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[California Court of Appeal Issues Ruling on Derivative Legal Malpractice Actions in Favila v. Katten Muchin Rosenman LLP](#)

Monday, October 4th, 2010

In *McDermott, Will & Emery v. Superior Court*, 83 Cal. App. 4th 378 (2000), the California Court of Appeal held that a shareholder derivative action against a corporation's outside counsel, in the absence of the corporation's waiver of the attorney-client privilege, cannot proceed. This is because when facing such a claim, outside counsel will be unable to mount an effective defense without disclosing the privileged communications with the corporation which are alleged to constitute the breach of duty. But what if the attorney-client privilege has allegedly been waived by the privilege holder or otherwise no longer exists? That issue was recently addressed in [Favila v. Katten Muchin Rosenman LLP](#), 188 Cal.App.4th 189 (2010).

In *Favila*, the assets of a dissolved corporation were sold to another corporation after the death of the dissolved corporation's founder and shareholder. The estate of the deceased shareholder then brought derivative claims for breach of fiduciary duty and professional negligence against outside counsel for the dissolved corporation. Outside counsel asserted that the attorney-client privilege prevented them from mounting a meaningful defense.

The Court of Appeal explained that "[t]he practical problem confronting a corporation's outside counsel named as a defendant in a derivative action that led to our decision in *McDermott, Will*, of course, is eliminated if the lawyer-client privilege has been waived by the privilege holder or otherwise no longer exists." The court went on to explain that, under the facts before it, there had been no transfer of the privilege to the successor corporation and persons winding up the dissolved corporation could continue to assert the privilege during the windup process. However, the court concluded that there was a "realistic possibility" that insiders of the dissolving corporation could waive the privilege in the future. The court also cited the unresolved issue as to whether the crime-fraud exception to the attorney-client privilege applied in the case.

In these circumstances, the court ruled that:

if a demurrer to a derivative complaint against outside counsel would otherwise be overruled but for the *McDermott, Will* issue and *there appears to be 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 not sustain the demurrer and dismiss the action. Rather, under these circumstances, the appropriate action is for the court to 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.

It would be unfair to the derivative plaintiff and unnecessary to the preservation of the lawyer-client privilege to dismiss the lawsuit based on the *McDermott, Will* holding only to see the attorneys' client willingly waive its

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privilege to permit other defendants to defend themselves in the same lawsuit or to discover after such a dismissal that the evidence developed in the lawsuit against the allegedly culpable corporate insiders establishes the applicability of the crime-fraud exception of Evidence Code section 956. Thus, the conditional stay should remain in place until the derivative plaintiff can demonstrate the privilege has been waived or the crime-fraud exception established or, alternatively, when the litigation between the derivative plaintiff and the other defendants has been finally resolved, by settlement or judgment, without a waiver or other basis for disregarding the privilege. At that time the trial court may consider and, if appropriate, sustain a demurrer or grant judgment on the pleadings on the causes of action against outside counsel based on *McDermott, Will*.

(Emphasis added.)

Although *Favila* may prevent early-stage dismissals of derivative legal malpractice claims when there is a realistic possibility that the attorney-client privilege will be waived, or that it no longer exists, absent such facts an early demurrer based on *McDermott, Will* should still lie.