

Reliance on Advice of Counsel Defense in Business Torts – Where We are in California Jurisprudence and What it Means for In-House Counsel . by Constance Yu, Partner, Sideman & Bancroft LLP ..

Attorneys are among the wide range of advisors that businesses, officers and directors rely upon to assist them in making informed business decisions. California courts have recognized the “advice of counsel” defense since as early as 1862.¹ Despite the defense’s long tenure in California jurisprudence, only a dearth of decisions exists in the context of business torts outside of patent infringement and bad faith insurance coverage cases. Moreover, California jurisprudence treats the defense differently depending on the context in which is raised. This article examines the current state of California law relating to the advice of counsel defense in business litigation.

The Advice of Counsel Defense – Application in Practice

Although the vast majority of over 200 California court opinions discussing the advice of counsel defense fall in the context of malicious prosecution actions or bad faith insurance claims, the defense is used in other contexts including: patent infringement actions in defense of “willful infringement” accusations, SEC violations, civil or criminal fraud, assertion of the business judgment rule, limitation of punitive damages, tortious interference claims, use of funds by a public officer, and taxpayer defense.²

The Elements. In general, reliance on advice of counsel defense has evolved under California law to require that the proponent establish:³ (1) good faith reliance on the opinion and advice of its lawyer; (2) that the lawyer’s advice was based on full disclosure by the party seeking to invoke the defense of all relevant facts that it knew or could have discovered with reasonable effort;⁴ (3) that selection of counsel for opinion was

What It All Means For In-House Counsel

The following questions highlight important factors that in-house counsel should consider as soon as an advice of counsel defense is anticipated to be potentially relevant.

- **Who may assert the defense?** Only the attorney’s client who received and relied on the attorney’s advice can waive the attorney-client privilege in order to assert the defense. Thus, it is important to determine who is the actual client who holds the ability to invoke the defense. For example, in a shareholder derivative action, if the board received legal advice regarding a particular strategy from the company’s counsel, who can assert the defense, and perhaps more pointedly, who is entitled to waive the attorney-client privilege?
- **How relevant and thorough is the legal opinion upon which a party seeks to rely?** Correct advice is not an element of the defense¹² but relevance, thoroughness of the opinion, the competency and expertise of its preparer, and the credibility of a party’s reliance becomes critically important to a party’s entitlement to assert the defense, and ultimately to the factfinder.
- **At what stage in the case must a party raise the defense?**¹³ A discovery complication arises for trial counsel who, for strategic purposes, would prefer a later disclosure of the defense so as to limit the scope of discoverable attorney-client communications. Yet, the law is clear that a party intending to assert reliance upon advice of counsel defense must make a timely and complete disclosure of the relied-upon attorney advice.¹⁴

belief that advice of lawyer was correct.⁶

The Consequences. It is well settled that “[t]he privilege which protects attorney-client communications may not be used both as a sword and a shield.”⁷ Thus, a party cannot rely on an advice of counsel defense without waiving its attorney-client privilege with respect to the relied-upon attorney-client communications. Courts are divided on the extent of the scope of the waiver, but the majority of courts construe the waiver to impliedly include a subject-matter waiver of at least all privileged communications leading up to the relied-upon opinion.⁸ Some federal courts find that the waiver only applies to pre-complaint attorney-client communications because the pivotal issue is the accused party’s state of mind at the time of the alleged bad act. Accordingly, documents created after the commencement of litigation are generally deemed not relevant, nor reasonably calculated to lead to admissible evidence.⁹ By contrast, other courts – particularly in the Northern District – have taken a broad view of the scope of waiver,¹⁰ finding that a party cannot preserve any privilege, including work product, by an express voluntary waiver. Under this line of reasoning, even work product not communicated to the client can be considered relevant and discoverable.¹¹

- **What happens when the advice of counsel defense is invoked by the corporate defendant against the best interests of the company’s director(s) or officer(s), or vice versa?** When company officers and directors seek to rely on the company’s counsel, in-house counsel necessarily must consider whether the company is inclined or disinclined to waive the privilege belonging to corporate client.
- **Should counsel who provided the relied-upon advice be segregated from the trial counsel team?** Whenever practical, it is a good idea to keep advice-giving counsel (or author(s) of legal opinions) separate from trial-team counsel because the advice-giving attorneys are invariably likely to serve as a witnesses at trial.¹⁵

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1. *Selden v. Cashman*, 20 Cal. 56, 67 (1862) appears to be the earliest reported California case asserting the defense, where defendants acted upon advice of counsel and wrongfully levied and seized goods against an individual based on mistaken identity. Defendants asserted the defense to mitigate punitive damages and demonstrate a lack of malice.

2. See e.g., *Protective Optics, Inc. v. Panoptx Inc.*, 488 F. Supp. 2d 922 (N.D. Cal. 2007), *Wolfsen v. Hathaway*, 32 Cal. 2d 632, 650-51 (1948) (punitive damages award void based on advice of counsel defense); *Stanson v. Mott*, 17 Cal. 3d 206, 225 -27 (1976) (stating that public official may be personally liable to repay expended funds only if he or she failed to exercise due care in authorizing the expenditure; finding that advice of counsel may be relevant to due care determination); *Beck v. State Farm Mutual Auto Ins. Co.* 54 Cal. App. 3d 347 (1976) (advice of counsel defense applied to punitive damages claim); *T.E. Johnston*, 119 T.C. 27 (August 8, 2002) (advice of defense by taxpayer resulted in implied waiver of attorney client privilege).

3. See generally, Schwing, *Cal. Affirmative Defense* (2010 ed.), Vol. 2, §41:27 Advice of counsel elements; 5 Witkin, *Summary of Calif. Law* (10th ed. 2005) Torts, §482. See also, CACI 1505 (form jury instruction for “Reliance on Counsel” in malicious prosecution cases) and CACI 2335 (form jury instruction in bad faith insurance cases: does not include “selection of competent counsel” and adds two additional elements for the party seeking to invoke the defense: that it “gave at least as much consideration to plaintiff’s interest as it gave to its own interest” and “was willing to reconsider and act accordingly when it determined that the lawyer’s advice was incorrect.”)

4. The defense can fail if it appears that counsel’s opinion was perfunctorily prepared to protect against a lawsuit. See e.g. *Bertero v. Nat’l Gen. Corp.*, 13 Cal.3d 43, 53–54 (1974)(“[I]f the initiator acts in bad faith or withholds from counsel facts he knew or should have known would defeat a cause of action otherwise appearing from the information supplied, [the] defense fails.”)

5. Over the years, California courts have reviewed other factors to determine whether reliance on advice of counsel was reasonable. *Fetterly v. Salyer*, 96 Cal. App. 2d 240 (1950) (punitive damages award not justified, where defendants hired land surveyors and consulted an attorney before taking action on disputed land boundaries). Independence and expertise of the attorney is an important factor. *Daly v. Smith*, 220 Cal. App. 2d 592, 601 (1963) (in mining trespass case, no damages awarded where defendant retained an experienced and competent mining counsel). The *Daly* court held that in determining whether a party acted in good faith upon advice of counsel, a trial court should consider the interest of the attorney in outcome of the matter, as well as the attorney’s expertise regarding the subject matter of the litigation. *Id.* While a finding of good faith reliance on advice of counsel does not negate the illegality of the party’s actions, it is relevant to whether or not the conduct was willful or fraudulent.)

6. “[T]he defense that a criminal prosecution was commenced upon the advice of counsel is unavailing in an action for malicious prosecution if it appears . . . that the defendant did not believe that the accused was guilty of the crime charged.” (*Singleton v. Singleton*, 68 Cal. App. 2d 681, 695 (1945))

7. *Bittaker v. Woodford*, 331 F.3d 715, 719 (9th Cir. 2003) (quoting *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1162 (9th Cir. 1992)).

8. *Transamerica Title Ins. Co. v. Superior Court*, 188 Cal. App. 3d 1047, 1054 (1987) (limited waiver where Transamerica invoked a reliance on counsel defense for a limited issue – the

reason why it filed a declaratory relief action – it had obtained a legal opinion, which included the declaratory relief action as an option); see also, *Southern Cal. Gas Co. v. Public Utilities Comm'n*, 50 Cal.3d 31, 41-43 (1990); *State Farm v. Superior Court*, 228 Cal. App. 3d 721 (1991); *Handgards, Inc. v. Johnson & Johnson*, 413 F. Supp. 926 (N.D. Cal. 1976)

9. *Hoover Universal Inc. v. Graham Packaging Corp.*, 44 U.S.P.Q.2d 1596, 1598 (C.D. Cal. 1997).

10. *McCormick-Morgan, inc. v. Teledyne Indus. Inc.*, 765 F. Supp. 611, 613-14 (N.D. Cal. 1991); *Mushroom Assocs. v. Monterey Mushrooms, Inc.*, 24 U.S.P.Q.2d (BNA) 1767, 1770-71 (N.D. Cal. 1992) (broad reading of waiver, requiring all work product relevant to infringement be produced without any discussion about whether production was limited to pre-litigation or post-litigation.)

11. *Electro Scientific Indus. Inc. v. Gen. Scanning, Inc.*, 175 F.R.D. 539, 546 (N.D. Cal. 1997) (in a patent infringement case, “what really was in the lawyer’s mind could be relevant to the issue of what really was in the client’s mind”).

12. “An insurer may defend itself against allegations of bad faith and malice in claims handling with evidence the insurer relied on the advice of competent counsel. The defense of advice of counsel is offered to show the insurer had ‘proper cause’ for its actions even if the advice it received is ultimately unsound or erroneous.” *State Farm Mutual Automobile Ins. Co.*, *supra*, 228 Cal. App. 3d at 725 (internal citations omitted).

13. Some authorities suggest the advice of counsel defense is an affirmative defense that must be raised in the answer or be waived. CCP §431.30; *Bertero v. Nat'l Gen'l Corp.*, 13 Cal. 3d 43, 53 (1974) (advice of counsel is an affirmative defense); *Walsh v. West Valley Mission Comm. College Dist.*, 66 Cal. App. 4th 1532, 1546 (1998) (matters not responsive to essential allegations of the complaint must be raised in the answer). By comparison, other authorities hold that the defense is raised by a general denial and can be reserved and asserted at any time before trial. *State Farm Mutual Auto. Ins. Co. v. Superior Court*, 228 Cal. App. 3d 721, 725-27 (1991) (advice of counsel defense need not be pleaded as an affirmative defense, and is raised by a general denial); *Albertson v. Raboff*, 185 Cal. App. 2d 372, 386 (1960) (holding that the advice of counsel defense may be raised by a general denial in the answer). At least one federal court has held that it need not be pleaded as an affirmative defense. *Clemco Indus. v. Commercial Union Inc. Co.*, 665 F. Supp. 816, 829-830 (N.D. Cal. 1987).

14. *Fox v. California Sierra Financial Services*, 120 F.R.D. 520, 530 (N.D. Cal. 1988) (ruling that a party who intends to rely on advice of counsel at trial must make full disclosure of that advice during discovery). *Columbia Pictures Television, Inc. v. Krypton Broadcasting of Birmingham, Inc.*, 259 F.3d 1186, 1196 (9th Cir. 2001) (holding that a party cannot claim the privilege throughout litigation and then attempt to rely upon an advice of counsel defense).

15. *Genentech, Inc. v. Insmad, Inc.*, 442 F. Supp. 2d 838, 843 (N.D. Cal. 2006)(observing that “decision to hire opinion counsel and trial counsel from the same firm entailed a certain amount of risk.”); Rules of Prof. Conduct, 5-210 (Lawyer as Witness).

