

***ETHICAL ISSUES IN CLASS ACTIONS
& DERIVATIVE LITIGATION***

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Ethical Issues in Class Actions & Derivative Litigation¹

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1. **Applicability of Ethics Rules in Class Action Litigation.**

“Traditional attorney ethics rules are not applied axiomatically in representative litigation.” (Diane L. Karpman, *Class Action Ethics Considerations* (2007) p. 2 (unpublished manuscript in progress, on file with author) (“Karpman Article”) (citing *In re Agent Orange Product Liability Litigation* (2d Cir. 1986) 800 F.2d 14, 19 (“*Agent Orange*”) (“The traditional rules that have been developed in the course of attorneys’ representation of the interests of clients outside of the class action context should not be mechanically applied to the problems that arise in the settlement of class action litigation.”)); *In re Corn Derivatives Antitrust Litigation* (3d Cir. 1984) 748 F.2d 157, 163 (“*Corn Derivatives*”) (conc. opn. of Adams, J.) (“courts cannot mechanically transpose to class actions the rules developed in the traditional lawyer-client setting context”); *Lazy Oil Co. v. Witco Corp.* (3d Cir. 1999) 166 F.3d 581, 590 (“*Witco*”) (citing and quoting both *Agent Orange* and Judge Adams’ concurring opinion in *Corn Derivatives*).)

In fact, there are only two (2) references to the California Rules of Professional Conduct (“CRPC”)² specifically relating to class actions:³

- a. Rule 3-310(D): When the settlement is subject to Court approval, the aggregate settlement provision requiring the informed written consent of a client does not apply.⁴
- b. Rule 3-510(B): Communication of the settlement offer must be made to the named class representatives.

Note, there is authority that states ethics rules which are inconsistent with the overarching goals of class actions are trumped if they are not harmonious with national goals. “Rule 23 is designed for the nation as a whole.” (*Rand v.*

¹ The opinions contained herein are those of the authors personally and should not be attributed to the Committee on Professional Responsibility and Conduct or the law firms of Parker Mills LLP, Jones Day or Karpman & Associates. These materials primarily focus on California authorities; differences may and will exist in other jurisdictions. The information provided is not intended as, nor may it be relied upon as, legal advice. The speakers wish to acknowledge Justin D. Denlinger, Theodore F. Frank and Ann C. Schneider, associates with Parker Mills LLP, along with Kevin Logan, an associate in the Irvine office of Jones Day, for their valuable assistance in the preparation of this article.

² Unless otherwise noted, all further references to any rule shall be to the CRPC.

³ See Menkel-Meadow, *Ethics and the Settlement of Mass Torts: When the Rules Meet the Road* (1995) 80 Cornell L. Rev. 1159 (arguing that, if only two sections of the CRPC exempt class actions, then logically, the remainder of the CRPC rules apply to class actions).

⁴ Rule 3-310 Official Discussion (“Paragraph (D) is not intended to apply to class action settlements subject to court approval.”).

Monsanto Co. (7th Cir. 1991) 926 F.2d 596, 600.) Nonetheless, practitioners should proceed with caution as preemption must be determined according to applicable authorities on a case by case basis.

2. Who Is the Client and What Are Class Counsel’s Obligations?

A written fee agreement in class action litigation is a rarity. However, even where a plaintiff has executed one, it will not bind any absent class members nor will such an agreement bind the Court. (*Long Beach City Employees Assn., Inc. v. City of Long Beach* (1981) 120 Cal.App.3d 950, 959.)

- a. Uncertified Class: Where the putative class has not been certified, the attorney acting as “class counsel” may represent multiple named plaintiffs seeking common relief on behalf of themselves and other similarly situated individuals (including unnamed plaintiffs). Here, the attorney’s clients are the **named** plaintiffs.⁵ (L.A. County Bar Assn. Formal Opn. 481 & fn. 2 (1995); Rest.3d Law Governing Lawyers, § 14, com. f.)⁶
 - i. Class Counsel’s Relationship with Class Representative: Close relationship between class counsel and class representative (i.e., familial, spousal and business associate) may create a barrier to class certification. (*Blue Chip Stamps v. Superior Court* (1976) 18 Cal.3d 381, 134.) Class certification has also been denied where class attorney is a percipient witness to an asserted claim. (*Reich v. Club Universe* (1981) 125 Cal.App.3d 965, 970-71 (“Reich”).)
- b. Certified Class: However, where the **class is certified**, and attorney acting as class counsel represents **all** class members (**including unnamed** members). (*Agent Orange, supra*, 800 F.2d at p. 18 (holding that the class attorney is guardian of the class and owes fiduciary duty to each member); but see Rule 3-510(B) and Bus. & Prof. Code § 6103.5(a) (for purposes of communicating settlement offers, class action “client” is limited to **named** class representatives).)
 - i. “[T]he scope of representation ([along with] duties owed to class members) by class counsel is [generally] determined with reference to the certification order. (*Janik v. Rudy, Exelrod & Zieff* (2004) 119 Cal.App.4th 930, 934 (“Janik”) ([holding that] once a class is certified, class counsel assumes duty to competently

⁵ Accord, American Bar Association Model Rules of Professional Conduct (“Model Rules”), Rule 1.7, com. 25 (“When a lawyer represents or seeks to represent a class of plaintiffs or defendants in a class-action lawsuit, unnamed members of the class are ordinarily not considered to be clients of the lawyer for [concurrent conflict of interest] purposes.”); see also *Schick v. Berg* (2d. Cir. 2005) 430 F.3d 112, 116-17 (holding that, for malpractice purposes, unnamed class members are not clients of class counsel until the class is certified).

⁶ Paul W. Vapnek, Mark L. Tuft, Ellen R. Peck and Justice Howard B. Wiener (Ret.), Cal. Practice Guide: Professional Responsibility (The Rutter Group 2007) ¶ 3:131.20 (“Vapnek, et al., Professional Responsibility”).

represent class members in pursuing claims “as to which the class was certified.”.)”⁷

- ii. “However, class counsel’s duties extend *beyond the claims literally described in the class certification* order to include advising class members of *all related claims* they reasonably would expect to be considered, [especially those claims that would be barred by *res judicata* if not asserted by class counsel.] (*Janik, supra*, 119 Cal.App.4th at pp. 939-42.)”⁸ “[T]he attorney may still have a duty to alert the client to reasonably apparent legal problems even though they fall *outside the scope of the retention*. (*Nichols v. Keller* (1993) 15 Cal.App.4th 1672, 1684 (“*Nichols*”); *Janik, supra*, 119 Cal.App.4th at pp. 940-41.).”⁹

‘The attorney need not advise and caution of every possible alternative, but only of those that may result in adverse consequences if not considered... The attorney need not represent the client on such matters. Nevertheless, the attorney should inform the client of the limitations of the attorney’s representation and of the possible need for other counsel.’ (*Nichols, supra*, 15 Cal.App.4th at p. 1684; *Janik, supra*, 119 Cal.App.4th at pp. 940-41.).”⁹

“While lead counsel owes a generalized [fiduciary] duty to unnamed class members, the existence of such a fiduciary does not create an inviolate attorney-client relationship with each and every member of the putative class.” (*In re McKesson HBOC, Inc. Securities Litigation* (N.D.Cal. 2000) 126 F.Supp.2d 1239, 1245 (“*McKesson*”); see also *Atari, Inc. v. Superior Court* (1985) 166 Cal.App.3d 867, 872 (“*Atari*”).)

- c. Duties of Co-Counsel: All attorneys in a co-counsel relationship in class action matters individually owe each and every client the duty of loyalty. In *Huber v. Taylor* (3d Cir. 2006) 469 F.3d 67, 81 (on remand to *Huber v. Taylor* (W.D.Pa. 2007) 519 F.Supp.2d 542) (collectively “*Huber*”),¹⁰ a putative class of plaintiffs brought an action against their former lead class counsel (attorneys at a large Texas firm) that had contracted with various local counsel around the country, alleging breach of fiduciary duty with

⁷ Vapnek, et al., Professional Responsibility, *supra*, ¶ 3:21.8.

⁸ Vapnek, et al., Professional Responsibility, *supra*, ¶ 3:21.8.

⁹ Vapnek, et al., Professional Responsibility, *supra*, ¶ 3:39.

¹⁰ It is important to note that the *Huber* court relied on *Burrow v. Arce* (Tex. 1999) 997 S.W.2d 229 (“*Burrow*”), in finding that punitive damages and attorneys’ fees were available to plaintiffs under Texas law. “Texas law does permit recovery of punitive damages in [breach of fiduciary duty] cases, even in the absence of actual harm or damages.” (*Huber, supra*, 519 F.Supp.2d at p. 561, fn. 5 (relying on *Burrow*).) “Under Texas law, ‘a client need not prove actual damages in order to obtain forfeiture of an attorney’s fee for the attorney’s breach of fiduciary duty to the client.’” (*Huber, supra*, 469 F.3d at p. 77 (citing *Burrow* at p. 240).)

respect to asbestos personal injury litigation. Lead counsel were found to have breached their fiduciary duty of undivided loyalty and candor to their clients by failing to disclose material terms of various settlements or the nature of lead counsel/local counsel's involvement in the case. The court found that lead counsel owed a fiduciary duty to plaintiffs under Texas law; although plaintiffs did not reside in Texas, lead counsel held themselves out as plaintiffs' attorneys, entered into agreements regarding representation of plaintiffs, signed and filed pleadings on plaintiffs' behalf, negotiated settlements for plaintiffs' claims, and collected fees from plaintiffs. "The [fiduciary] duty [that an attorney owes a client] may not be dispensed with or modified simply for the conveniences and economies of class actions." (*Id.* at p. 82.)

3. Attorney Communications.

Prior to certification, a potential class member is not a party¹¹ within the meaning of Rule 2-100's anti-contact provisions.¹²

a. Reasons for Contact:¹³

- i. Plaintiffs' lawyers may want to contact potential claimants (pre-certification) for a variety of reasons, including:
 - (1) to notify them that a class is pending;
 - (2) to notify them of applicable statute of limitation issues;
 - (3) to locate new class representatives if the court has concluded that a class cannot otherwise be certified;¹⁴ or
 - (4) "[o]ther plaintiff's lawyers or firms may attempt to compete in contact with prospective claimants to garner the largest number of plaintiffs in their client pool before the appointment of lead counsel. The number of plaintiffs represented by counsel is a factor considered by the court in the appointment of lead counsel."¹⁵

¹¹ Communication by defense counsel with potential class members (pre-certification) is generally permissible, because no attorney client relationship exists. (*Babbitt v. Albertson's Inc.* (N.D.Cal. Jan. 28, 1993, No. C-92-1883 SBA(PJH)) 1993 U.S. Dist. Lexis 18801, at *5.); *Atari, supra*, 166 Cal.App.3d at p. 873.)

¹² Model Rule 4.2 is the counterpart to CRPC Rule 2-100.

¹³ Class Action & Complex Case Management--California (Comr. Bruce Mitchell ed., forthcoming 2008) (unpublished manuscript in progress, on file with Class Action Publishers, Inc.).

¹⁴ *Budget Finance v. Superior Court* (1973) 34 Cal.App.3d 794, 799; *La Sala v. American Savings & Loan Assn.* (1971) 5 Cal.3d 864, 874; *Best Buy v. Superior Court* (2006) 137 Cal.App.4th 772, 779 ("*Best Buy*").

¹⁵ Karpman Article, *supra*, at pp. 9-10. This is especially true in securities class actions and is required by the Private Securities Litigation Reform Act of 1995. (*Id.* at p. 10, fn. 25.)

ii. Defendants’ attorneys may want to contact potential claimants prior to certification:¹⁶

- (1) to investigate the claim as to class certification and the merits;
- (2) to develop an affirmative defense;
- (3) to settle with a named plaintiff or a potential class; or
- (4) to encourage prospective claimants to opt-out.

b. Pre-Certification Communications with Potential Class Members: While solicitation is generally prohibited,¹⁷ class counsel is permitted to contact potential class members to investigate and prepare the action. (*Howard Guntz Profit Sharing Plan v. Superior Court* (2001) 88 Cal.App.4th 572, 578 (“*Howard Guntz*”) (“[Plaintiffs] are permitted precertification communication with potential class members for the purpose of investigation and preparation of their claims or defenses.”).)¹⁸

“Model Rules of Professional Conduct 4.2 [anti-contact rule] and 7.3 [solicitation] do not generally prohibit counsel for either plaintiff or defendant from communicating with persons who may in the future become members of the class. Both plaintiff’s and defense counsel must nevertheless comply with Model Rule 4.3 [dealing with unrepresented persons].” (ABA Com. on Prof. Ethics, Formal Ethics Opn. 07-445 (2007).)

“[B]anning communications with class members presumptively violates the First Amendment []. (*Gulf Oil Co. v. Bernard* (1981) 452 U.S. 89, 103-04 [101 S.Ct. 2193] (“*Gulf Oil*”) (order prohibiting plaintiffs and lawyers from communicating with potential class members interfered with efforts to inform potential class members of lawsuit’s existence and made it difficult to obtain information about lawsuit’s merits from persons they sought to represent); see also Fed. Rules Civ.Proc., rule 23(d), 28 U.S.C.; ABA Model Rules Prof. Conduct, rule 7.2, com. 4 (excluding notification of class action members from solicitation prohibition in Model Rules, rule 7.3).)”¹⁹

General Rule: Thus, generally there is no court oversight of pre-certification communications with potential class members. (*Parris v.*

¹⁶ After class certification, counsel for the class becomes the sole legal representative, which then bars defense counsel from contacting any class member (directly or indirectly). See Mallen & Smith, Legal Malpractice (4th Ed. 2007) (“Mallen & Smith”) § 30:53, p. 691 (citing *Blanchard v. EdgeMark Financial Corp.* (N.D.Ill. 1997) 175 F.R.D. 293).

¹⁷ Rule 1-400(B), (C).

¹⁸ See Vapnek, et al., Professional Responsibility, *supra*, ¶ 2:333.10.

¹⁹ See Vapnek, et al., Professional Responsibility, *supra*, ¶ 2:333.10.

Superior Court (2003) 109 Cal.App.4th 285, 296 (“*Parris*”) (finding such oversight to be an improper prior restraint on speech); *Atari, supra*, 166 Cal.App.3d at p. 871 (“Absent a showing of actual or threatened abuse, both sides should be permitted to investigate the case fully.”).)

Exception: Court oversight of pre-certification communications is permissible upon a showing of necessity to avoid particular harm. (*Parris, supra*, 109 Cal.App.4th at pp. 299-300 (“A trial court may rule on the propriety of precertification communications only if the opposing party seeks an injunction, protective order or other relief. If such a motion is brought, the trial court may impose restrictions on such communications only ‘by a showing of *direct, immediate and irreparable harm.*’” (emphasis added)); *Atari, supra*, 166 Cal.App.3d at p. 871 (“Absent a showing of *actual or threatened abuse*, both sides should be permitted to investigate the case fully.” (emphasis added)); *Howard Gunty, supra*, 88 Cal.App.4th at p. 580 (“any ‘order limiting communications between parties and potential class members should be based on a clear record and *specific findings* that reflect a weighing of the *need for a limitation* and the potential interference with the rights of the parties.’” (*Gulf Oil, supra*, 452 U.S. at p. 101.).”) (emphasis added).)

Beware of Use of Term “Notice” in Communications with Class Members: Federal Rules of Civil Procedure (“FRCP”) Rule 23 refers to the court’s use of “notices,” e.g., to inform potential class members of the nature of the action and their rights, as well as proposed settlements. Use of the term “notice” in attorney communications with class members may be deceptive in that it suggests that the communication was required by the court. (*McKesson, supra*, 126 F.Supp.2d at pp. 1242-44 (enjoining use of mass mailed solicitations entitled “Notice of Opportunity to Join McKesson HBOC/Proxy/Breach of Fiduciary Duty Litigations” and which inadequately described the class action process, requiring dissemination of “curative” notice, and allowing rescission of solicited “opt out” agreements).)

- c. Miscommunication to the Class: Counsel, who represented a competing subsequent class, was sanctioned for misrepresenting to initial class members that they could opt out of settlement. (Cohelan, *Cohelan on California Class Actions* (2006-07 ed.) § 6.7, p. 139 (“Cohelan”) (citing *Bell v. American Title Insurance Co.* (1991) 226 Cal.App.3d 1589).)

4. Adequacy of Representation.²⁰

Courts apply a “heightened standard” to class counsel, closely scrutinizing the qualifications of such attorneys. (*Cal Pak Delivery, Inc. v. United Parcel Service* (1997) 52 Cal.App.4th 1, 12 (“*Cal Pak*”).) Courts will not hesitate to refuse to certify a class if prospective class counsel is not deemed adequate. (*Sipper v. Capital One Bank* (C.D.Cal. Feb. 28, 2002, CV 01-9547 LGB(Mcx)) 2002 U.S. Dist. Lexis 3881, at **19-20.)

- a. “Adequate Representation” of Class Members Required: In a class action for damages, “due process requires that class members receive adequate notice of the proceedings, the opportunity to “opt out” and ‘adequate representation’ of their interests. (*Phillips Petroleum Co. v. Shutts* (1985) 472 U.S. 797, 810 [105 S.Ct. 2965].)

‘Adequate representation’ in class actions refers to representation by the class representative **and his or her counsel** –i.e., ‘whether the representative, through qualified counsel, vigorously and tenaciously protected the interests of the class.’ (*Gonzales v. Cassidy* (5th Cir. 1973) 474 F.2d 67, 75; see also *Agent Orange, supra*, 800 F.2d at p. 18 (holding that the class attorney is the guardian of the class and owes a fiduciary duty to each member).)”²¹

- b. Illustrative List of Factors Considered by the Court in Evaluating “Adequacy:”²²

- i. Prior experience in other class actions (“affidavits submitted to the district court show[ing] experience prosecuting dozens of high profile class action cases”);²³
- ii. An attorney’s ethics in handling the class action to date (e.g., manner of solicitation, conflicts of interest);²⁴
- iii. Capacity to handle the class (e.g., ability to communicate with the entire class; capability to manage/keep safe large sums of money; financial and experienced employee resources to manage the litigation).²⁵

²⁰ While the courts will evaluate both the class representative’s and class counsel’s ability to adequately represent the interests of the class, the focus of this seminar is on class counsel.

²¹ Vapnek, et al., Professional Responsibility, *supra*, ¶ 4:157.21.

²² Karpman Article, *supra*, at pp. 13-14.

²³ *Hanlon v. Chrysler Corp.* (1998) 150 F.3d 1011, 1021; see also *Cal Pak, supra*, 52 Cal.App.4th at p. 1.

²⁴ Schwarzer, et al., Cal. Practice Guide: Federal Civil Procedure Before Trial (The Rutter Group 2007) chapter 10(c).

²⁵ See *Janik, supra*, 119 Cal.App.4th at p. 937.

5. Conflicts.²⁶

Conflict of interest rules are not easily applied to class actions, and may be at odds with policies underlying class action rules.

Exact application of joint/dual representation conflict of interest rules in the class action litigation arena is not always possible due to their inherent differences from conventional litigation (e.g., attorneys generally initiate class action cases, with little input from clients, and attorneys generally manage the cases without the class members' consent). Further, attorneys' fees are subject to ultimate court approval.

All class action cases have an inherent potential conflict between class counsel's interest in maximizing fees and class members' interest in maximizing recovery. (See *Zucker v. Occidental Petroleum Corp.* (9th Cir. 1998) 192 F.3d 1323, 1226-27.)²⁷ In class action litigation, attorneys' fees usually far exceed the maximum recovery of any individual class member. (See *Epstein v. MCA, Inc.* (9th Cir. 1999) 179 F.3d 641, upon reconsideration of 126 F.3d 1235, 1255 (9th Cir. 1997), cert. den. (after remand from the United States Supreme Court, the Ninth Circuit found that it is a potential conflict when an attorney may favor his or her own interest in legal fees over the interests of the class members).)²⁸

- a. Plaintiff Representation: Lawyer's duty of undivided loyalty directly relates to the adequacy of representation for class action purposes. (*Jaurigui v. Ariz. Bd. of Regents* (D.Ariz. 1979) 82 F.R.D. 64, 66; see also *Fiandaca v. Cunningham* (1st Cir. 1987) 827 F.2d 825, 828-31 (finding that a law firm had a conflict where the relief it was seeking in two different class actions might cause one class to benefit at the expense of the other).)
 - i. Attorney cannot serve in the dual capacities as class representative **and** class counsel:²⁹ this is to prevent an irreconcilable conflict of interest (i.e., the attorney might stand to gain much more in fees than any class member's individual recovery). The risk is that an attorney-class member would be tempted to subordinate the interests of his or her fellow class members to maximizing legal fees. (*Apple Computer, Inc. v. Superior Court* (2005) 126

²⁶ Conflicts of interest are of great sensitivity in representative litigation. (*Developments in the Law—Conflicts of Interest in the Legal Profession* (1981) 94 Harv. L.Rev. 1244, 1247 (“Every class action presents a potential conflict-of-interest problem.”).)

²⁷ Karpman Article, *supra*, at p. 19 (“Conflict-of-interest rules do not purport to regulate circumstances that are common to **all** lawyers, but only circumstances that are unique to **particular** lawyers.” (quoting Moore, *Who Should Regulate Class Action Lawyers?* (2003) 5 U. Ill. L.Rev. 1477).) The rules prohibiting conflicts (e.g., ABA Model Rule 1.7 and CRPC Rule 3-310) do not apply to “generic” or unavoidable conflicts, those that apply to all lawyers such as issues involving “fees.” The rules apply to specific lawyers, specific firms and specific factual situations.

²⁸ See also Vapnek, et al., Professional Responsibility, *supra*, ¶ 4:157.20.

²⁹ Cf. *Best Buy*, *supra*, 137 Cal.App.4th at pp. 777-79 (holding that class counsel **can** be the class representative—at least temporarily).

Cal.App.4th 1253, 1272 (“*Apple*”);³⁰ *Turoff v. May Co.* (6th Cir. 1976) 531 F.2d 1357, 1360; *Susman v. Lincoln American Corp.* (7th Cir. 1977) 561 F.2d 86, 90-92.) Moreover, “there is an appearance of impropriety that may exist and requires protection of the public’s interest in the integrity of class actions.” (Mallen & Smith, § 30:53, p. 695; see also Vapnek, et al., Professional Responsibility, *supra*, ¶ 4:157.24.)

(1) “A class representative’s failure to monitor class counsel may constitute the functional equivalent of class counsel serving as class representative. Actions taken under such circumstances may be set aside. (*In re California Micro Devices Securities Litigation* (N.D.Cal. 1996) 168 F.R.D. 257, 260).”³¹

ii. “The mere fact that an attorney is a member of the class [represented] (and will benefit from the class action) is insufficient by itself to disqualify the attorney from acting as class counsel. (*Pepper v. Superior Court* (1977) 76 Cal.App.3d 252, 261-62.)

However, a class attorney/class member may be disqualified from class representation where he or she will be called to **testify as a witness** in the action. (*Reich, supra*, 125 Cal.App.3d at pp. 971-72; see also *Sicinski v. Reliance Funding Corp.* (S.D.N.Y. 1979) 82 F.R.D. 730, 734;”³² *Arthur v. Zearley* (1995) 320 Ark. 273, 279-82 [895 S.W.2d 928] (finding attorney for plaintiffs in prospective class action who testified at class certification hearing improperly testified and acted as advocate in same proceeding).)³³

iii. “[C]ourts generally refuse to permit the named plaintiff to employ as counsel for the class a law partner or associate; or a spouse; or member of the family... [out of concern that] any attorneys’ fees paid would diminish the class recovery and, thus, pose an irreconcilable conflict of interest. (*Zylstra v. Safeway Stores, Inc.* (5th Cir. 1978) 578 F.2d 102, 104;”³⁴ *Apple, supra*, 126 Cal.App.4th at p. 1253.) “Because disqualification is based on the risk of conflicts and the appearance of impropriety, neither the attorney class member’s motives, nor the actuality of or the quality of the

³⁰ In *Apple*, the court found that a law firm was precluded from representing the class where one of the lawyers at the firm was the named plaintiff. The prohibition was found to extend to firms that regularly worked closely with the directly disqualified firm. The findings of fact revealed that within a two-year period, two law firms had jointly filed eleven class actions under the Unfair Competition Law in which an attorney from one of the firms (or a relative of one of the attorneys) was the named plaintiff.

³¹ Vapnek, et al., Professional Responsibility, *supra*, ¶ 4:157.25.

³² Vapnek, et al., Professional Responsibility, *supra*, ¶ 4:157.26.

³³ But see Rule 5-210(c) (unless the court orders otherwise, a lawyer may assume the dual role of advocate and witness in any case where the client has given “informed written consent.”).

³⁴ Vapnek, et al., Professional Responsibility, *supra*, ¶ 4:157.27.

legal representation is relevant.” (Mallen & Smith § 30:53, p. 697.)

- iv. “Where some class representatives object to a settlement negotiated on their behalf, class counsel may continue to represent the remaining class representatives and the class, ‘as long as the interest of the class in continued representation by experienced counsel is not outweighed by the actual prejudice to the objectors of being opposed by their former counsel.’ (*Witco, supra*, 166 F.3d at p. 590;”³⁵ compare *Corn Derivatives, supra*, 748 F.2d at pp. 161-62 (wherein the court did not allow class counsel to withdraw from representing the class so that he could represent the only objector); see also *Agent Orange, supra*, 800 F.2d at pp. 18-19 (holding that motions to disqualify class counsel in disputed settlement situations require balancing of interests).)

Recent decisions relating to class counsel’s duty when members of the class disagree underscore “that class counsel represents the interests of the class as a whole, not the interests of the individual members, which may be divergent or, even, adverse.” (*Sanders v. Leavitt* (Utah 2001) 37 P.3d 1052 (class counsel did not owe a duty to the divergent needs of individual member where they sought institutional reform of child welfare system).)

- v. “A conflict of interest preventing class counsel from providing adequate representation also exists where counsel:
- (1) previously represented the defendant (*Doe v. A Corp.* (5th Cir. 1983) 709 F.2d 1043, 1047-48; *Corn Derivatives, supra*, 748 F.2d at p. 161);
 - (2) represents another class against the same defendant (*Sullivan v. Chase Inv. Services of Boston, Inc.* (N.D.Cal. 1978) 79 F.R.D. 246, 258);
 - (3) is suing class members for unpaid fees, or represents opposing factions within the same class (*Piambino v. Bailey* (11th Cir. 1985) 757 F.2d 1112, 1144-45);”³⁶
 - (4) simultaneously represents class against a corporation and shareholders on behalf of the corporation in a derivative action. (*Stull v. Baker* (S.D.N.Y. 1976) 410 F.Supp. 1326, 1336-37 (“[I]t is difficult to understand how an attorney can properly represent the interests of a corporation and its present shareholders in a derivative action brought on their

³⁵ Vapnek, et al., Professional Responsibility, *supra*, ¶ 4:157.28.

³⁶ Vapnek, et al., Professional Responsibility, *supra*, ¶ 4:157.29.

behalf, and, at one and the same time, properly represent its present and/or former shareholders in a class action against the corporation, without compromising his independence of professional judgment and loyalty to these two groups of clients with potentially conflicting interests.”); *Ruggiero v. American Bioculture, Inc.* (S.D.N.Y. 1972) 56 F.R.D. 93, 95-96 (“*Ruggiero*”) (ordering separate counsel for class action plaintiffs and derivative suit plaintiffs, even though some plaintiffs were in both groups); *Koenig v. Benson* (E.D.N.Y. 1987) 117 F.R.D. 330, 334 (“When a plaintiff brings a derivative suit seeking recovery for the corporation and simultaneously files a class suit for damages against that same corporation, there is an inherent conflict.”); Cf. *In re National Student Marketing Litigation* (D.D.C. Oct. 2, 1973, No. 105) 1973 U.S. Dist. Lexis 11662, at *7 (challenge to counsel representing both class and derivative claims creates potential for conflict of interest); *Hurwitz v. R.B. Jones Corp.* (W.D.Mo. 1977) 76 F.R.D. 149, 165 (strong likelihood that conflict would preclude adequate representation if plaintiffs asserted a derivative claim on behalf of the corporation and simultaneously asserted a class claim against it.)

- vi. “Some courts have cautioned that, because of the nature of class representation and the importance of retaining counsel with the most experience for the case, automatic disqualification should not be applied in a rigid fashion. (*Agent Orange, supra*, 800 F.2d at p. 19; *Witco, supra*, 166 F.3d at p. 590).”³⁷
- vii. Where an attorney represents plaintiff classes in two separate and unrelated actions and, in one of the actions, the attorney is suing a party who happens to be an unnamed member of the plaintiff class in the other action. Is the lawyer suing a current client? A handful of cases have held that the answer is “no” and have allowed the attorneys to proceed. (*Dean v. Kraft Foods North America, Inc.* (E.D.Pa. Mar. 26, 2004, Civ. A. No. 02-8609) 2004 U.S. Dist. Lexis 5491; *In re Fine Paper Antitrust Litigation* (3d Cir. 1980) 617 F.2d 22; *In re Firestorm* (Wash.Ct.App. 1991) 106 Wash. App. 217 [22 P.3d 849].)
- viii. *Co-Counsel Disclosure*: In *Huber, supra*, 469 F.3d at pp. 70-71, lead counsel in a class action case contracted with numerous local counsel in other jurisdictions to grow their “inventory” of clients in the matter. However, lead counsel failed to advise the class members of their various co-counsel fee splitting agreements that

³⁷ Vapnek, at al., Professional Responsibility, *supra*, ¶ 4:157.30.

adversely affected the class members' settlement payouts. In today's climate, all fees, referrals, enhancements or the like must be fully disclosed to the court.

b. Defense Counsel Representing Multiple Defendants:

- i. The classic conflict of interest arises “when, in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose.” (*Flatt v. Superior Court* (1994) 9 Cal.4th 275, 283, fn. 2 (“*Flatt*”) (quoting ABA Canon of Professional Ethics (1908), Canon 6); see also ABA Model Rules Prof. Conduct, rule 1.7³⁸ & 1.9; ABA Model Code Prof. Responsibility, DR 5-101).)
- ii. Rule 3-310(C) provides, in pertinent part, that an attorney “shall not, without the informed written consent of each client:”
 - (1) “Accept representation of more than one client in a matter in which the interests of the clients potentially conflict; or”
 - (2) “Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict[.]”
- iii. *Informed Written Consent:* Under Rule 3-310, “informed written consent” means “the client’s or former client’s written agreement to the representation following written disclosure.”

c. Insurer v. Insured: Many Directors & Officers (“D & O”) liability policies obligate an insurer to defend certain officers or board members of a corporation in the event of a suit for a covered claim.³⁹ This creates a “tripartite relationship” between the insured, the insurer, and the attorney. (Vapnek, et al., Professional Responsibility, *supra*, ¶ 3:130.)

- i. The tripartite relationship creates a fiduciary duty by the attorney to both the insured and the insurer. (*Purdy v. Pac. Automobile Ins. Co.* (1984) 157 Cal.App.3d 59, 76.)
- ii. The attorney’s obligation to the insurer, however, is subordinate to its obligation to the insured. If the insurer appoints defense

³⁸ See also Model Rule 1.7, comment 25 (“[A] lawyer seeking to represent an opponent in a class action does not typically need the consent of an unnamed member of the class whom the lawyer represents in an unrelated matter.”).

³⁹ Although beyond the scope of this article, traditional D & O policies were structured more on an indemnity basis with the directors and officers engaging counsel of their choice, with the fees paid or reimbursed by the D & O carrier who did not otherwise assume or control the defense. In this instance, the relationship between defense counsel and the D & O insurer may be more akin to independent counsel in a conflict situation created by the insurer’s reservation of rights. In California, see Civil Code section 2860.

counsel, such counsel owes its primary obligation to the insured to provide the same level of competent, ethical representation as if the insured had retained it personally. (*Dynamic Concepts, Inc. v. Truck Ins. Exch.* (1998) 61 Cal.App.4th 999, 1008.)

- iii. An attorney may represent both the insurer and the insured, as long as there is no conflict of interest. (*Unigard Ins. Group v. O’Flaherty & Belgum* (1995) 38 Cal.App.4th 1229, 1235.) Such a conflict of interest, however, may be created when an insurer denies that a claim against the insured is covered by the terms of the insurance policy and agrees to defend on a reservation of rights basis. (Vapnek, et al., Professional Responsibility, *supra*, ¶ 3:131.) For example, such a conflict may occur regarding what constitutes a director’s “breach of fiduciary duty,” and thus what falls under a state director exculpatory statute.
 - iv. Under California law, the insurer generally has the right to settle an action for within the policy limits. “When a defense is being provided without reservation by an insurance carrier, a settlement by the carrier within policy limits does not prejudice the ‘substantial rights’ of the insured.” (*Robertson v. Chen* (1996) 44 Cal.App.4th 1290, 1294 (interpreting Code Civ. Proc. § 664.6.) Where the insured is fully covered by primary insurance, the primary insurer is entitled to take control of the settlement negotiations and the insured is precluded from interfering therewith. (*Ibid.*)
- d. General Rule: Attorneys may not directly/indirectly pay or guarantee the payment of personal/business expenses of prospective or existing clients, except as authorized by Rule 4-210(A).
- i. *Exception for Class Action Securities Fraud Litigation*: If a plaintiffs’ class is certified in an action for violation of Section 10(b) of the Securities Exchange Act of 1934, for example, the attorneys representing the class or the attorneys for the defense may be required, as well as their respective clients, to execute an undertaking to pay certain fees and expenses that may be awarded. (15 U.S.C. § 78u-4(a)(8).)⁴⁰

⁴⁰ Vapnek, et al., Professional Responsibility, *supra*, ¶ 2:395.

- ii. On the other hand, it is permissible for class counsel to agree to indemnify class representative's liability for an award of taxable costs in the event defendants prevail. (L. A. County Bar Assn. Professional Responsibility and Ethics Com. Formal Opn. No. 517 (2006), cited in *Sheller v. Superior Court* (2008) 158 Cal.App.4th 1697, 1708, fn. 15 (as modified); see also *Rand, supra*, 926 F.2d at p. 600.)

- e. Disqualification:
 - i. If a simultaneous representation conflict exists and the clients have not provided their informed consent, disqualification is generally *per se* or automatic. (*Flatt, supra*, 9 Cal.4th at pp. 284-85.)
 - ii. As a remedy for a conflict of interest, a motion to disqualify is much less likely to be granted when only a *hypothetical*, as opposed to an actual, conflict exists. (*Fox Searchlight Pictures, Inc. v. Paladino* (2001) 89 Cal.App.4th 294, 302.)

- f. Special Issues Raised by Derivative Suits:
 - i. *Dual Representation as Plaintiffs' Counsel in Both Class and Derivative Actions:* The interests of plaintiffs in securities class actions and derivative actions based on the same facts have been described as a "zero sum" game and, consequently, raise potential conflicts of interest.
 - (1) "As counsel for the derivative shareholder, the attorney is charged with obtaining the largest possible recovery for the company, whereas acting as counsel for the class, the attorney's responsibility is to obtain the greatest recovery for the individual plaintiffs, often against the company. This dual role could divide class members in several ways." (Miller, *Conflicts of Interest in Class Action Litigation: An Inquiry into the Appropriate Standard* (2003) 2003 U. Chi. Legal F. 581, 604.)
 - (2) "Plaintiffs who sold their shares would get no benefit from a recovery to the corporation, whereas those who held would benefit from a derivative recovery because their stock may become more valuable as a result of the payment into the corporate treasury." (*Ibid.*)
 - (3) "Plaintiffs who need liquidity would benefit from a class recovery (since they receive a check in the mail), whereas those who are not liquidity-constrained might be happier with a recovery for the corporation." (*Id.* at pp. 604-05.)

- (4) “Plaintiffs who happen to be creditors of the corporation would benefit from a derivative remedy because the amounts recovered would be available to pay the firm’s debts; non-creditor plaintiffs would gain no benefit from increasing creditor security.” (*Id.* at p. 604.)
- (5) *In re Pacific Enterprises Securities Litigation* (9th Cir. 1995) 47 F.3d 373, 378. The Ninth Circuit suggested in dicta that representation of both class action plaintiffs and derivative plaintiffs could create a conflict of interest. The defendant demanded that settlements in the derivative and class actions be “linked,” and the same firm represented plaintiffs in both actions. The court was concerned about the potential conflicts, but declined to consider the argument as a basis for throwing out the settlements because the argument was raised for the first time on appeal. (*Ibid.*) As for the timing of such challenges in the future, the court strongly hinted that “[a] timely objection could have been properly evaluated before extensive settlement negotiations were concluded.” (*Ibid.*)
- (i) Courts in other jurisdictions have split on the issue of whether such dual representation is permissible. (See generally DeMott, *Shareholder Derivative Actions Law & Practice* (2007), § 6:26.)
- (ii) Although New York courts disclaim having adopted a *per se* rule prohibiting dual representation, the courts have applied a “strict standard in scrutinizing simultaneous direct and derivative actions for signs of conflict.” (*Ryan v. Aetna Life Ins. Co.* (S.D.N.Y. 1991) 765 F.Supp. 133, 135; see also *Ruggiero, supra*, 56 F.R.D. at p. 95 (“I fail to see how, on the one hand, [counsel] can vigorously seek recovery on behalf of those who have an equity interest in the corporation and, on the other hand vigorously seek recovery from the corporation on behalf of those who have no equity interest in the corporation”)); *Levine v. Am. Export Industries, Inc.* (2d Cir. 1973) 473 F.2d 1008, 1009.)
- (iii) Courts in other jurisdictions have required the showing of an actual conflict in the dual representation on a case-by-case basis. (See, e.g., *Keyser v. Commonwealth Nat’l Fin. Corp.* (M.D.Pa. 1988) 120 F.R.D. 489, 492 (superseded by statute on other grounds); *First American Bank & Trust by*

Levitt v. Frogel (S.D.Fla. 1989) 726 F.Supp. 1292, 1298 (“The theoretical distinction between individual and derivative stockholder suits ... is just that, a theoretical one, not rooted in the realities of most individual and derivative suits, which usually are equally contingent upon the proof of the same nucleus of facts.”) (ellipsis in original).)

ii. *Dual Representation of Corporation as a Nominal Defendant and Individual Defendants:*

- (1) Rule 3-600(E) provides that counsel “representing an organization may also represent any of its directors, officers, employees, members, shareholders, or other constituents, subject to the provisions of rule 3-310.” However, the unusual nature of a shareholder derivative suit, in which the plaintiff seeks to recover for the benefit of the corporation and its whole body of shareholders when injury is caused to the corporation that may not otherwise be redressed because of failure of the corporation to act, raises special concerns.⁴¹
- (2) In a derivative suit, the corporation is a nominal defendant, but for purposes of an ethics analysis, it may be viewed as a plaintiff. If the allegations of a director’s wrongs are proved, the corporation stands to benefit from the recovery. Thus, at least one court has stated, where the directors of a corporation are alleged in a derivative action to have committed fraud, “case law clearly forbids dual representation of a corporation and directors in a shareholder derivative suit,” because such representation would offend the conflict of interest provisions of Rule 3-310. (*Forrest v. Baeza* (1997) 58 Cal.App.4th 65, 74 (“*Forrest*”).)⁴² This is not necessarily the prevailing view.

⁴¹ See *Oakland Raiders v. Nat. Football League* (2005) 131 Cal.App.4th 621, 650 (“[An] action is derivative, i.e., in the corporate right, if the gravamen of the complaint is injury to the corporation, or to the whole body of its stock and property without any severance or distribution among individual holders, or it seeks to recover assets for the corporation or to prevent the dissipation of its assets.”) (citing *Jones v. H.F. Ahmanson & Co.* (1969) 1 Cal.3d 93, 106.)

⁴² In *Forrest*, the court disqualified an attorney from dual representation of a closely held corporation and its directors in a shareholder derivative suit. The court, however, allowed the attorney to continue his representation of the individual defendants. (*Forrest, supra*, 58 Cal.App.4th at p. 82.) The court reasoned that the attorney may continue to represent one of its former clients against the other “[b]ecause the functioning of these closely held corporations had been so intertwined with the individual defendants that any distinction between them was entirely fictional, application of a strict rule of disqualification would have been meaningless.” (*Ibid.*) (emphasis added.)

An older California case, *Jacuzzi v. Jacuzzi Brothers, Inc.* (1966) 243 Cal.App.2d 1, 35-36 (“*Jacuzzi*”), held that, prior to an adjudication that the corporation is entitled to relief against its officers or directors, the same

Further distinctions must be considered, such as representation of the corporation and outside or independent directors or members of a special litigation committee.

- (3) Although Rule 3-600(E) permits a corporation to consent to representation, notwithstanding a conflict of interest, 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,” in the context of derivative litigation an “appropriate constituent” may be difficult to find. 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, such as Rules 3-600(E) and 3-310. (*In re Oracle Securities Litigation* (N.D. Cal. 1993) 829 F.Supp. 1176, 1189.)
- (4) Because the representation of adverse clients implicates an attorney’s duty of loyalty, and not simply the duty to preserve confidential information, a law firm cannot employ an “ethical screen” that would purport to cure defects that may exist in representing a corporation and its directors simultaneously in a derivative action.⁴³ (*Concat LP v. Unilever, PLC* (N.D. Cal. 2004) 350 F.Supp.2d 796, 822.)
- (5) A director has a continuing fiduciary duty to the corporation despite potential adversity in a derivative litigation. Thus, the director may not improperly disclose privileged attorney-client information, trade secrets, or other confidential corporate information. (Vapnek, et al., *Professional Responsibility, supra*, at ¶ 4:93.1.) If there is a concern that a dissident director might disclose confidential communications concerning the litigation, the corporation can form a litigation committee to discuss litigation matters in confidence without the presence of directors or shareholders who are adverse to the corporation’s position. (*La Jolla Cove Motel & Hotel*

attorney may represent both sides of the dispute. *Jacuzzi* has been criticized as “illogical and against the weight of authority.” (Forrest, *supra*, 58 Cal.App.4th at p. 75.)

⁴³ California courts generally do not support the use of screening of attorneys by private law firms to rebut the presumption created by the imputed knowledge rule. (See, e.g., *Rosenfeld Construction Co., Inc. v. Superior Court* (1991) 235 Cal.App.3d 566, 577; *Henriksen v. Great American Savings & Loan* (1992) 11 Cal.App.4th 109, 115-16.)

Apartments, Inc. v. Superior Court (2004) 121 Cal.App.4th 773, 788.)

iii. *Dual Representation of a Plaintiff's Individual Claims Against a Corporation and a Plaintiff's Derivative Claims Brought on Behalf of the Corporation:*

- (1) A plaintiff suing a corporation in a derivative capacity assumes a fiduciary duty to the corporation and its stockholders as a group.
 - (i) “A stockholder who institutes [a derivative suit] sues purely as a trustee to redress corporate injuries. He has the unquestioned right to sue, but it is in no sense his duty to sue... He is a trustee pure and simple, seeking in the name of another a recovery for wrongs that have been committed against that other. His position in the litigation is in every legal sense the precise equivalent of that of the guardian ad litem.” (*Whitten v. Dabney* (1915) 171 Cal. 621, 629-31.)
 - (ii) Derivative plaintiffs (like class representatives) are required to fairly and adequately represent the interests of other shareholders. (Fed. Rules Civ.Proc., rule 23.1(a), 28 U.S.C; *Zarowitz v. BankAmerica Corp.* (9th Cir. 1989) 866 F.2d 1164, 1166 (“Rule 23.1 requires a representative plaintiff to represent the other shareholders ‘fairly and adequately.’ Under this standard, [a derivative plaintiff can] not serve as a representative plaintiff...[where his] interests converge with the interests of [the corporation’s] shareholders in a few respects, but [] diverge from them significantly in others.”).)
 - (iii) The United States Supreme Court set forth in strong terms the strict obligations of a plaintiff in a derivative suit: “[A] stockholder who brings suit on a cause of action derived from the corporation assumes a position, not technically as a trustee perhaps, but one of a fiduciary character. He sues, not for himself alone, but as representative of a class comprising all who are similarly situated. The interests of all in the redress of the wrongs are taken into his hands, dependent upon his diligence, wisdom and integrity. And while the stockholders

have chosen the corporate director or manager, they have no such election as to a plaintiff who steps forward to represent them. He is a self-chosen representative and a volunteer champion.” (*Cohen v. Beneficial Loan Corp.* (1949) 337 U.S. 541, 549 [69 S. Ct. 1221].)⁴⁴

- (iv) Other jurisdictions: “Plaintiff herein purports to bring this action in both an individual and derivative capacity; however, his papers do not address the issue of the propriety of his seeking to recover personally against Federated, and simultaneously, prosecuting a claim on behalf of Federated. This potential conflict of interest has been recognized by the courts in this jurisdiction, with the result that plaintiff must, on occasion, choose between the pursuit of his personal interest and that of the corporation. See e.g., *Hawk Industries, Inc. v. Bausch & Lomb, Inc.* (S.D.N.Y. 1973) 59 F.R.D. 619; *Ruggiero, supra*, 56 F.R.D. 93. See also, *Emler Ind., Inc. v. Patentex, Inc.* (2d Cir. 1973) 478 F.2d 562. Since plaintiff ignores this substantial question and has made no showing that he can ‘fairly and adequately represent the interests of the shareholders...in enforcing the right of the corporation’ as required by Fed. Rules Civ.Proc., rule 23.1, 28 U.S.C., it must be assumed that he presses the Section 14(e) claim in his individual capacity only.” (*Petersen v. Federated Development Co.* (S.D.N.Y. 1976) 416 F.Supp. 466, 475.)
- (2) Counsel representing a plaintiff’s derivative claims against a corporation assumes plaintiff’s fiduciary duties to that corporation.
 - (i) Agency: Basic principles of agency dictate that, a plaintiff’s counsel assumes plaintiff’s fiduciary duties. (Civ. Code § 2295, et seq.; Rest.3d Agency, § 1.01, com. e & g; Rest.2d Torts, § 874, com. c (“A person who knowingly assists a fiduciary in committing a breach of trust is himself guilty of tortious conduct and is subject to liability for the harm thereby caused.”); 1 Witkin, Cal. Procedure

⁴⁴ Other jurisdictions have come to similar conclusions. (See, e.g., *Certain-Teed Products Corp. v. Topping* (2d Cir. 1948) 171 F.2d 241, 243 (holding that plaintiff carrying the torch owes a duty to the corporation).)

(4th ed. 1997) Attorneys, § 128, p. 168 (“The fiduciary relationship makes it improper for an attorney to act contrary to, or assume a position inconsistent with, the interests of a present or former client.”); *Zador Corp. v. Kwan* (1995) 31 Cal.App.4th 1285, 1293 (“Because of this fiduciary relationship, it is improper for an attorney to assume a position which is inconsistent with the interest of present or former clients.”)

- (ii) Compare *In re Oracle Corp. Securities Litigation* (N.D.Cal. Apr. 22, 2005, No. C 01-0988 MJJ) 2005 U.S. Dist. Lexis 35723, at *5 (finding that an attorney’s former client’s interests and the attorney’s present client’s interests were not adverse and, thus, the presumption of a conflict (and hence, mandatory disqualification of the attorney) under California law did not apply. Moreover, the court found that there was no evidence that an actual conflict had ripened out of a mere theoretical conflict brought about by the attorney’s former representation of the first client. In support, the court cited *In re Dayco Corp. Derivative Securities Litigation* (S.D. Ohio 1984) 102 F.R.D. 624, 630 (“counsel can represent a stockholder bringing *both* an individual and a derivative action” because playing this dual role is only a “surface duality” that presents a *potential* for conflict, and is not a conflict *per se*).
- (iii) Other jurisdictions: Cited for its broadest principle, *Teckni-Plex, Inc. v. Meyer* (1996) 89 N.Y.2d 123, 136 [674 N.E.2d 663], stands for the proposition that any counsel who serves in a dual capacity where there are corporations and shareholders involved has a conflict. (Compare *Gonzalez v. Chillura* (Fla. 2004) 892 So.2d 1075, 1077-78 (holding that an attorney representing both plaintiff’s derivative and personal claims against a corporation was *not* in an attorney-client relationship with the corporation merely because attorney represented plaintiff’s derivative claims against the corporation).)
- (iv) It is elementary in derivative litigation that the organization is named as a nominal defendant, but is, in reality, a plaintiff since the derivative plaintiff

is suing on behalf of the organization; the plaintiff is merely standing in the shoes of the organization's rights, not their own. (*McDermott Will & Emery v. Superior Court* (2000) 83 Cal.App.4th 378, 383; *Spellacy v. Superior Court in and for L. A. County* (1937) 23 Cal.App.2d 142, 147 (holding that the corporation is the real party in interest in derivative suits by minority stockholders and that such minority stockholders stand in a fiduciary relationship akin to a trustee or guardian ad litem). Therefore, for all intents and purposes, counsel for a derivative plaintiff represents the corporation and its interests. (*Ibid.*.)

- (3) Derivative plaintiff's counsel breaches its fiduciary duty of loyalty to a corporation when it represents interests adverse to a corporation's derivative claims.
 - (i) While allegedly "championing" the rights of the corporation, in the guise of derivative claims, a complaint wherein the plaintiff is also alleging personal claims *against* the corporation reveals on its face that plaintiff (and therefore, plaintiff's counsel) has taken a position directly adverse to the corporation and its shareholders. While plaintiff (in his individual capacity) is seeking to succeed on these allegations against the corporation, these exact same allegations against the corporation are per se harmful to the corporation and its shareholders as the benefit of a judgment on these claims in plaintiff's favor are inversely proportional to the detriment of such a judgment on the corporation and its shareholders.⁴⁵ It is here, at the threshold, where plaintiff's personal interests and the interests of the corporation diverge—thus, dividing loyalties owed by plaintiff's counsel.
 - (ii) Concurrent Representation of Clients with Divergent Interests: "The primary value at stake in cases of simultaneous or dual representation is the

⁴⁵ "A conflict of interest exists when a lawyer's duty on behalf of one client obligates the lawyer to take action prejudicial to the interests of another client, i.e., 'when in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose.' [*Flatt, supra*, 9 Cal.4th at p. 282.] An 'adverse' interest is one that is 'hostile, opposed, antagonistic...detrimental, unfavorable' to one's own interests. [See *Ames v. State Bar* (1973) 8 Cal. 3d 910, 917]." (*Moreno v. AutoZone, Inc.* (N.D.Cal. Dec. 6, 2007, No. C05-04432 MJJ), 2007 WL 4287517, slip op. at *5.)

attorney's duty-and the client's legitimate expectation-of *loyalty*, rather than confidentiality.” (*Flatt, supra*, 9 Cal.4th at p. 284 (italics in original).) “[R]epresentation adverse to a *present* client must be measured not so much against the similarities in litigation, as against the duty of undivided loyalty which an attorney owes to each of his clients.” (*Truck Ins. Exchange v. Fireman's Fund Ins. Co.* (1992) 6 Cal.App.4th 1050, 1056 (italics in original) (“*Truck Ins.*”).)⁴⁶

6. **Privilege Waiver Issues in Connection with SEC Investigations.**

Securities class actions may piggy back on the Securities and Exchange Commission’s (“SEC”) power as a regulatory agency to induce corporations to turn over otherwise privileged documents. Plaintiffs often subpoena the SEC for documents related to investigations.⁴⁷ In *In re Worlds of Wonder Securities Litigation* (N.D.Cal. 1992) 147 F.R.D. 208, the SEC conducted an informal investigation of a Fresno-based toymaker after the company filed for bankruptcy protection. The toymaker turned over certain documents to the SEC, expressly reserved all its rights, submitted the information confidentially, and requested confidential treatment from the SEC’s Freedom of Information Act officer. The court, however, refused to quash a subpoena served on the SEC for the documents, concluding that, in sharing the documents with the SEC, the toymaker had waived any work product privilege. The court rejected any distinction between a formal and informal SEC inquiry for the purposes of analyzing waiver. (*Id.* at p. 212.) The court also rejected the toymaker’s policy argument that permitting third parties to subpoena documents voluntarily given to the SEC by targets of informal inquiries would render corporations less likely to cooperate with the SEC. “[T]here is no need to encourage corporations to cooperate with agencies' investigations,” the court reasoned, “since it is in the corporations’ best interests to do so, in order to forestall enforcement actions by the agencies.” (*Id.* at p. 213.)

a. Selective Waiver

- i. Informal investigations by the SEC present a particular quandary for counsel representing the target. The SEC is often willing to enter into confidentiality agreements with the target of the investigation in exchange for full cooperation, but, by turning over privileged materials, the corporation risks waiving its attorney-client and work product privileges. A number of courts have

⁴⁶ Cf. *Flatt, supra*, 9 Cal.4th at p. 283 (discussing the attorney’s fiduciary duty of *confidentiality* (as opposed to loyalty) as being the primary value at stake where counsel represents a present client with interests adverse to counsel’s former client); *Truck Ins., supra*, 6 Cal.App.4th at p. 1056.

⁴⁷ See Mahoney, *The SEC Enforcement Process: Practice and Procedure in Handling an SEC Investigation in the Sarbanes-Oxley Era* (BNA Corporate Practice Series (3rd ed. 2007)), no. 77-3rd, Chap. XVI.

considered this question more generally in terms of whether cooperation with a government agency constitutes disclosure that waives the attorney-client and/or work product privileges.

- ii. *Majority Rule:* Most circuits have ruled that the holder of the attorney-client privilege may not “selectively” waive it in the context of a government investigation, i.e., it cannot waive the privilege to the government but maintain the privilege vis-à-vis others. (*In re Qwest Communications Internat., Inc.* (10th Cir. 2006) 450 F.3d 1179, 1201; *In re Columbia/HCA Healthcare Corp. Billing Practices Litigation* (6th Cir. 2002) 293 F.3d 289, 302-03; *Westinghouse Electric Corp. v. Republic of Philippines* (3d Cir. 1991) 951 F.2d 1414, 1424-25; *U.S. v. Mass. Inst. of Technology* (1st Cir. 1997) 129 F.3d 681, 686; *In re Martin Marietta Corp.* (4th Cir. 1988) 856 F.2d 619, 623-24; *In re John Doe Corp.* (2d Cir. 1982) 675 F.2d 482, 489; *Permian Corp. v. U.S.* (D.C. Cir. 1981) 665 F.2d 1214, 1220 (“*Permian*”).)
- iii. *Minority Rule:* Selective waiver is available in limited circumstances in cases of disclosure to government agencies. (*Diversified Industries, Inc. v. Meredith* (8th Cir. 1977) 572 F.2d 596, 611 (“*Diversified Industries*”) (en banc) (disclosure of privileged documents to SEC pursuant to a subpoena constituted only a “limited waiver”).)
- iv. The dueling policy interests behind selective waiver:
 - (1) Courts rejecting selective waiver: “The client cannot be permitted to pick and choose among his opponents, waiving the privilege for some and resurrecting the claim of confidentiality to obstruct others, or to invoke the privilege as to communications whose confidentiality he has already compromised for his own benefit.” (*Permian, supra*, 665 F.2d at p. 1221.)
 - (2) Courts adopting selective waiver: “To hold otherwise may have the effect of thwarting the developing procedure of corporations to employ independent outside counsel to investigate and advise them in order to protect stockholders, potential stockholders and customers.” (*Diversified Industries, supra*, 572 F.2d at p. 611.)
- v. In the Ninth Circuit, the law regarding selective waiver continues to be evaluated by the courts. (*Aronson v. McKesson HBOC, Inc.* (N.D.Cal. Mar. 31, 2005, No. 99-CV-20743) 2005 U.S. Dist. Lexis 7098, at *38.)

- (1) The leading recent case is *U.S. v. Reyes* (N.D.Cal. 2006) 239 F.R.D. 591, in which Brocade Communications Systems, Inc., hired two firms to conduct an internal investigation of its practices for granting stock options. The firms took handwritten notes of interviews with Brocade employees, but did not prepare a written report of their findings. After Brocade issued a major earnings restatement, the firms provided an oral presentation to the SEC and Department of Justice (DOJ), but no written materials, regarding their findings. Reyes, Brocade's CEO, was indicted, and he sought to subpoena the firms' notes and presentation to the government, which he argued would be exculpatory. Brocade asserted both the attorney-client and attorney work product privileges. The court ruled that Brocade had waived these by permitting counsel to provide such materials to the SEC and DOJ. (*Id.* at p. 604.)
 - (2) In another Northern District of California case, *SEC v. Roberts*, 07cv4580, the court expressed skepticism at oral argument that the corporation had waived its attorney-client privilege in a similar set of facts simply by cooperating with an outside law firm conducting an independent investigation. The court has yet to rule on the issue. (Anderson, *Disclosure Shouldn't Always Waive Privilege*, *Judge Says*, L.A. Daily Journal (Feb. 26, 2008).)
- b. In late 2006, the DOJ announced revisions to its corporate charging guidelines for federal prosecutors. In accordance with those guidelines, requirements have been imposed before federal prosecutors may seek waivers of attorney-client privilege and work product protections in corporate criminal investigations. The guidelines indicate "that attorney-client communications should be sought only in rare circumstances" and that, in deciding whether to charge a corporation, prosecutors are not to consider whether the corporation declined to provide attorney-client communications. (U.S. Deputy Attorney General Paul J. McNulty Revises Charging Guidelines for Prosecuting Corporate Fraud, Department of Justice (Dec. 12, 2006), *available at* http://www.usdoj.gov/opa/pr/2006/December/06_odag_828.html) (as of March 27, 2008).)

7. Settlement and Fees.

"Courts have affirmative duties to protect the interests of the absent class members. A court has a 'fiduciary duty' to the absent members in the context of settlement approval. (*7-Eleven Owners for Fair Franchising v. The Southland Corp.* (2000) 85 Cal.App.4th 1135, 1146-47 ("the trial court was under a fiduciary duty running to the absent class members to ensure the settlement was 'fair,

adequate and reasonable.”).) The Class Action Fairness Act of February 2006 encourages that the court view coupon settlements suspiciously and evaluate them in detail.” (Karpman Article, *supra*, at p. 21.)

While the attorneys’ substantial involvement in the handling and resolution of class action litigation is undeniable, the courts monitor the proceedings closely on behalf of the absent class members, i.e., despite agreement among counsel, a class action settlement cannot be consummated without a thorough review by the courts and a determination that the terms are fair, reasonable and adequate to the absent class members. Pursuant to Rule 23 of the Federal Rules of Civil Procedure (28 U.S.C.), the court presides over a fairness hearing where it fully reviews the entire settlement. Such depth of involvement by the court and continual hands-on management by the attorneys in class actions tend to relegate clients to little more than bit players in the show’s supporting cast. (*Best Buy, supra*, 137 Cal.App.4th at pp. 777-79 (finding that if a client is deemed inadequate, an attorney can personally step in as a “place holder” until an adequate client can be located).)

“The concurrent negotiation of settlement and fees creates a classic conflict (*Ramirez v. Sturdevant* (1994) 21 Cal.App.4th 904, 923 (“*Ramirez*”)), because the duty of preference suggests a lawyer will prefer his own interest to the detriment of the class. Therefore, generally, fees should be negotiated after settlement.” (Karpman Article, *supra*, at p. 21.) However, the courts engage in a nuanced analysis in this area;⁴⁸ simultaneously negotiated fees will not automatically be rejected, but will be balanced with a consideration of other factors.⁴⁹ Each case must be separately considered and scrutinized, because specific circumstances could “neutralize” the conflict.⁵⁰

- a. Defense Perspective: Once settlement in principle is reached, it is not uncommon for defense counsel to want to enlarge the class or claim in order to increase the scope of the preclusive effect and protect their client from future claims.
- b. Third-Party Payments: Another ethical issue appears where the legal fees are to be paid by a third party of a settlement. In this instance, the attorney should first settle the client’s claim and, thereafter, obtain the necessary

⁴⁸ Parrish, *The Dilemma: Simultaneous Negotiation of Attorney’s Fees and Settlement in Class Actions* (1999) 36 Hous. L.Rev. 531.

⁴⁹ *Ramirez, supra*, 21 Cal.App.4th at pp. 919-26.

⁵⁰ In *Mendoza v. U.S.* (9th Cir. 1980) 623 F.2d 1338, 1352-53, cert. den. (1981) 450 U.S. 912 [101 S.Ct. 1351] (“*Mendoza*”), the court articulated a general ban on simultaneous negotiations of merits and attorneys’ fees issues in order to prevent attorneys from trading relief benefiting the class for a more generous fee for themselves in a school desegregation case. However, the court made an exception due to the neutral factors that were created by the involvement and constant presence of the Justice Department in the settlement of the action. Moreover, in 1986, the U.S. Supreme Court disapproved of *Mendoza*’s own general disapproval of the simultaneous settlement negotiation of both the merits of a case and attorneys’ fees. (*Evans v. Jeff D.* (1986) 475 U.S. 717, 725 [106 S.Ct. 1531].) Thus, the simultaneous negotiation of settlement and fees is not per se improper, but must be considered with the surrounding environment of the case.

court approval before negotiating fees. (*Prandini v. Nat. Tea Co.* (3d Cir.1977) 557 F.2d 1015, appeal after remand (1978) 585 F.2d 47.)

- c. Conflicts: Be mindful of inherent conflicts in the settlement arena. In *Cal Pak, supra*, 52 Cal.App.4th 1, counsel was disqualified for a breach of the duty of loyalty (and, hence, failing to provide adequate representation) when counsel offered to have the sole class representative of a prospective class release the claim in exchange for paying the attorney \$8-10 million while the class would receive nothing.
- d. Due Process and Settlement: Due process requires that notice in a class action present a fair recital of the subject matter and proposed terms and provide an opportunity to be heard to all class members. (*Marshall v. Holiday Magic, Inc.* (9th Cir. 1977) 550 F.2d 1173, 1177 (superseded on other grounds by *Phillips Petroleum v. Shutts* (1985) 472 U.S. 797).)

Notice of a class settlement must advise class members of everything they need to know in order to make an informed decision about being bound by the settlement, opting out, or objecting to its terms if the class is certified. Class settlement documentation must include, among other things, a brief description of the case, the exclusion date for persons not wishing to be bound by the settlement, specific exclusion criteria, attorneys' fees to be paid by the class as part of the settlement, and the total recovery and anticipated benefit to the class with expenses and costs specified. (Cohelan, *supra*, at § 9.11, p. 375; see *Valerio v. Boise Cascade Corp.* (N.D.Cal. 1978) 80 F.R.D. 626, 636-37 (“*Valerio*”).)

Documentation should state that class members who do not exclude themselves will be subject to a binding judgment in favor of the settling defendant under *res judicata* and that the attorneys for the proposed class in the settlement will continue to represent all class member who do not opt out. (Cohelan, *supra*, at § 9.11, p. 376; see also L.A. County Superior Court Rules, Class Actions Manual, § 15.18(f).) Adequate notice may satisfy the requirement of adequacy of representation: “due process may be satisfied by notice alone and [], where due process is thus satisfied, adequacy of representation need not be shown as a matter of constitutional necessity.” (*Valerio, supra*, 80 F.R.D. at p. 639 (citing *In re Four Seasons Securities Laws Litigation* (10th Cir. 1974) 502 F.2d 834, 843).) Information on pending but unresolved class cases as of the date of the proposed settlement is also important. (*Trotsky v. L. A. Federal Savings & Loan Assn.* (1975) 48 Cal.App.3d 134, 150-51.)

- e. Fees: Settlement may entail significant potential conflicts of interest. Plaintiff's counsel, particularly in common fund situations, face the tension of a contingent fee morphing into a set amount in settlement discussions. Well-structured settlements explicitly subordinate the

interests of the lawyers to the interests of the clients. (Cohelan, *supra*, at § 9.16, p. 381.)

8. Improper Payments to Class Representatives.

This issue has been the subject of a great deal of media attention in the past year. Civil and criminal actions have targeted many high profile members of the bar with serious repercussions.

- a. California Business and Professions Code sections 6152 and 6153 prohibit the solicitation of persons to act as runners or cappers for the solicitation of business for attorneys.
- b. The payment of enhancements or incentive awards to class representatives by class counsel must be approved by the court at the fairness hearing.
- c. Enhancements are justified because class representatives incur hardships not incurred by the absent class members. They are subjected to discovery, must communicate with absent class members, and communicate with class counsel and assume burdens that other members do not share.⁵¹ Incentives can compensate class representatives for their out of pocket costs and can vary depending upon the character of the underlying litigation and the risk assumed by the representative. Therefore, greater incentives are approved for employment discrimination cases where a class representative may become the target for retaliation.⁵²
- d. These payments must be approved and fully disclosed to the court in the fairness hearing. Undisclosed payments are tantamount to kickbacks, and may fall within the penumbra of Business and Professions Code sections 6152 and 6153.
- e. Disclosure obligations to the court are enhanced in aggregate litigation. The court becomes a fiduciary for absent class members.⁵³ When the court stands in the shoes of absent clients, deception to the court is tantamount to dishonesty to the client, and may constitute obstruction of justice. This enhanced duty of honesty exists in other forums, such as bankruptcy proceedings.⁵⁴ In 2006, a prominent law firm and several client recipients of undisclosed “incentives” were indicted for failure to disclose alleged “side payments.”⁵⁵

⁵¹ Nagareda, *Restitution, Rent Extraction, and Class Representatives: Implications of Incentive Awards* (2006) 53 UCLA L.Rev. 1483 (“Nagareda Article”).

⁵² Eisenberg and Miller, *Incentive Awards to Class Action Plaintiffs: An Empirical Study* (2006) 53 UCLA L.Rev. 1303.

⁵³ *Cal Pak*, *supra*, at p. 12.

⁵⁴ Regan, *Eat What You Kill: The Fall Of A Wall Street Lawyer* (2005) (a story of a Millbank Tweed partner who was indicted for failing to disclose a conflict of interest on several occasions to a bankruptcy court).

⁵⁵ Nagareda Article, *supra*, at p. 1494.