. 788 (1930). The California Supreme Court stated in Anderson: "[A]n attorney is precluded from assuming any relation which would prevent him from devoting his entire energies to his client's interests. Nor does it matter that the intention and motives of the attorney are honest." \textit{Id.} at 116, 293 P. at 790.

\textsuperscript{121} See notes 58-64 & accompanying text supra for a discussion of potential conflict.

\textsuperscript{122} ABA CANONS OF PROFESSIONAL ETHICS No. 6.
tation frees the attorney from the untenable position of representing conflicting interests in violation of Canon 5 of the CPR. Forbidding dual representation ensures that the corporation will obtain full and fair inquiry into the merits of the case, be the recipient of its independent counsel's undivided loyalty, and not have its recovery prejudiced by procedural defenses interposed on its behalf by counsel favoring the rights of the insider defendants. The corporation will be adequately represented in any settlement negotiations, and protected from the hardship of counsel withdrawing from the action if an actual conflict arises.

The lead of the federal courts and other state jurisdictions in disallowing dual representation should be followed by the California courts, and the Jacuzzi opinion overruled insofar as it permits dual representation in derivative actions. Only when the California courts adopt a policy of forbidding dual representation in derivative actions where directors and officers of the corporation are named as individual defendants will the corporation and the shareholders be assured of full and fair representation in the courts of the state.