The Necessity for Independent Counsel in Derivative Litigation

Brandon Schwartz

Derivative litigation is relatively rare, but growing, in Minnesota.[1] On the other hand, the necessity that each party in litigation has independent counsel advocating on behalf of their respective rights is well-established. This article discusses the interplay between these two concepts and when it is necessary for independent counsel to be engaged on behalf of the entity[2] in derivative litigation. To do so, however, it is necessary to understand what derivative litigation is, what derivative litigation entails, and the particular Minnesota Rules of Professional Conduct which impact the decision to retain independent counsel on behalf of the entity.

Derivative Claims vs. Direct Claims.

A derivative claim is a creation of equity in which the individual[3], in effect, steps into the entity's shoes and seeks restitution on the entity's behalf.[4] "Derivative suits allow [individuals] to bring suit against wrongdoers on behalf of the [entity], and force liable parties to compensate the [entity] for injuries so caused."[5] As a general rule, the individual may not assert a cause of action that belongs to the entity[6] unless and until the entity fails to take action on its own behalf.[7] Derivative actions provide concerned individuals a check against abuses committed by those in control of the entity.[8] Commonly, derivative suits allege improper actions by those in charge of the entity including, self-dealing by those in charge, entity mismanagement, or breaches of the duties of loyalty and care owed to the entity and the entity's owners.

Direct claims are those seeking redress to the individual directly. Examples of direct claims include the individual being unable to vote on a particular entity action[9] or the denial of

[1] *See In re Xcel Energy, Inc.*, 222 F.R.D. 603, 606 (D. Minn. 2004).

[2] Because Minnesota provides statutory authority for shareholders to bring derivative litigation for the benefits of a corporation, Minn. R. Civ. P. 23.09, members to bring derivative litigation for the benefits of a limited liability company, Minn. R. Civ. P. 23.09, and partners to bring derivative litigation for the benefits of a partnership, Minn. Stat. § 321.1002, "entity", "corporation", "limited liability company" and "LLC" are used interchangeably in this article.

[3] The term "individual" will be used to describe the shareholder, member or partner bringing the derivative suit. It is important to note that the individual must have an ownership interest in the entity during the applicable time to derive standing to bring the derivative action. *See* Minn. R. Civ. P. 23.09 requiring the individual to be a "shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law" and Minn. Stat. § 321.1002 which requires the individual to be a "partner" of the partnership.

[4] *In re UnitedHealth Group Inc., S'holder Derivative Litig*., 754 N.W.2 544, 550 (Minn. 2008).

[5] *UnitedHealth Group Inc.*, 754 N.W.2d at 550 (quoting *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 882 (Minn. 2003)).

[6] *Northwest Racquet Swim & Health Clubs, Inc. v. Deloitte & Touche*, 535 N.W.2d 612, 617 (Minn. 1995).

[7] *Blohm v Kelly*, 756 N.W.2d 147, 153 (Minn. Ct. App. 2009) (citing *Janssen*, 662 N.W.2d at 882).

[8] *UnitedHealth Group Inc.*, 754 N.W.2d at 550.

[9] *Warthan v. Midwest Consol. Ins. Agencies, Inc.*, 450 N.W.2d 145, 149 (Minn. Ct. App. 1995).

an individual's right to inspect the entity's books and records[10] or when only one individual has been singled out to not receive a dividend from the entity.[11] Simply, a direct claim seeks redress for harm to that particular individual and not as a consequence of damage to the entity that the individual holds an ownership interest in.[12]

The central inquiry in determining whether a claim is direct or derivative is "whether the complained-of injury was an injury to the [individual] directly, or to the [entity]."[13] "In analyzing whether a claim is direct or derivative, [Minnesota courts] look not to the theory in which the claim is couched, but instead to the injury itself."[14] "Where the injury is to the [entity], and only indirectly harms the [individual], the claim must be pursued as a derivative claim."[15]

Asserting a Derivative Claim.

Once it has been determined that the claim is a derivative claim, there are procedural requirements to properly asserting it.

Minn. R. Civ. P. 23.09[16] requires, in pertinent part, that the individual's complaint contain the following:

> The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action ***or*** for not making the effort.

(Emphasis added.)

Thus, to properly bring a derivative action on behalf of the entity, the individual must specifically state what efforts they made prior to filing the litigation to obtain the redress sought in the litigation, or alternatively, allege why the individual did not previously seek redress. Minnesota courts have provided guidance on these two alternative requirements.

One route is for the individual to make a demand on the entity's

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[10] *Warthan*, 450 N.W.2d at 149.

[11] *Wessin v. Archives Corp*., 592 N.W.2d 460, 464 (Minn. 1999) (citing *Segerstrom v. Holland Piano Mfg. Co.*, 199 N.W. 897, 899 (Minn. 1924); *Murphy v. Country House, Inc.*, 349 N.W.2d 289, 292 (Minn. Ct. App. 1984)).

[12] *See Stocke v. Berryman*, 632 N.W.2d 242, 247 (Minn. Ct. App. 2001) ("To be entitled to bring a direct action, a shareholder or member must be able to allege some injury or harm that is separate and distinct from the injury or harm to the corporation and that is not dependent on the harm to the corporation.").

[13] *Blohm*, 765 N.W.2d at 153 (quoting *Wessin*, 592 N.W.2d at 464).

[14] *Wessin*, 592 N.W.2d at 464.

[15] *Blohm*, 765 N.W.2 at 153 (quoting *Wessin*, 592 N.W.2d at 464).

[16] As it relates to partnerships, Minn. Stat. § 321.1003 requires a similar demand futility requirement, providing:

> A partner may maintain a derivative action to enforce a right of a limited partnership if: (1) the **partner first makes a demand on the general partners**, requesting that they cause the limited partnership to bring an action to enforce the right, and the general partners do not bring the action within a reasonable time; **or** (2) a **demand would be futile**.

(emphasis added).

management[17] before filing a derivative action.[18] The requirement to demand redress from the entity's management is because the decision to pursue a legal claim on behalf of the entity involves "the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most [entity] problems."[19] This decision is best done by the entity's management, "which is familiar with the appropriate weight to attribute to each factor given the [entity's] product and history."[20]

Alternatively, Minnesota law has long held that a demand is unnecessary if the wrongdoers constitute a majority of those in control of the entity and it is "plain from the circumstances that [demand] would be futile."[21] While Minnesota courts have held that disinterested entity management is in the best position to determine whether the entity should pursue redress, the demand futility requirement acknowledges that wrongdoers are not going to willingly have the entity pursue claims against themselves for their own wrongdoing. "The determination of demand futility is a mixed question of law and fact left to the discretion of the district court. Minnesota courts often look to the decisions of Delaware courts for guidance in this area. Delaware has developed two approaches to claims of demand futility."[22]

Under the first approach set forth in *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984), a pre-suit demand may be excused when there is reasonable doubt "as to whether, at the time the suit was filed, a majority of the [management was] disinterested in the matter and able to act independently."[23] In the second prong, "the demand requirement is also excused if it is doubtful that the transaction objected to in the lawsuit resulted from the [management's] proper exercise of business judgment. To satisfy either prong of the *Aronson* analysis, however, the complaint must set forth, with particularity, facts showing that a demand would have been futile."[24]

The business judgment rule[25] means "that as long as the disinterested [management] made an informed decision, in good faith, without an abuse of discretion, he or she will not be liable for [entity] losses resulting from his or her decision."[26] The business judgment rule grants a degree of deference to the decisions of management.[27] In *Janssen,*

[17] "Management", in this article, refers to a corporation's board, a limited liability company's manager(s), or a partnership's general partner.

[18] *Markewich ex rel. Medtronic, Inc. v. Collins*, 622 F.Supp.2d 802, 807 (D.Minn. 2009) *citing Winter v. Farmers Educ. & Co-op. Union of Am.*, 107 N.W.2d 226, 233 (Minn. 1961).

[19] *Janssen*, 662 N.W.2d at 883.

[20] *Janssen*, 662 N.W.2d at 883.

[21] *Winter*, 107 N.W.2d at 234 ("Ordinarily a demand should be made on the board of directors **unless** the **wrongdoers constitute a majority of the board**, and a demand should be made on the shareholders unless **they are powerless to ratify the wrong** alleged or **unless the majority of their number is interested**." (emphasis added)); *see also Markewich ex rel. Medtronic, Inc. v. Collins*, 622 F.Supp.2d 802, 808 (D. Minn. 2009) (quoting *Rales v. Blasband*, 634 A.2d 927, 930 (Del. 1993) ("a demand is futile when 'particularized facts create a reasonable doubt that a majority of the Board would be disinterested or independent in making a decision on a demand.")).

[22] *In re Xcel Energy, Inc.*, 222 F.R.D. at 606.

[23] *Id.*

[24] *Id.*

[25] The business judgment rule is codified as Minn. Stat. § 302A.251 for corporations and Minn. Stat. § 322B.69 for limited liability companies.

[26] *Janssen*, 662 N.W.2d at 882.

[27] *Id.*

the Minnesota Supreme Court stated that one reason the business judgment rule is used in derivative claims is because "courts are ill-equipped to judge the wisdom of business ventures and have been reticent to replace a well-meaning decision by [management] with their own."[28] The *Xcel Energy* Court also noted that courts are "reluctant to interfere in the inner workings of an [entity]."[29] "As a result, there is a 'presumption that in making a business decision, the [management] of [an entity] acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the [entity]."[30] If, however, there is a reasonable doubt that management properly applied their business judgment, then the demand requirement is excused.[31]

The second approach to determine whether a demand would have been futile in a derivative claim is based on *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993). This analysis recognizes that the business judgment rule only applies to cases of affirmative management action.[32] The purpose of this approach is to determine whether the management was so conflicted that it could not have properly responded to a demand. "Where there is no conscious decision by [management] to act or refrain from acting, the business judgment rule has no application."[33] That being so, if the management's inaction "is not the product of conscious decision, the demand futility analysis considers only whether a majority of the [management] had a disqualifying interest in the matter or were otherwise unable to act independently."[34] Basically, if management did not deliberately exclude themselves from making a decision on the allegations, then the court should only consider whether most of the management has a disqualifying (personal) interest in the matter or if they were unable to exercise independent judgment for other reasons. "Under the *Rales* analysis, the absence of a pre-suit demand is excused only if a majority of the directors had a personal interest in the disputed conduct or were unable to exercise independent judgment for some other reason."[35]

Captioning the Case.

When asserting a derivative action, although the claim is on behalf of the entity, the entity is actually labeled a "defendant" in the case caption. The title of "plaintiff" versus "defendant" has caused some confusion with regards to the conflict of interest analysis discussed below.

It is well established that the entity is named as a "nominal" defendant in a derivative action, notwithstanding the fact that the derivative claims are asserted by the individual on behalf of the entity and against the wrongdoers:

> It is well established that an entity on whose behalf a derivative claim is asserted is a necessary defendant in the derivative action.[36]

[28] *Id.*
[29] *In re Xcel Energy, Inc.*, 222 F.R.D. at 606 (quoting *Westgor*, 318 N.W.2d at 58).
[30] *Id.* (quoting *Aronson*, 473 A.2d at 812).
[31] *Professional Management Associates, Inc. v. Coss*, 574 N.W.2d 107, 110 (Minn. Ct. App. 1998) (citing *Aronson*, 473 A.2d 805).
[32] *In re Xcel Energy, Inc.*, 222 F.R.D. at 606.
[33] *Id.* (citing *Aronson*, 473 A.2d at 813).
[34] *Id.*
[35] *Id.*
[36] *Buckley v. Control Data Corp.*, 923 F.2d 96, 99 (8th Cir. 1991) (emphasis added); *see also*

A number of secondary sources similarly explain that a derivative action is captioned with the entity named as a nominal defendant:

> The shareholder is considered a nominal plaintiff in a particular derivative suit. The **corporation then becomes the nominal defendant**. However, the corporation usually gains from the recovery if ever the shareholder wins the case.[37]

Thus, while it is somewhat of an anomaly to be asserting claims, but be named as a defendant, the entity is only a nominal defendant and is in effect a plaintiff asserting claims against the alleged wrongdoers. The individual asserting the derivative claims on behalf of the entity is a named plaintiff, while the management alleged of wrongdoing is the true defendant. While the entity is named as a nominal defendant, the entity will recover any settlement or judgment against the management if the derivative claim is successful.

Representation of Multiple Parties.

With that (basic) understanding of derivative litigation, the potential conflicts of interest involved in derivative litigation come to light – conflicts of interest which the Minnesota Rules of Professional Conduct address.

Minnesota law makes clear that an entity is separate and distinct from its owners.[38] Separate and distinct from its owners, an entity is thus entitled to its own legal representation. In fact, an entity cannot appear *pro se* and must appear through an attorney in litigation.[39]

Minnesota Rule of Professional Conduct 1.13 deals with an attorney's representation of an entity. Rule 1.13(a) provides that a lawyer retained by the entity represents the entity, "acting through its duly authorized constituents." As it relates to derivative litigation, Rule 1.13(f) provides:

> A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders, or other constituents, subject to the provisions of Rule

Warner v. E.C. Warner Co., 266 Minn. 565, 570 (Minn. 1948); *Tomash*, 281 Minn. 21, 24; *Janssen*, 704 N.W.2d at 761.

[37] *Understanding the Shareholders Derivative Suit*, Lala C. Ballatan (emphasis added); *see also Derivative Lawsuits*, Robert J. McGaughey; *Corporations in Conflict*, Sa'id Vakili, Los Angeles Lawyer, March 2012.

[38] *See Singer v. Allied Factors*, 13 N.W.2d 378, 380 (Minn. 1944) (holding that a corporation was a distinct entity from its shareholders and all corporate powers, franchises and rights were vested in corporation and not stockholders, and included among such rights was that of suing and defending in its own name); Minn. Stat. § 302A.161, subd. 3 ("A corporation may sue and be sued, complain and defend and participate as a party or otherwise in any legal, administrative, or arbitration proceeding, in its corporate name."); Minn. Stat. § 322B.20, subd. 3 ("A limited liability company may sue and be sued, and complain, defend, and participate as a party or otherwise in any legal, administrative, or arbitration proceeding, in its limited liability company name."); Minn. Stat. § 321.0104(a) ("A limited partnership is an entity distinct from its partners."); Minn. Stat. § 323A.0201(a) ("A partnership is an entity distinct from its partners.").

[39] *Save Our Creeks v. City of Brooklyn Park*, 699 N.W.2d 307, 309 (Minn. 2005).

> 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.[40]

The comments to Rule 1.13 further provide:

> The question can arise whether counsel for the organization may defend such an action. The proposition that the organization is the lawyer's client does not alone resolve the issue. Most derivative actions are a normal incident of an organization's affairs, to be defended by the organization's lawyer like any other suit. However, if the **claim involves serious charges of wrongdoing by those in control of the organization**, a conflict may arise between the lawyer's duty to the organization and the lawyer's relationship with the board. In those circumstances, Rule 1.7 governs who should represent the directors and the organization.[41]

Referenced throughout Minnesota Rule of Professional Conduct 1.13 is Rule 1.7, the Rule of Professional Conduct relating to an attorney's conflict of interest as to current clients. Pertinent to derivative litigation in which the entity has claims against the entity's management, Rule 1.7 (a) provides in pertinent part:

> …a lawyer shall **not** represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
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> (1) the representation of one client will be **directly adverse to another client**; or
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> (2) **there is a significant risk** that the representation of one or more clients will **be materially limited by the lawyer's responsibilities to another client**…[42]

The determination of whether a conflict of interest exists in a derivative action is not resolved, however, by simple, automatic rules. Instead, the inquiry requires a thoughtful balancing of competing interests and a careful review of each case's fact pattern. That inquiry, whether by the entity's and individual defendants' attorney, or by a court examining the propriety of the concurrent representation via a motion to disqualify, begins by considering the distinction between "serious charges of wrongdoing" and "non-serious" charges of wrongdoing as detailed in the

[40] (Emphasis added).
[41] (Emphasis added).
[42] (Emphasis added).

comments to Minnesota Rule of Professional Conduct 1.13.

As aptly noted by one scholar, if the allegations of wrongdoing are serious, there should be no question that an attorney cannot concurrently represent the entity and those charged with wrongdoing:

> While the typical shareholder derivative action is brought against the officers and directors of a corporation, it also names the corporation as a defendant. As such, the question arises as to whether an attorney can simultaneously represent the officers and directors on one hand and the corporation on the other. If the case involves allegations of wrongdoing against the officers or directors, the answer is an ***emphatic no***.
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> …
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> Dual representation of the corporation and individual defendants in a derivative proceeding which asserts a claim of serious wrongdoing by those in control of the corporation is considered **improper** because a potential conflict of interest exists between counsel's duty to the corporate entity and counsel's relationship with the individual defendants.[43]

The Minnesota Court of Appeals has similarly proclaimed its stance when the same attorney represents both the entity and those charged with wrongdoing, requiring said attorney to testify at trial:

> The trial court compelled two members of that firm to testify as to communications between themselves and Blesi [individual charged with wrongdoing] on the theory that by representing both the majority shareholder and the corporation, the **lawyers were in a conflict of interest** position and had a duty to advise Mr. Evans, the minority shareholder, of their advice regarding corporate matters. Therefore, their conversations with Blesi were not privileged.[44]

On the other hand, if the allegations of wrongdoing are not "serious" or are obviously or patently frivolous, having joint counsel represent the entity and those charged with wrongdoing at the outset of a derivative case have obvious benefits. This arrangement is cost effective and

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[43] *Corporations in Conflict*, Sa'id Vakili, Los Angeles Lawyer, March 2012 (citing 13 Fletcher, Cyclopedia of Corporations § 6025 and *Developments in the Law – Conflicts of Interest in the Legal Profession*, 94 Harv. L. Rev. 1244, 1339-40 (1981)).

[44] *Evans v. Blesi*, 345 N.W.2d 775, 780-81 (Minn. Ct. App. 1984) (emphasis added).

convenient for the entity and its management. It also permits all of the defendants to easily share information, present a united defense to the claims, and coordinate their strategy at the early stages of the litigation.

The issue, thus, pivots on the determination of whether the charges of wrongdoing are "serious" or obviously or patently frivolous. At the outset of a derivative action, and certainly prior to any motion to dismiss or disqualify, counsel for the entity should investigate the substance of the claims asserted. If the preliminary investigation unveils no evidence of "serious" wrongdoing, joint representation of the entity and the entity's management charged with wrongdoing is proper. However, if the preliminary investigation reveals the potential for merit to serious charges of wrongdoing, independent counsel should be retained for the entity and those charged with wrongdoing. Retaining separate counsel for the entity and those charged with wrongdoing avoids the appearance of a conflict and avoids the litigation expense should the individual's counsel pursue a motion to disqualify, which would require the court to determine whether the charges of wrongdoing are "serious" or obviously or patently frivolous. As a result, counsel should proceed with extreme caution and undertake a thorough investigation into the claims alleged when determining whether concurrent representation of the entity and the individual management charged with wrongdoing is permissible.

Based on the foregoing, when there are charges of fraud, unethical or illegal conduct, breaches of fiduciary duty, or usurpation of entity opportunities, to name a few "serious" charges of wrongdoing commonly asserted in derivative actions, against the entity's management, counsel should <u>not</u> concurrently represent the entity and those charged of wrongdoing. In these situations, the entity is better served by independent representation: there is no appearance of impropriety; there is no conflict to be raised by the individual to the court; and independent representation for the entity may help resolve the matter early and cost effectively. Avoiding the appearance of conflicted representation by an attorney also ensures that said attorney acts with high ethical standards and retains his or her credibility with the court.

Conclusion.

Derivative suits present complex legal and ethical questions, including questions regarding conflicts of interest. Understanding the differences between direct and derivative claims is necessary to examining whether concurrent representation of the entity and the entity's management is permitted if a derivative claim is asserted. Counsel must be cautious and thorough in investigating the viability of the claims and whether the derivative claims asserted represent "serious" charges of wrongdoing. If they do, independent counsel is necessary for the entity and the individuals comprising the entity's management charged with wrongdoing.

Because of the growing number of derivative actions being asserted in Minnesota, the body of law regarding conflicts of interest in this setting will also probably be expanded and further defined by Minnesota's appellate courts. Counsel should continue to conduct their own thorough analysis and investigation based upon the Minnesota Rules of Professional Conduct with regards to the

propriety of undertaking concurrent representation or continuing concurrent representation when derivative claims are asserted. Ensuring compliance with the Minnesota Rules of Professional Conduct and ensuring that the entity is properly represented must be front and center throughout this analysis and at no time should conflicted representation be undertaken.

As a trial attorney at Schwartz Law Firm in Oakdale, Minnesota, Brandon M. Schwartz focuses his practice primarily on business law and business litigation involving such matters as shareholder disputes, derivative actions, contract creation and litigation, company formation and age discrimination for clients throughout Minnesota, Iowa and Wisconsin. He also provides counsel and litigation representation in personal injury and family law cases. Brandon can be reached at brandon@mdspalaw.com or 651-528-6800. For additional information regarding Brandon and Schwartz Law Firm, please visit schwartzlawfirmpa.com.