

## PROFESSIONAL LIABILITY UPDATE

### ATTORNEY-CLIENT PRIVILEGE

By Jennifer A. Becker

#### ***Reilly v. Greenwald & Hoffman, LLP (2011) 196 Cal.App.4th 891***

*The Fourth District holds that an attorney must be dismissed on demurrer from a shareholder derivative suit where there is no indication that the corporation has waived the privilege and thus the attorney is unable to reveal attorney-client communications in his defense.*

Minority shareholder Mark S. Reilly filed a shareholder derivative action against a corporation and its majority shareholder, Lena Brion and its counsel Greenwald & Hoffman, LLP, and Paul E. Greenwald (“Greenwald”). Reilly sued Greenwald for constructive fraud and negligent misrepresentation, legal malpractice, breach of contract, and conspiracy. Reilly alleged that Greenwald, while acting as corporate counsel, advised the corporation that Brion had no duty or obligation to account for the monies, receivables, personal property and work in progress as of the date of the termination. Reilly also alleged that Greenwald counseled Brion that she and her related business were entitled to appropriate corporate assets to their own use. Greenwald demurred on the premise that the attorney-client privilege between himself and the corporation rendered his defense impossible. The trial court sustained the demurrer without leave to amend.

The Court of Appeal noted that a shareholder derivative action is brought on behalf of the corporation itself when the corporate directors fail to act. A derivative action does not transfer the cause of action from the corporation to the shareholders; the suit belongs to and remains with the corporation. Although the corporation

is a named defendant, the corporation is the real plaintiff and it alone benefits.

A derivative lawsuit for malpractice against corporate outside counsel raises unique attorney-client privilege issues. Evidence Code § 958, which holds there is no privilege for communications that relate to breach of the attorney-client relationship, does not apply to derivative actions. Shareholders “stand in the shoes” of the corporation for most purposes; however this concept does not apply to the attorney-client privilege. The corporation, not the shareholder, holds the privilege and shareholders do not enjoy access to privileged information merely because the attorney’s actions may also benefit them. Nor can shareholders waive the privilege simply by filing a derivative action.

This differs from a direct legal malpractice action which, under E.C. § 958, results in an automatic waiver of the privilege where the attorney can disclose privileged information to the extent necessary for the attorney’s defense. A derivative action has the potential to deprive the attorney defendant of the only means he or she may have to mount any meaningful defense. In the absence of a waiver by the corporation, a

derivative action, necessarily brought in equity, cannot go proceed.

California rejects the federal case-by-case approach which allows a shareholder access to privileged information in a derivative action on a finding of good cause, including a likelihood that the corporate decision would be outside the protections of the business judgment rule. The strict principles set forth in the Evidence Code preclude judicially created exceptions to the attorney-client privilege.

The analysis does not change because the corporation has been dissolved. A dissolved corporation continues to exist for various purposes and its ongoing personnel should be able to assert the privilege, at least until all matters involving the company has been fully resolved and no further proceedings are contemplated. Reilly's derivative suit itself demonstrates the continued existence of the corporation and it is only logical that the corporation continues to hold the privilege. Reilly's complaint concedes that Brion manages the corporation post-dissolution. Even if Brion were not following statutorily required wind-up activities Greenwald is duty bound to claim the privilege absent a waiver.

Evidence Code § 953(d) provides that the holder of the attorney-client privilege is a "successor, assign, trustee in dissolution, or any similar representative of a ... corporation ... *that is no longer in existence.*" A corporation winding up affairs remains in existence including for the purpose of litigating derivative lawsuits and is the holder of the privilege.

The Court rejected Reilly's argument that it was premature to determine the privilege issue at the pleading stage. To dismiss a case at the pleading stage, a court must determine whether (1) the evidence at issue is the client's confidential information, and the client insists that it remain confidential; (2) given the nature of plaintiff's claim the confidential information

is highly material to the defendants' defenses; (3) there are "ad hoc" measures available to avoid dismissal such as sealing and protective orders, limited admissibility of evidence, orders restricting the use of testimony in successive proceedings, and, where appropriate, in camera proceedings; and (4) it would be fundamentally unfair to proceed.

It was unnecessary to perform that analysis because on its face the complaint alleges Greenwald's negligence and tortious conduct facilitated Brion's conversion of corporate assets to her own use. It is clear that Greenwald's confidential communications with Brion are highly material to his defenses. Nor is there any allegation of waiver by the corporation. Under the circumstances, it would be fundamentally unfair to proceed against Greenwald.

A demurrer based on the attorney's inability to defend due to the attorney-client privilege is unique because it asks the trial court to speculate about matters in the future *e.g.*, can the lawyer-defendant adequately defend the case if privileged information cannot be disclosed, rather than to evaluate the legal sufficiency of the complaint actually before it. If it appears that there is a realistic possibility that litigation of the remainder of the action against corporate insiders will result in a waiver of the corporation's privilege or produce additional evidence supporting an exception to that privilege, the trial court should conditionally stay further proceedings against outside counsel, including discovery as to the causes of action against them, and defer consideration of any demurrer or judgment on the pleadings based on counsel's inability to defend because of the lawyer-client privilege. However, Reilly made no showing that there was a realistic possibility of a future waiver and thus the Court of Appeal would not consider the issue.

*Comment:* In practice, courts are reluctant to dismiss claims at the pleading stage based on the attorney's claim that the defense is impaired

by the necessity to protect the attorney-client privilege. Conditional stays are generally easy to obtain upon any showing of a potential that the holder of the privilege will waive the privilege in her or her own defense.