

**Utah State Bar  
Business Law Section**

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**NON-MAJORITY ENTERPRISE INTERESTS**

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1. A sliding scale of ownership
  - a. Clear majority
  - b. 50-50 ownership
  - c. Clear minority
2. Corporations—Utah Revised Business Corporations Act, § 16-10a-101 *et seq.*
  - a. Restrictions on transfer § 16-10a-627
  - b. Shareholders' preemptive rights § 16-10a-630
  - c. Court ordered shareholder meeting on application of any shareholder if no meeting within preceding 15 months or any person demanding a meeting under § 16-10a-702(1) (board, others authorized in bylaws, 10% of the shares)
  - d. Shareholder agreements § 16-10a-732(1): An agreement among the shareholders of a corporation that complies with this section is effective among the shareholders and the corporation even though it is inconsistent with one or more other provisions of this chapter in that it
    - i. Eliminates or restricts the board
    - ii. Governs distributions
    - iii. Establishes directors
    - iv. Affects voting power
    - v. Governs use of property or the provision of services
    - vi. Requires dissolution at election of one or more stockholders
    - vii. Otherwise governs powers or management
      - May be in articles, bylaws, or agreement
      - Agreement must be noted on stock certificates
      - Can shift liability for acts and omissions away from directors
  - e. Procedures in derivative proceedings § 16-10a-740
  - f. General standard of conduct for directors § 16-10a-840: in good faith, with the care of an ordinary prudent person, and in the best interests of the corporation—fiduciary duty
  - g. Conflicting interest transactions §§ 16-10a-850—853
  - h. Director indemnification § 16-10a-902
    - i. Corporation may indemnify a director if director's conduct was in good faith and director reasonably believed conduct was in, or not opposed to, best interests of corporation and, in criminal proceeding, no reasonable cause to believe conduct was unlawful
    - ii. May not indemnify a director
      1. In proceeding by corporation in which director held liable

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2. Any other proceeding in which director is found to have “derived an improper personal benefit” (see commentary)
  - iii. May advance expenses in advance of final determination § 16-10a-904
- i. Merger § 16-10a-1101—Commentary: “Some of the holders of a single class of shares may be required to accept securities or properties while the remaining holders may be compelled to accept different securities, property, or cash.”
- j. Share exchange § 16-10a-1101—Operative language similar to § 1101, but commentary silent
- k. Dissenters’ rights—Part 13
  - i. “Fair value” means the value of the shares immediately before effectuation of the corporate action to which the dissenter objects, excluding any appreciation and depreciation in anticipation of the corporate action—§ 16-10a-1301(4) (Control premium vs. minority discount—*Hogle v. Zinetics Medical, Inc.*, 2002 UT 121, 63 P.3d 80 (2002))
  - ii. No right to dissent if securities exchange traded or held of record by more than 2,000 shareholders if stockholder gets similarly liquid shares § 16-10a-1302(3)
- l. Judicial proceeding brought by shareholder may dissolve the corporation § 16-10a-1430
  - i. If directors are deadlocked and the shareholders are unable to break the deadlock, irreparable injury to the corporation is threatened or being suffered, OR the business can no longer be conducted to the benefit of the shareholders generally
  - ii. Directors or those in control are acting in a manner that is illegal, oppressive, or fraudulent
  - iii. The shareholders are deadlocked in voting power and have failed for two years to elect directors whose terms have expired
  - iv. Corporate assets are being misapplied or wasted
- m. Books and records—Part 16
  - i. Records required § 16-10a-1601
    1. Board and shareholder minutes, consents, notices
    2. Appropriate accounting records
    3. Stockholder list
    4. Maintain at principal office
      - a. Articles
      - b. Bylaws
      - c. Shareholder minutes and consents for previous three years
      - d. Shareholder communications for previous three years
      - e. Names and addresses of officers and directors
      - f. Most recent annual report to Division of Corporations
      - g. Financial statements for the last three years
  - ii. Shareholders and directors can inspect and copy § 16-10a-1602
    1. On five business days’ notice, records required to be maintained at principal office [m.i.4 above]
    2. If shareholder gives five business days’ notice, describes “proper purpose” and acts in good faith
      - a. All board and all shareholder minutes, consents and notices
      - b. Accounting records
      - c. Stockholder list
    3. Does not limit litigation discovery
  - iii. Corporation can impose reasonable charges § 16-10a-1603
  - iv. Court can order inspection and assess costs, including damages if corporation did not act in good faith in denying access

- n. Watch your back! See provisions of California Corporations Code applicable to foreign corporations based on application of property factor, payroll factor and sales factor, plus more than one-half of outstanding voting securities owned by persons with addresses in California—Section 2115 *et seq.* of California Corporations Code
- 3. Limited partnerships—Utah Revised Uniform Limited Partnership Act, § 48-2a-101 *et seq.*
  - a. Limited partner is generally liable for obligations of limited partnership if “he participates in the control of the business.” § 48-2a-303—does not “participate in control” by
    - i. Being a contractor, agent, employee, or officer or director of general partner
    - ii. Consulting with and advising a general partner
    - iii. Acting as surety
    - iv. Bringing a derivative action
    - v. Participating in company meetings
    - vi. Proposing, approving, or disapproving company actions as owner
  - b. Inspection of records
    - i. Limited partner has right to (§ 48-2a-305)
      - 1. Inspect § 48-2a-105 records: list of partners, certificate of partnership, tax returns, partnership agreement, capital contributions, contribution details, distribution rights, and dissolution events
      - 2. Obtain from general partner a copy of § 48-2a-105 records, state of business and financial condition, copy of tax returns; and
      - 3. Inspect other information “as is just and reasonable”
  - c. Charging order—“On application of a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of any partner with payment of the unsatisfied amount of the judgment with interest.” § 48-2a-703
  - d. Assignee of partnership interest may become partner to extent permitted in agreement or if all other partners consent § 48-2a-704
  - e. In death or incompetence, estate representative may “exercise all of the partner’s rights for the purpose of settling his estate, including right to give an assignee right to become partner § 48-2a-705
  - f. Derivative actions—Article 10
    - i. Derivative action authorized if general partners have refused to bring action and refusal constitutes abuse of discretion or involves a conflict of interest that prevents unprejudiced exercise of judgment or if effort to cause general partners to bring action is unlikely to proceed § 48-2a-1001
    - ii. Derivative plaintiff may recover expenses § 48-2a-1004
    - iii. In derivative action, the limited partnership may require the plaintiff limited partner to post security for costs § 48-2a-1005.
- 4. General and limited liability partnerships, § 48-1-1 *et seq.*
  - a. Applies to “limited partnerships unless in so far as [sic] the statutes relating to such partnerships are inconsistent herewith”
  - b. On application of a partner, a court shall decree a dissolution whenever “(f) Other circumstances render a dissolution equitable”
- 5. Limited liability companies—Utah Revised Limited Liability Company Act, § 48-2c-101 *et seq.*
  - a. Inspection of records by members and managers § 48-2c-113
    - i. Current or former member or manager can inspect and copy, after five days’ notice
      - 1. List of names and addresses of members
      - 2. Articles of organization
      - 3. Organizer’s statement per § 48-2c-401
      - 4. Tax returns for three years
      - 5. Financial statements for three years

6. Operating agreement
7. Minutes or consents of members
8. Written information re: contributions, required additional contributions, distribution rights, redemption triggers, and dissolution events
  - ii. Does not limit litigation discovery
  - iii. Cannot use information for improper purpose
  - iv. Division may subpoena records if company denies access
  - v. Court can order inspection and levy costs, including attorney's fees and damages resulting from refusal
- b. Under § 48-2c-119, member or manager may transact business with company, but does not relieve duty under § 48-2c-807
- c. Authorizes operating agreement adopted by unanimous consent of all members § 48-2c-501—may be amended in accordance with terms of agreement; if not specified, amendment must be unanimous § 48-2c-506
- d. A member ceases to be a member and becomes an assignee of the member's interest in event of (§ 48-2c-708)
  - i. Death, except for settling the estate
  - ii. Incapacity of member, except for the purpose of administering the member's property
  - iii. Voluntary withdrawal
  - iv. Assignment of a member's entire interest
  - v. Expulsion unless otherwise agreed or with the consent of all other members, on bankruptcy or similar proceedings
  - vi. Other events specified in agreement
- e. Member may be expelled § 48-2c-710
  - i. As provided in operating agreement
  - ii. By unanimous vote if it is unlawful to carry on company's business with member
  - iii. On application by company or another member, by judicial determination that member has engaged in wrongful conduct that adversely and materially affected business, willfully or persistently materially breached company agreement or duty owed to company, or engaged in conduct that makes it not reasonably practicable to carry on the business with the member
- f. Duties of managers and members § 48-2c-807
  - i. Not liable unless acts or omissions constitute
    1. Gross negligence
    2. Willful misconduct
    3. Breach of a higher standard established in the articles or operating agreement
  - ii. Members and managers hold in trust profits derived by such person without consent of majority or higher percentage specified in articles or operating agreement from
    1. Operating or winding up of business
    2. Use of company tangible or intangible property, including confidential or proprietary information
  - iii. Unless otherwise provided in articles or operating agreement, a member of manager-managed company "owes no fiduciary duties to the company or to the other members solely by reason of acting in the capacity of a member." *Cf. McLaughlin v. Schenk*, 2009 UT 64 (October 2, 2009)
- g. Court may remove manager in manager-managed company in proceeding commenced by company or 25% in interest of members if manager engaged in fraudulent or dishonest conduct or gross abuse of authority or discretion respecting company and removal is in

company's best interests and may bar reelection § 48-2c-809 (Note that there is no "except as provided in articles or operating agreement" exception)

- h. Assignment of interests. Part 11
    - i. Assignment of interest does not entitle assignee to become a member § 48-2c-1102
    - ii. Assignee can become member only upon consent of all members, unless otherwise provided in operating agreement, and signing operating agreement
  - i. Judicial dissolution § 48-2c-1210
    - i. Proceeding filed by any member if it is established that
      - 1. Managers are deadlocked, irreparable damage is threatened or being suffered, or business can no longer be conducted to advantage of members
      - 2. Managers or those in control are acting or will act in manner that is illegal, oppressive, or fraudulent
      - 3. Members are deadlocked in voting that has lasted for over six months
      - 4. It is not reasonably practical to carry on business in conformity with charter
  - j. Court in judicial dissolution proceeding may appoint receiver § 48-2c-1212
  - k. Convert from a corporation or other type of entity to a limited liability company § 48-2c-1402
    - i. Assets, liabilities etc. transfer by operation of law
    - ii. Interests in previous can be converted to "cash, property, interests in, or securities of or rights in the domestic company to which it is converted" or another entity—a triangular transaction § 48-2c-1403
    - iii. If not otherwise provided by law or charter, conversion requires unanimous consent § 48-2c-1404 (Note absence of dissenters' rights, but law applicable to other entity, such as a corporation, may provide for dissenters' rights)
  - l. Convert from limited liability company to a corporation or other type of entity § 48-2c-1406
    - i. If the operating agreement does not specify manner of converting and does not prohibit conversion, approve as if merger, i.e., per § 48-2c-803(3), by approval of 2/3 of profits interest
    - ii. If not otherwise provided by law or charter [and prohibited by charter], conversion requires unanimous consent § 48-2c-1406 (Note absence of dissenters' rights)
    - iii. Assets, liabilities etc. transfer by operation of law
  - m. Mergers among one or more entities § 48-2c-1407
    - i. Can include entity other than limited liability company § 48-2c-1407(2)(e)
    - ii. Approve per § 48-2c-803(3) by 2/3 of profits interest (Note no dissenters' rights)
    - iii. The ownership interests of each owner "that are to be converted into ownership interests or obligations of the surviving entity or any other entity, or into cash or other property, are converted as provided in the plan of merger." § 48-2c-1410(f). *Compare* § 16-10a-1106(1)(f). *See* Delaware limited Liability Company Act § 18-209
6. Agreements among equity owners
- a. Cross purchase
  - b. Voting agreements
  - c. Collateral issues
7. Complications in real-world situations: The drama—see handouts at presentation.
8. Ethical considerations

**a. Rule 1.6. Confidentiality of Information**

A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

**b. Rule 1.7. Conflict of Interest: Current Clients.**

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(a)(1) The representation of one client will be directly adverse to another client;  
or

(a)(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, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(b)(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(b)(2) the representation is not prohibited by law;

(b)(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(b)(4) each affected client gives informed consent, confirmed in writing.

**c. Rule 1.9. Duties to Former Clients.**

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client

(b)(1) whose interests are materially adverse to that person; and

(b)(2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter;

unless the former client gives informed consent, confirmed in writing.

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

(c)(1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or

(c)(2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

d. *Margulies by Margulies v. Upchurch*, 696 P.2d 1195 (Utah 1985)

9. Application of federal and state securities laws

10. The new fiduciary duty: *McLaughlin v. Schenk*, 2009 UT 64 (October 2, 2009)

11. The new plaintiff: *Angel Investors, LLC, v. Garrity*, 2009 UT 40 (July 21, 2009)

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### Additional Resources

F. HODGE O'NEAL & ROBERT B THOMPSON, OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS: PROTECTING MINORITY SHAREHOLDERS AND LLC MEMBERS, (Thompson-West Rev. 2d ed. 2005-2007)

CHARLES MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS, (Redford, Virginia, Wilder Publications LLC 1847)

A history of popular folly. The book chronicles its targets in three parts” “National Delusions,” “Peculiar Follies,” and “Philosophical Delusions.” Learn why intelligent people do amazingly stupid things when caught up in speculative endeavors. The subjects of MacKay’s debunking include alchemy, beards (influence of politics and religion on), witch-hunts, crusades and duels.

RON CHERNOV, TITAN: THE LIFE OF JOHN D. ROCKEFELLER SR., (New York, Random House 1998)

JOHN KENNETH TOOLE, A CONFEDERACY OF DUNCES, (New York, Grove Press 1980)

THE BIG LEBOWSKI (Ethan Coen & Joel Coen 1998)

**Rule 1.6. Confidentiality of Information.**

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(b)(1) to prevent reasonably certain death or substantial bodily harm;

(b)(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interest or property of another and in furtherance of which the client has used the lawyer's services;

(b)(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud and in furtherance of which the client has used the lawyer's services;

(b)(4) to secure legal advice about the lawyer's compliance with these Rules;

(b)(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(b)(6) to comply with other law or a court order.

(c) For purposes of this rule, representation of a client includes counseling a lawyer about the need for or availability of treatment for substance abuse or psychological or emotional problems by members of the Utah State Bar serving on an Utah State Bar endorsed lawyer assistance program.

Comment

[1] This Rule governs the disclosure by a lawyer of information relating to the representation of a client during the lawyer's representation of the client. See Rule 1.18 for the lawyer's duties with respect to information provided to the lawyer by a prospective client, Rule 1.9(c)(2) for the lawyer's duty not to reveal information relating to the lawyer's prior representation of a former client and Rules 1.8(b) and 1.9(c)(1) for the lawyer's duties with respect to the use of such information to the disadvantage of clients and former clients.

[2] A fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, the lawyer must not reveal information relating to the representation. See Rule 1.0(e) for the definition of informed consent. This contributes to the trust that is the hallmark of the client-lawyer relationship. The client is thereby encouraged to seek legal assistance and to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter. The lawyer needs this information to represent the client effectively and, if necessary, to advise the client to refrain from wrongful conduct. Almost without exception, clients come to lawyers in order to determine their rights and what is, in the complex of laws and regulations, deemed to be legal and correct. Based upon experience, lawyers know that almost all clients follow the advice given, and the law is upheld.

[3] The principle of client-lawyer confidentiality is given effect by related bodies of law: the attorney-client privilege, the work-product doctrine and the rule of confidentiality established in professional ethics. The attorney-client privilege and work-product doctrine apply in judicial and other proceedings in which a lawyer may be called as a witness or otherwise required to produce evidence concerning a client. The rule of client-lawyer confidentiality applies in situations other than those where evidence is sought from the lawyer through compulsion of law. The confidentiality rule, for example, applies not only to matters communicated in confidence by the client but also to all

information relating to the representation, whatever its source. A lawyer may not disclose such information except as authorized or required by the Rules of Professional Conduct or other law. See also Scope.

[4] Paragraph (a) prohibits a lawyer from revealing information relating to the representation of a client. This prohibition also applies to disclosures by a lawyer that do not in themselves reveal protected information but could reasonably lead to the discovery of such information by a third person. A lawyer's use of a hypothetical to discuss issues relating to the representation is permissible so long as there is no reasonable likelihood that the listener will be able to ascertain the identity of the client or the situation involved.

#### Authorized Disclosure

[5] Except to the extent that the client's instructions or special circumstances limit that authority, a lawyer is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation. In some situations, for example, a lawyer may be impliedly authorized to admit a fact that cannot properly be disputed or to make a disclosure that facilitates a satisfactory conclusion to the matter. Lawyers in a firm may, in the course of the firm's practice, disclose to each other information relating to a client of the firm, unless the client has instructed that particular information be confined to specified lawyers.

#### Disclosure Adverse to Client

[6] Although the public interest is usually best served by a strict rule requiring lawyers to preserve the confidentiality of information relating to the representation of their clients, the confidentiality rule is subject to limited exceptions. Paragraph (b)(1) recognizes the overriding value of life and physical integrity and permits disclosure reasonably necessary to prevent reasonably certain death or substantial bodily harm. Such harm is reasonably certain to occur if it will be suffered imminently or if there is a present and substantial threat that a person will suffer such harm at a later date if the lawyer fails to take action necessary to eliminate the threat. Thus, a lawyer who knows that a client has accidentally discharged toxic waste into a town's water supply may reveal this information to the authorities if there is a present and substantial risk that a person who drinks the water will contract a life-threatening or debilitating disease and the lawyer's disclosure is necessary to eliminate the threat or reduce the number of victims.

[7] Paragraph (b)(2) is a limited exception to the rule of confidentiality that permits the lawyer to reveal information to the extent necessary to enable affected persons or appropriate authorities to prevent the client from committing a crime or fraud, as defined in Rule 1.0(d), that is reasonably certain to result in substantial injury to the financial or property interests of another and in furtherance of which the client has used or is using the lawyer's services. The client can, of course, prevent such disclosure by refraining from the wrongful conduct. Although paragraph (b)(2) does not require the lawyer to reveal the client's misconduct, the lawyer may not counsel or assist the client in conduct the lawyer knows is criminal or fraudulent. See Rule 1.2(d). See also Rule 1.16 with respect to the lawyer's obligation or right to withdraw from the representation of the client in such circumstances, and Rule 1.13(c) which permits the lawyer, where the client is an organization, to reveal information relating to the representation in limited circumstances.

[8] Paragraph (b)(3) addresses the situation in which the lawyer does not learn of the client's crime or fraud until after it has been consummated. Although the client no longer has the option of preventing disclosure by refraining from the wrongful conduct, there will be situations in which the loss suffered by the affected person can be prevented, rectified or mitigated. In such situations, the lawyer may disclose information relating to the representation to the extent necessary to enable the affected persons to prevent or mitigate reasonably certain losses or to attempt to recoup their losses. Paragraph (b)(3) does not apply when a person who has committed a crime or fraud thereafter employs a lawyer for representation concerning that offense.

[9] A lawyer's confidentiality obligations do not preclude a lawyer from securing confidential legal advice about the lawyer's personal responsibility to comply with these Rules. In most situations, disclosing information to secure such advice will be impliedly authorized for the lawyer to carry out the representation. Even when the disclosure is not impliedly authorized, paragraph (b)(4) permits such disclosure because of the importance of a lawyer's compliance with the Rules of Professional Conduct.

[10] Where a legal claim or disciplinary charge alleges complicity of the lawyer in a client's conduct or other misconduct of the lawyer involving representation of the client, the lawyer may respond to the extent the lawyer reasonably believes necessary to establish a defense. The same is true with respect to a claim involving the conduct or representation of a former client. Such a charge can arise in a civil, criminal, disciplinary or other proceeding and can be based on a wrong allegedly committed by the lawyer against the client or on a wrong alleged by a third person, for example, a person claiming to have been defrauded by the lawyer and client acting together.

The lawyer's right to respond arises when an assertion of such complicity has been made. Paragraph (b)(5) does not require the lawyer to await the commencement of an action or proceeding that charges such complicity, so that the defense may be established by responding directly to a third party who has made such an assertion. The right to defend also applies, of course, where a proceeding has been commenced.

[11] A lawyer entitled to a fee is permitted by paragraph (b)(5) to prove the services rendered in an action to collect it. This aspect of the rule expresses the principle that the beneficiary of a fiduciary relationship may not exploit it to the detriment of the fiduciary.

[12] Other law may require that a lawyer disclose information about a client. Whether such a law supersedes Rule 1.6 is a question of law beyond the scope of these Rules. When disclosure of information relating to the representation appears to be required by other law, the lawyer must discuss the matter with the client to the extent required by Rule 1.4. If, however, the other law supersedes this Rule and requires disclosure, paragraph (b)(6) permits the lawyer to make such disclosures as are necessary to comply with the law.

[13] A lawyer may be ordered to reveal information relating to the representation of a client by a court or by another tribunal or governmental entity claiming authority pursuant to other law to compel the disclosure. Absent informed consent of the client to do otherwise, the lawyer should assert on behalf of the client all nonfrivolous claims that the order is not authorized by other law or that the information sought is protected against disclosure by the attorney-client privilege or other applicable law. In the event of an adverse ruling, the lawyer must consult with the client about the possibility of appeal to the extent required by Rule 1.4. Unless review is sought, however, paragraph (b)(6) permits the lawyer to comply with the court's order.

[14] Paragraph (b) permits disclosure only to the extent the lawyer reasonably believes the disclosure is necessary to accomplish one of the purposes specified. Where practicable, the lawyer should first seek to persuade the client to take suitable action to obviate the need for disclosure. In any case, a disclosure adverse to the client's interest should be no greater than the lawyer reasonably believes necessary to accomplish the purpose. If the disclosure will be made in connection with a judicial proceeding, the disclosure should be made in a manner that limits access to the information to the tribunal or other persons having a need to know it and appropriate protective orders or other arrangements should be sought by the lawyer to the fullest extent practicable.

[15] Paragraph (b) permits but does not require the disclosure of information relating to a client's representation to accomplish the purposes specified in paragraphs (b)(1) through (b)(6). In exercising the discretion conferred by this Rule, the lawyer may consider such factors as the nature of the lawyer's relationship with the client and with those who might be injured by the client, the lawyer's own involvement in the transaction and factors that may extenuate the conduct in question. A lawyer's decision not to disclose as permitted by paragraph (b) does not violate this Rule. Disclosure may be required, however, by other rules. Some rules require disclosure only if such disclosure would be permitted by paragraph (b). See Rules 1.2(d), 4.1(b), 8.1 and 8.3. Rule 3.3, on the other hand, requires disclosure in some circumstances regardless of whether such disclosure is permitted by this Rule. See Rule 3.3(c).

#### Acting Competently to Preserve Confidentiality

[16] A lawyer must act competently to safeguard information relating to the representation of a client against inadvertent or unauthorized disclosure by the lawyer or other persons who are participating in the representation of the client or who are subject to the lawyer's supervision. See Rules 1.1, 5.1 and 5.3.

[17] When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. This duty, however, does not require that the lawyer use special security measures if the method of

communication affords a reasonable expectation of privacy. Special circumstances, however, may warrant special precautions. Factors to be considered in determining the reasonableness of the lawyer's expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement. A client may require the lawyer to implement special security measures not required by this Rule or may give informed consent to the use of a means of communication that would otherwise be prohibited by this Rule.

#### Former Client

[18] The duty of confidentiality continues after the client-lawyer relationship has terminated. See Rule 1.9(c)(2). See Rule 1.9(c)(1) for the prohibition against using such information to the disadvantage of the former client.

[19] Paragraph (c) is an addition to ABA Model Rule 1.6 and provides for confidentiality of information between lawyers providing assistance to other lawyers under an Utah State Bar endorsed lawyer assistance program.

**Rule 1.7. Conflict of Interest: Current Clients.**

- (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
- (a)(1) The representation of one client will be directly adverse to another client; or
  - (a)(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, a former client or a third person or by a personal interest of the lawyer.
- (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
- (b)(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
  - (b)(2) the representation is not prohibited by law;
  - (b)(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
  - (b)(4) each affected client gives informed consent, confirmed in writing.

Comment

*General Principles*

[1] Loyalty and independent judgment are essential elements in the lawyer’s relationship to a client. Concurrent conflicts of interest can arise from the lawyer’s responsibilities to another client, a former client or a third person or from the lawyer’s own interests. For specific rules regarding certain concurrent conflicts of interest, see Rule 1.8. For former client conflicts of interest, see Rule 1.9. For conflicts of interest involving prospective clients, see Rule 1.18. For definitions of “informed consent” and “confirmed in writing,” see Rules 1.0(e) and (b).

[2] Resolution of a conflict of interest problem under this Rule requires the lawyer to: 1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentable; and, 4) if so, consult with the clients affected under paragraph (a)(1) and obtain their informed consent, confirmed in writing. The clients affected under paragraph (a)(1) include both of the clients referred to in paragraph (a)(1) and the one or more clients whose representation might be materially limited under paragraph (a)(2).

[3] A conflict of interest may exist before representation is undertaken, in which event the representation must be declined, unless the lawyer obtains the informed consent of each client under the conditions of paragraph (b). To determine whether a conflict of interest exists, a lawyer should adopt reasonable procedures, appropriate for the size and type of firm and practice, to determine in both litigation and nonlitigation matters the persons and issues involved. See also Comment to Rule 5.1. Ignorance caused by a failure to institute such procedures will not excuse a lawyer’s violation of this Rule. As to whether a client-lawyer relationship exists or, having once been established, is continuing, see Comment to Rule 1.3 and Scope.

[4] If a conflict arises after representation has been undertaken, the lawyer ordinarily must withdraw from the representation, unless the lawyer has obtained the informed consent of the client under the conditions of paragraph (b). See Rule 1.16. Where more than one client is involved, whether the lawyer may continue to represent any of the clients is determined both by the lawyer’s ability to comply with duties owed to the former client and by the lawyer’s ability to represent adequately the remaining client or clients, given the lawyer’s duties to the former client. See Rule 1.9. See also Comments [5] and [29].

[4a] To eliminate confusion, former Rule 2.2 “Intermediary” has been deleted entirely. The term “intermediation” is changed in Rule 1.7 to “common representation”. Comment [4] sets out the analysis that a lawyer should make in order to determine when common representation is improper. The comments to Rule 1.7 specifically instruct lawyers on what informed consent means in the situations.

[5] Unforeseeable developments, such as changes in corporate and other organizational affiliations or the addition or realignment of parties in litigation, might create conflicts in the midst of a representation, as when a company sued by the lawyer on behalf of one client is bought by another client represented by the lawyer in an unrelated matter. Depending on the circumstances, the lawyer may have the option to withdraw from one of the representations in order to avoid the conflict. The lawyer must seek court approval where necessary and take steps to minimize harm to the clients. See Rule 1.16. The lawyer must continue to protect the confidences of the client from whose representation the lawyer has withdrawn. See Rule 1.9(c).

#### Identifying Conflicts of Interest: Directly Adverse

[6] Loyalty to a current client prohibits undertaking representation directly adverse to that client without that client’s informed consent. Thus, absent consent, a lawyer may not act as an advocate in one matter against a person the lawyer represents in some other matter, even when the matters are wholly unrelated. The client as to whom the representation is directly adverse is likely to feel betrayed, and the resulting damage to the client-lawyer relationship is likely to impair the lawyer’s ability to represent the client effectively. In addition, the client on whose behalf the adverse representation is undertaken reasonably may fear that the lawyer will pursue that client’s case less effectively out of deference to the other client, i.e., that the representation may be materially limited by the lawyer’s interest in retaining the current client. Similarly, a directly adverse conflict may arise when a lawyer is required to cross-examine a client who appears as a witness in a lawsuit involving another client, as when the testimony will be damaging to the client who is represented in the lawsuit. On the other hand, simultaneous representation in unrelated matters of clients whose interests are only economically adverse, such as representation of competing economic enterprises in unrelated litigation, does not ordinarily constitute a conflict of interest and thus may not require consent of the respective clients.

[7] Directly adverse conflicts can also arise in transactional matters. For example, if a lawyer is asked to represent the seller of a business in negotiations with a buyer represented by the lawyer, not in the same transaction but in another, unrelated matter, the lawyer could not undertake the representation without the informed consent of each client.

#### Identifying Conflicts of Interest: Material Limitation

[8] Even where there is no direct adverseness, a conflict of interest exists if there is a significant risk that a lawyer’s ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer’s other responsibilities or interests. For example, a lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer’s ability to recommend or advocate all possible positions that each might take because of the lawyer’s duty of loyalty to the others. The conflict in effect forecloses alternatives that would otherwise be available to the client. The mere possibility of subsequent harm does not itself require disclosure and consent. The critical questions are the likelihood that a difference in interests will eventuate and, if it does, whether it will materially interfere with the lawyer’s independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.

#### Lawyer’s Responsibilities to Former Clients and Other Third Persons

[9] In addition to conflicts with other current clients, a lawyer’s duties of loyalty and independence may be materially limited by responsibilities to former clients under Rule 1.9 or by the lawyer’s responsibilities to other persons, such as fiduciary duties arising from a lawyer’s service as a trustee, executor or corporate director.

### Personal Interest Conflicts

[10] The lawyer's own interests should not be permitted to have an adverse effect on representation of a client. For example, if the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. Similarly, when a lawyer has discussions concerning possible employment with an opponent of the lawyer's client, or with a law firm representing the opponent, such discussions could materially limit the lawyer's representation of the client. In addition, a lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed financial interest. See Rule 1.8 for specific rules pertaining to a number of personal interest conflicts, including business transactions with clients. See also Rule 1.10 (personal interest conflicts under Rule 1.7 ordinarily are not imputed to other lawyers in a law firm).

[11] When lawyers representing different clients in the same matter or in substantially related matters are closely related by blood or marriage, there may be a significant risk that client confidences will be revealed and that the lawyer's family relationship will interfere with both loyalty and independent professional judgment. As a result, each client is entitled to know of the existence and implications of the relationship between the lawyers before the lawyer agrees to undertake the representation. Thus, a lawyer related to another lawyer, e.g., as parent, child, sibling or spouse, ordinarily may not represent a client in a matter where that lawyer is representing another party, unless each client gives informed consent. The disqualification arising from a close family relationship is personal and ordinarily is not imputed to members of firms with whom the lawyers are associated. See Rule 1.10.

[12] A lawyer is prohibited from engaging in sexual relationships with a client unless the sexual relationship predates the formation of the client-lawyer relationship. See Rule 1.8(j).

### Interest of Person Paying for a Lawyer's Service

[13] A lawyer may be paid from a source other than the client, including a co-client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty or independent judgment to the client. See Rule 1.8(f). If acceptance of the payment from any other source presents a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's own interest in accommodating the person paying the lawyer's fee or by the lawyer's responsibilities to a payer who is also a co-client, then the lawyer must comply with the requirements of paragraph (b) before accepting the representation, including determining whether the conflict is consentable and, if so, that the client has adequate information about the material risks of the representation.

### Prohibited Representations

[14] Ordinarily, clients may consent to representation notwithstanding a conflict. However, as indicated in paragraph (b), some conflicts are nonconsentable, meaning that the lawyer involved cannot properly ask for such agreement or provide representation on the basis of the client's consent. When the lawyer is representing more than one client, the question of consentability must be resolved as to each client.

[15] Consentability is typically determined by considering whether the interests of the clients will be adequately protected if the clients are permitted to give their informed consent to representation burdened by a conflict of interest. Thus, under paragraph (b)(1), representation is prohibited if in the circumstances the lawyer cannot reasonably conclude that the lawyer will be able to provide competent and diligent representation. See Rule 1.1 (competence) and Rule 1.3 (diligence).

[16] Paragraph (b)(2) describes conflicts that are nonconsentable because the representation is prohibited by applicable law. For example, in some states substantive law provides that the same lawyer may not represent more than one defendant in a capital case, even with the consent of the clients, and under federal criminal statutes certain representations by a former government lawyer are prohibited, despite the informed consent of the former client. In addition, decisional law in some states limits the ability of a governmental client, such as a municipality, to consent to a conflict of interest.

[17] Paragraph (b)(3) describes conflicts that are nonconsentable because of the institutional interest in vigorous development of each client's position when the clients are aligned directly against each other in the same litigation or other proceeding before a tribunal. Whether clients are aligned directly against each other within the meaning of this paragraph requires examination of the context of the proceeding. Although this paragraph does not preclude a lawyer's multiple representation of adverse parties to a mediation (because mediation is not a proceeding before a "tribunal" under Rule 1.0(m)), such representation may be precluded by paragraph (b)(1).

#### Informed Consent

[18] Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. See Rule 1.0(e) (informed consent). The information required depends on the nature of the conflict and the nature of the risks involved. When representation of multiple clients in a single matter is undertaken, the information must include the implications of the common representation, including possible effects on loyalty, confidentiality and the attorney-client privilege and the advantages and risks involved. See Comments [30] and [31] (effect of common representation on confidentiality).

[19] Under some circumstances it may be impossible to make the disclosure necessary to obtain consent. For example, when the lawyer represents different clients in related matters and one of the clients refuses to consent to the disclosure necessary to permit the other client to make an informed decision, the lawyer cannot properly ask the latter to consent. In some cases the alternative to common representation can be that each party may have to obtain separate representation with the possibility of incurring additional costs. These costs, along with the benefits of securing separate representation, are factors that may be considered by the affected client in determining whether common representation is in the client's interests.

#### Consent Confirmed in Writing

[20] Paragraph (b) requires the lawyer to obtain the informed consent of the client, confirmed in writing. Such a writing may consist of a document executed by the client or one that the lawyer promptly records and transmits to the client following an oral consent. See Rule 1.0(b). See also Rule 1.0(n) (writing includes electronic transmission). If it is not feasible to obtain or transmit the writing at the time the client gives informed consent, then the lawyer must obtain or transmit it within a reasonable time thereafter. See Rule 1.0(b). The requirement of a writing does not supplant the need in most cases for the lawyer to talk with the client, to explain the risks and advantages, if any, of representation burdened with a conflict of interest, as well as reasonably available alternatives, and to afford the client a reasonable opportunity to consider the risks and alternatives and to raise questions and concerns. Rather, the writing is required in order to impress upon clients the seriousness of the decision the client is being asked to make and to avoid disputes or ambiguities that might later occur in the absence of a writing.

#### Revoking Consent

[21] A client who has given consent to a conflict may revoke the consent and, like any other client, may terminate the lawyer's representation at any time. Whether revoking consent to the client's own representation precludes the lawyer from continuing to represent other clients depends on the circumstances, including the nature of the conflict, whether the client revoked consent because of a material change in circumstances, the reasonable expectations of the other client and whether material detriment to the other clients or the lawyer would result.

### Consent to Future Conflict

[22] Whether a lawyer may properly request a client to waive conflicts that might arise in the future is subject to the test of paragraph (b). The effectiveness of such waivers is generally determined by the extent to which the client reasonably understands the material risks that the waiver entails. The more comprehensive the explanation of the types of future representations that might arise and the actual and reasonably foreseeable adverse consequences of those representations, the greater the likelihood that the client will have the requisite understanding. Thus, if the client agrees to consent to a particular type of conflict with which the client is already familiar, then the consent ordinarily will be effective with regard to that type of conflict. If the consent is general and open-ended, then the consent ordinarily will be ineffective, because it is not reasonably likely that the client will have understood the material risks involved. On the other hand, if the client is an experienced user of the legal services involved and is reasonably informed regarding the risk that a conflict may arise, such consent is more likely to be effective, particularly if, e.g., the client is independently represented by other counsel in giving consent and the consent is limited to future conflicts unrelated to the subject of the representation. In any case, advance consent cannot be effective if the circumstances that materialize in the future are such as would make the conflict nonconsentable under paragraph (b).

### Conflicts in Litigation

[23] Paragraph (b)(3) prohibits representation of opposing parties in the same litigation, regardless of the clients' consent. On the other hand, simultaneous representation of parties whose interests in litigation may conflict, such as coplaintiffs or codefendants, is governed by paragraph (a)(2). A conflict may exist by reason of substantial discrepancy in the parties' testimony, incompatibility in positions in relation to an opposing party or the fact that there are substantially different possibilities of settlement of the claims or liabilities in question. Such conflicts can arise in criminal cases as well as civil. The potential for conflict of interest in representing multiple defendants in a criminal case is so grave that ordinarily a lawyer should decline to represent more than one codefendant. On the other hand, common representation of persons having similar interests in civil litigation is proper if the requirements of paragraph (b) are met.

[24] Ordinarily a lawyer may take inconsistent legal positions in different tribunals at different times on behalf of different clients. The mere fact that advocating a legal position on behalf of one client might create precedent adverse to the interests of a client represented by the lawyer in an unrelated matter does not create a conflict of interest. A conflict of interest exists, however, if there is a significant risk that a lawyer's action on behalf of one client will materially limit the lawyer's effectiveness in representing another client in a different case; for example, when a decision favoring one client will create a precedent likely to seriously weaken the position taken on behalf of the other client. Factors relevant in determining whether the clients need to be advised of the risk include: where the cases are pending, whether the issue is substantive or procedural, the temporal relationship between the matters, the significance of the issue to the immediate and long-term interests of the clients involved and the clients' reasonable expectations in retaining the lawyer. If there is significant risk of material limitation, then absent informed consent of the affected clients, the lawyer must refuse one of the representations or withdraw from one or both matters.

[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 purposes of applying paragraph (a)(1) of this Rule. Thus, the lawyer does not typically need to get the consent of such a person before representing a client suing the person in an unrelated matter. Similarly, 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.

### Nonlitigation Conflicts

[26] Conflicts of interest under paragraphs (a)(1) and (a)(2) arise in contexts other than litigation. For a discussion of directly adverse conflicts in transactional matters, see Comment [7]. Relevant factors in determining whether there is significant potential for material limitation include the duration and intimacy of the lawyer's relationship with the client or clients involved, the functions being performed by the lawyer, the likelihood that disagreements will arise and the likely prejudice to the client from the conflict. The question is often one of proximity and degree. See Comment [8].

[27] For example, conflict questions may arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and, depending upon the circumstances, a conflict of interest may be present. In estate administration the identity of the client may be unclear under the law of a particular jurisdiction. Under one view, the client is the fiduciary; under another view, the client is the estate or trust, including its beneficiaries. In order to comply with conflict of interest rules, the lawyer should make clear the lawyer's relationship to the parties involved.

[28] Whether a conflict is consentable depends on the circumstances. For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them. Thus, a lawyer may seek to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest or arranging a property distribution in settlement of an estate. The lawyer seeks to resolve potentially adverse interests by developing the parties' mutual interests. Otherwise, each party might have to obtain separate representation, with the possibility of incurring additional cost, complication or even litigation. Given these and other relevant factors, the clients may prefer that the lawyer act for all of them.

### Special Considerations in Common Representation

[29] In considering whether to represent multiple clients in the same matter, a lawyer should be mindful that if the common representation fails because the potentially adverse interests cannot be reconciled, the result can be additional cost, embarrassment and recrimination. Ordinarily, the lawyer will be forced to withdraw from representing all of the clients if the common representation fails. In some situations, the risk of failure is so great that multiple representation is plainly impossible. For example, a lawyer cannot undertake common representation of clients where contentious litigation or negotiations between them are imminent or contemplated. Moreover, because the lawyer is required to be impartial between commonly represented clients, representation of multiple clients is improper when it is unlikely that impartiality can be maintained. Generally, if the relationship between the parties has already assumed antagonism, the possibility that the clients' interests can be adequately served by common representation is not very good. Other relevant factors are whether the lawyer subsequently will represent both parties on a continuing basis and whether the situation involves creating or terminating a relationship between the parties.

[30] A particularly important factor in determining the appropriateness of common representation is the effect on client-lawyer confidentiality and the attorney-client privilege. With regard to the attorney-client privilege, the prevailing rule is that, as between commonly represented clients, the privilege does not attach. Hence, it must be assumed that if litigation eventuates between the clients, the privilege will not protect any such communications, and the client should be so advised.

[31] As to the duty of confidentiality, continued common representation will almost certainly be inadequate if one client asks the lawyer not to disclose to the other client information relevant to the common representation. This is so because the lawyer has an equal duty of loyalty to each client, and each client has the right to be informed of anything bearing on the representation that might affect that client's interests and the right to expect that the lawyer will use that information to that client's benefit. See Rule 1.4. The lawyer should, at the outset of the common representation and as part of the process of obtaining each client's informed consent, advise each client that information will be shared and that the lawyer will have to withdraw if one client decides that some matter material to the representation should be kept from the other. In limited circumstances, it may be appropriate for the lawyer to

proceed with the representation when the clients have agreed, after being properly informed, that the lawyer will keep certain information confidential. For example, the lawyer may reasonably conclude that failure to disclose one client's trade secrets to another client will not adversely affect representation involving a joint venture between the clients and agree to keep that information confidential with the informed consent of both clients.

[32] When seeking to establish or adjust a relationship between clients, the lawyer should make clear that the lawyer's role is not that of partisanship normally expected in other circumstances and, thus, that the clients may be required to assume greater responsibility for decisions than when each client is separately represented. Any limitations on the scope of the representation made necessary as a result of the common representation should be fully explained to the clients at the outset of the representation. See Rule 1.2(c).

[33] Subject to the above limitations, each client in the common representation has the right to loyal and diligent representation and the protection of Rule 1.9 concerning the obligations to a former client. The client also has the right to discharge the lawyer as stated in Rule 1.16.

### Organizational Clients

[34] A lawyer who represents a corporation or other organization does not, by virtue of that representation, necessarily represent any constituent or affiliated organization, such as a parent or subsidiary. See Rule 1.13(a). Thus, the lawyer for an organization is not barred from accepting representation adverse to an affiliate in an unrelated matter, unless the circumstances are such that the affiliate should also be considered a client of the lawyer, there is an understanding between the lawyer and the organizational client that the lawyer will avoid representation adverse to the client's affiliates, or the lawyer's obligations to either the organizational client or the new client are likely to limit materially the lawyer's representation of the other client.[35] A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at board meetings while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.

**Rule 1.9. Duties to Former Clients.**

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client

(b)(1) whose interests are materially adverse to that person; and

(b)(2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter;

unless the former client gives informed consent, confirmed in writing.

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

(c)(1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or

(c)(2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

Comment

[1] After termination of a client-lawyer relationship, a lawyer has certain continuing duties with respect to confidentiality and conflicts of interest and thus may not represent another client except in conformity with this Rule. Under this Rule, for example, a lawyer could not properly seek to rescind on behalf of a new client a contract drafted on behalf of the former client. So also a lawyer who has prosecuted an accused person could not properly represent the accused in a subsequent civil action against the government concerning the same transaction. Nor could a lawyer who has represented multiple clients in a matter represent one of the clients against the others in the same or a substantially related matter after a dispute arose among the clients in that matter, unless all affected clients give informed consent. See Comment [9]. Current and former government lawyers must comply with this Rule to the extent required by Rule 1.11.

[2] The scope of a "matter" for purposes of this Rule depends on the facts of a particular situation or transaction. The lawyer's involvement in a matter can also be a question of degree. When a lawyer has been directly involved in a specific transaction, subsequent representation of other clients with materially adverse interests in that transaction clearly is prohibited. On the other hand, a lawyer who recurrently handled a type of problem for a former client is not precluded from later representing another client in a factually distinct problem of that type even though the subsequent representation involves a position adverse to the prior client. Similar considerations can apply to the reassignment of military lawyers between defense and prosecution functions within the same military jurisdictions. The underlying question is whether the lawyer was so involved in the matter that the subsequent representation can be justly regarded as a changing of sides in the matter in question.

[3] Matters are "substantially related" for purposes of this Rule if they involve the same transaction or legal dispute or if there otherwise is a substantial risk that confidential factual information as would normally have been obtained in the prior representation would materially advance the client's position in the subsequent matter. For example, a lawyer who has represented a businessperson and learned extensive private financial information about that person may not then represent that person's spouse in seeking a divorce. Similarly, a lawyer who has previously represented a client in securing environmental permits to build a shopping center would be precluded from representing neighbors seeking to oppose rezoning of the property on the basis of environmental considerations; however, the lawyer would not be precluded, on the grounds of substantial relationship, from defending a tenant of

the completed shopping center in resisting eviction for nonpayment of rent. Information that has been disclosed to the public or to other parties adverse to the former client ordinarily will not be disqualifying. Information acquired in a prior representation may have been rendered obsolete by the passage of time, a circumstance that may be relevant in determining whether two representations are substantially related. In the case of an organizational client, general knowledge of the client's policies and practices ordinarily will not preclude a subsequent representation; on the other hand, knowledge of specific facts gained in a prior representation that are relevant to the matter in question ordinarily will preclude such a representation. A former client is not required to reveal the confidential information learned by the lawyer in order to establish a substantial risk that the lawyer has confidential information to use in the subsequent matter. A conclusion about the possession of such information may be based on the nature of the services the lawyer provided the former client and information that would in ordinary practice be learned by a lawyer providing such services.

#### Lawyers Moving Between Firms

[4] When lawyers have been associated within a firm but then end their association, the question of whether a lawyer should undertake representation is more complicated. There are several competing considerations. First, the client previously represented by the former firm must be reasonably assured that the principle of loyalty to the client is not compromised. Second, the rule should not be so broadly cast as to preclude other persons from having reasonable choice of legal counsel. Third, the rule should not unreasonably hamper lawyers from forming new associations and taking on new clients after having left a previous association. In this connection, it should be recognized that today many lawyers practice in firms, that many lawyers to some degree limit their practice to one field or another, and that many move from one association to another several times in their careers. If the concept of imputation were applied with unqualified rigor, the result would be radical curtailment of the opportunity of lawyers to move from one practice setting to another and of the opportunity of clients to change counsel.

[5] Paragraph (b) operates to disqualify the lawyer only when the lawyer involved has actual knowledge of information protected by Rules 1.6 and 1.9(c). Thus, if a lawyer while with one firm acquired no knowledge or information relating to a particular client of the firm, and that lawyer later joined another firm, neither the lawyer individually nor the second firm is disqualified from representing another client in the same or a related matter even though the interests of the two clients conflict. See Rule 1.10(b) for the restrictions on a firm once a lawyer has terminated association with the firm.

[6] Application of paragraph (b) depends on a situation's particular facts, aided by inferences, deductions or working presumptions that reasonably may be made about the way in which lawyers work together. A lawyer may have general access to files of all clients of a law firm and may regularly participate in discussions of their affairs; it should be inferred that such a lawyer in fact is privy to all information about all the firm's clients. In contrast, another lawyer may have access to the files of only a limited number of clients and participate in discussions of the affairs of no other clients; in the absence of information to the contrary, it should be inferred that such a lawyer in fact is privy to information about the clients actually served but not those of other clients. In such an inquiry, the burden of proof should rest upon the firm whose disqualification is sought.

[7] Independent of the question of disqualification of a firm, a lawyer changing professional association has a continuing duty to preserve confidentiality of information about a client formerly represented. See Rules 1.6 and 1.9(c).

[8] Paragraph (c) provides that information acquired by the lawyer in the course of representing a client may not subsequently be used or revealed by the lawyer to the disadvantage of the client. However, the fact that a lawyer has once served a client does not preclude the lawyer from using generally known information about that client when later representing another client.

[9] The provisions of this Rule are for the protection of former clients and can be waived if the client gives informed consent, which consent must be confirmed in writing under paragraphs (a) and (b). See Rule 1.0(e). With regard to the effectiveness of an advance waiver, see Comment [22] to Rule 1.7. With regard to disqualification of a firm with which a lawyer is or was formerly associated, see Rule 1.10.

MARGULIES BY MARGULIES v. UPCHURCH, 696 P.2d 1195 (Utah 1985)

696 P.2d 1195

JASON MARK MARGULIES, BY AND THROUGH HIS  
GUARDIAN AD LITEM, DAVID K.

MARGULIES; DAVID K. MARGULIES; AND JANET C. MARGULIES, PLAINTIFFS, RESPONDENTS, AND  
CROSS-APPELLANTS,

v.

JOHN J. UPCHURCH, M.D.; CARL T. WOOLSEY, JR., M.D.; DAN L. CHICHESTER, M.D.; OB-GYN  
ASSOCIATES, INC., A UTAH PROFESSIONAL CORPORATION;  
ST. MARK'S HOSPITAL, A UTAH CORPORATION; AND DENNIS L. MORRIS, M.D.,  
DEFENDANTS, APPELLANTS, AND CROSS-RESPONDENTS,

v.

THIRD JUDICIAL DISTRICT COURT IN AND FOR SALT LAKE COUNTY,  
STATE OF UTAH,

AND THE HONORABLE DEAN E. CONDER, DISTRICT JUDGE, RESPONDENTS.

JOHN J. UPCHURCH, M.D., PLAINTIFF, v. THIRD JUDICIAL DISTRICT COURT AND THE HONORABLE  
DEAN E. CONDER, DISTRICT JUDGE, DEFENDANTS.

JASON MARK MARGULIES, ETC., PLAINTIFFS AND CROSS-APPELLANTS,

v.

JOHN J. UPCHURCH, ET AL.; ST. MARK'S HOSPITAL, A UTAH CORPORATION, DEFENDANTS,

APPELLANT, AND CROSS-RESPONDENTS,

v.

THIRD JUDICIAL DISTRICT COURT AND THE  
HONORABLE DEAN E. CONDER, DISTRICT JUDGE, RESPONDENTS.

Nos. 19762, 19763 and 19776.

Supreme Court of Utah.  
January 28, 1985.

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Appeal from the District Court.

Elliot J. Williams, David W. Slagle, Salt Lake City, for Morris.

P. Keith Nelson, Salt Lake City, for Upchurch.

Stewart M. Hanson, Jr., Michael W. Homer, Salt Lake City, for Woolsey and Chichester.

Carman E. Kipp, Salt Lake City, for St. Marks.

Donald Holbrook, William B. Bohling, Jeffrey L. Fillerup, Salt Lake City, for Margulies.

David L. Wilkerson, Atty. Gen., for third Dist. Ct.

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DURHAM, Justice:

This is an interlocutory appeal, involving consolidated cases, from an order of the district court denying appellants' (Upchurch, Woolsey, and Chichester) motion to disqualify plaintiffs' counsel in the case of *Margulies v. Upchurch*. The plaintiffs have filed a cross-appeal challenging the trial court's findings regarding the existence of a conflict of interest on the part of plaintiffs' counsel. We reverse on the appeal and affirm on the cross-appeal.

The law firm of Jones, Waldo, Holbrook & McDonough ("Jones, Waldo") represents the plaintiffs and cross-appellants Margulies in a major medical malpractice action filed in Third District Court. The defendants in that action include the appellants and cross-respondents Upchurch, Woolsey, Chichester, and St. Mark's Hospital. The complaint alleges negligence resulting in severe disabilities (quadriplegia, blindness, brain damage, and cerebral palsy) in the plaintiff Jason Margulies. The claim is for several million dollars in general and punitive damages, which amounts are likely to be in excess of available insurance coverage.

At the time of the entry of the order appealed from, Jones, Waldo was also involved as counsel in a federal case, *Diversified Energy/Intermountain Capital Private Drilling Fund 1981-A v. First City National Bank of Midland*, No. C840041A (D. Utah filed Jan. 17, 1984) (hereinafter cited as "*Diversified*"). In that case, Jones, Waldo represented the plaintiff Diversified Energy/Intermountain Capital Private Drilling Fund 1981-A ("*Diversified Energy*"), a Utah limited partnership with nineteen limited partners. Appellants Woolsey and Chichester are limited partners of Diversified Energy. Appellant Upchurch is a stockholder, former officer, and director of Intermountain Capital, a corporation that is co-general partner in Diversified Energy.

In order to become limited partners, Upchurch, Chichester, and Woolsey were all required to submit "suitability" forms outlining their personal financial status and investment experience to Diversified Energy. They were also required to purchase units in Diversified Energy by paying twenty percent of the value of the units in cash and financing the remaining eighty percent by obtaining individual, personal letters of credit. Those letters of credit were subsequently pledged by Diversified Energy to First City National Bank of Midland ("Midland"). Appellant Upchurch, in addition to the above-described participation, also provided Intermountain Capital with personal financial statements and co-signed on lines of credit for the corporation from Midland.

The Margulies' malpractice action was filed in October 1982 and was scheduled for trial in March 1984. In approximately September 1983, David Sundstrom, a co-general partner (along with Intermountain Capital, of which he was president) of Diversified Energy, retained Jones, Waldo as counsel for the partnership. Jones, Waldo informed Sundstrom of the pending medical malpractice suit against three of Diversified's limited partners and requested that Sundstrom attempt to acquire the three limited partners' written consent to Jones, Waldo's representation of Diversified Energy in a lawsuit against Midland. The *Diversified* litigation was aimed at preventing foreclosure on the individual letters of credit.

Sundstrom discussed the proposed representation with the appellants Woolsey and Upchurch, but failed to acquire their written consent. Chichester was not contacted at all, and he and Woolsey were apparently never informed of the nature and ethical implications of the potential conflict of interest. Upchurch discussed the problem with his individual counsel in the malpractice action and, after being told about the significance of the conflict, declined to consent to Jones, Waldo's undertaking the *Diversified* litigation. The uncontroverted facts appear to establish that the appellants neither consented to the representation nor affirmatively objected to it at this

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stage.<sup>[fn1]</sup> It is also established that Jones, Waldo never discussed the problem with any of appellants' individual counsel in the malpractice action.

Jones, Waldo filed a complaint in the *Diversified* case in January 1984. During that same month, the trial court entered an order in the malpractice action regarding discovery efforts by Jones, Waldo, on behalf of the plaintiffs, to obtain detailed information regarding Upchurch's personal and professional finances. Upchurch, upon learning that Jones, Waldo had not withdrawn from either lawsuit, contacted his lawyer, and a motion was made to have the firm disqualified in the *Margulies* case.

After hearing the motion for disqualification, the trial court prepared a memorandum decision in which it found that: (1) for all practical purposes, the appellants are parties in the *Diversified* litigation; (2) Jones, Waldo had a conflict of interest in violation of the Utah Rules of Professional Conduct in undertaking its representation in both cases; (3) there was "no willful nor intentional violation of [the] standards" in the rules by Jones, Waldo; and (4) there was not full disclosure to the appellants of the possible effect of the representation on the exercise of Jones, Waldo's professional judgment, as required by Utah Code of Professional Responsibility DR 5-105(C) (1977) and, therefore, any consent to or acquiescence in the representation did not satisfy the rule's requirement regarding exceptions. Further finding that "great inconvenience and problems of delay" would be imposed on the plaintiffs by Jones, Waldo's withdrawal from the malpractice case, the court gave the firm the alternative option of withdrawing from the *Diversified* case in federal court and submitting to an order prohibiting them from using in the *Margulies* case any information "gained or available" in connection with the federal court action. The court also found that "in addition to the ethical considerations . . . , there is a direct conflict in that in this action the plaintiffs have sought the financial statements of these defendants which was denied by the court but now the access to these very statements is [inherently] included in the federal case." Jones, Waldo withdrew from the federal actions, and an order was subsequently entered as outlined above.

There being relatively few reported decisions from this Court regarding the principles applicable to professional conduct, we look initially to standards of review articulated in other jurisdictions under similar rules of conduct. Trial courts are usually given broad discretion in controlling the conduct of attorneys in matters before the court, *Redd v. Shell Oil Co.*, [518 F.2d 311](#), [314](#) (10th Cir. 1975); their discretion extends to deciding whether disqualification is a proper sanction after a finding of an ethical violation, *W.T. Grant Co. v. Haines*, [531 F.2d 671](#), [676](#) (2d Cir. 1976). Some appellate courts, however, have undertaken review without deference to the trial court on the ground that the interpretation of the ethical rules governing the legal profession involves substantial legal questions. *Unified Sewerage Agency v. Jelco Inc.*, [646 F.2d 1339](#), [1344](#) n. 3 (9th Cir. 1981); *Kramer v. Scientific Control Corp.*, [534 F.2d 1085](#), [1088](#) (3d Cir. 1976), *cert. denied*, [429 U.S. 830](#), 97 S.Ct. 90, 50 L.Ed.2d 94 (1976); *American Roller Co. v. Budinger*, [513 F.2d 982](#), [985](#) n. 3 (3d Cir. 1975).

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We believe that the trial court's findings in the instant case generally involve mixed questions of fact and law which, on review, do not require the deference due to findings on questions of pure fact. However, the proper standard of review of that portion of the trial court's order which allowed Jones, Waldo to remain as counsel in the malpractice action is the abuse of discretion standard. *See Central Milk Producers Cooperative v. Sentry Food Stores, Inc.*, [573 F.2d 988](#), [991](#) (8th Cir. 1978); (*W.T. Grant Co. v. Haines*, 531 F.2d at 676; *Bicas v. Superior Court*, [116 Ariz. 69](#), [69](#), [567 P.2d 1198](#), [1198](#) (Ariz.Ct.App. 1977).

The record here adequately supports, and we agree with, the trial court's findings that an attorney-client relationship existed between Jones, Waldo and the appellants; that Jones, Waldo's concurrent representation of the doctors and the Margulies family created a conflict of interest; and that Jones, Waldo did not fully disclose the nature and possible effects of its concurrent representation to the appellants. Furthermore, under the circumstances of this case, we are persuaded that the trial court's order permitting Jones, Waldo to continue representing the Margulieses constituted an abuse of discretion.

Unless an attorney-client relationship or some fiduciary duty existed between Jones, Waldo and the appellants, there could be no conflict of interest created by the firm's representation of the Margulieses in their malpractice suit. The lower court found that an attorney-client relationship did in fact exist because the federal action, if successful, would directly aid and benefit Upchurch, Woolsey, and Chichester. We agree.

Jones, Waldo contends that a personal request for legal services or advice by the client and an acceptance by the attorney is necessary for an attorney-client relationship to be formed. We disagree. Even in the absence of an express attorney-client relationship, circumstances may give rise to an implied professional relationship or a fiduciary duty toward the client, thereby invoking the ethical mandates governing the practice of law. *Westinghouse Electric Corp. v. Kerr-McGee Corp.*, [580 F.2d 1311](#), [1319-20](#) (7th Cir. 1978), *cert. denied*, 439 U.S. 955, 99 S.Ct. 353, 58 L.Ed.2d 346 (1978). In a situation similar to this one, a federal district court implied a professional relationship where an officer of a corporation reasonably believed that an attorney had represented him although the attorney disclaimed any such relationship. *E.F. Hutton & Co. v. Brown*, [305 F. Supp. 371](#), [387-92](#) (S.D.Tex. 1971). Jones, Waldo's successful representation of the limited partnership in *Diversified* would have protected the appellants from substantial personal liability. Therefore, it was not at all unreasonable for the limited partners to believe that Jones, Waldo was acting for their individual interests as well as the interests of the partnership in that litigation. All three of the appellants attested that this was their impression and belief. Jones, Waldo's efforts, although limited, to notify appellants of the potential conflict of interest indicate that Jones, Waldo also recognized that the appellants might consider the firm to be representing their individual interests. Under these circumstances, actual consent is not necessary, and an attorney-client relationship or fiduciary duty may be implied. *See E.F. Hutton*, 305 F. Supp. at 387-92.

It should be noted that we do not find that an attorney automatically becomes counsel for limited partners when he or she undertakes representation of a limited partnership. Ethical Consideration 5-18 of the Utah Code of Professional Responsibility (1977) states that an attorney representing a corporation or similar entity owes allegiance to the entity rather than to its shareholders. A limited partnership is an entity equivalent to a corporation for litigation purposes, *Wall Investment Co. v. Garden Gate Distributing, Inc.*, Utah, [593 P.2d 542](#), [544](#) (1979), and therefore representation of a limited partnership does not of itself require allegiance to the interests of the limited partners. If the limited partners stand to gain nothing more from the

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attorney's representation of the limited partnership than the incidental gain which will accrue to them as partners, and not in their individual capacities, no attorney-client relationship should be implied. When, however, the individual interests of the limited partners are directly involved, as they are here, there may be sufficient grounds for implying the existence of an attorney-client relationship. [\[fn2\]](#)

Jones, Waldo argues that its representation in the federal action could neither benefit nor harm the appellants because the letters of credit pledged to Midland were obtained by appellants to finance eighty percent of their individual capital contributions to the limited partnership in lieu of cash. Because the limited partners would remain liable to the partnership for the value of the letters of credit even if Jones, Waldo succeeded in blocking Midland's execution on the note, any benefit realized would come from the renewed financial health of the partnership rather than from any individual benefit. This argument ignores the potential personal liability of the limited partners to Midland should the federal action be unsuccessful. The loan agreement between the partnership and Midland expressly makes the limited partners personally liable to Midland up to the amount of their individual letters of credit. Similarly, pursuant to assumption agreements signed by appellants, the limited partners were liable for the partnership's indebtedness up to the face value of their letters of credit. These documents demonstrate that the limited partners would benefit directly from Jones, Waldo's efforts to prevent Midland from collecting on the obligation. The fact that the partnership might at some future date utilize the letters of credit in some other transaction does not reduce the direct benefit the limited partners would receive by being freed from possible personal liability to Midland.

Under these circumstances, Jones, Waldo's representation of the limited partnership in the federal action gave rise to an attorney-client relationship between the firm and appellants, with a consequent obligation to conform to all applicable standards of professional behavior. We, therefore, uphold the district court's finding in this regard.

Jones, Waldo also argues that appellants should be stopped from objecting to the firm's representation of the Margulieses because of the timing of their motion, or should be deemed to have waived any right to object, based on appellants' consent to the firm's dual representation. Although Jones, Waldo is correct in pointing out that motions to disqualify opposing counsel may be used as a tool to harass and delay the opposition, such is not the case here. There is no basis in the record for the contention that appellants acted in bad faith in this case. The initial motion to disqualify was made shortly after the federal action was filed (and more than a month before trial of the malpractice action was to commence), the first time that the full dimensions of the conflict of interest became action. The facts here are not comparable to those in *Redd v. Shell Oil Co.*, [518 F.2d 311](#) (10th Cir. 1975), where the motion to disqualify was not filed until the Friday afternoon before a Monday trial, although the information upon which the motion was based had been known for five months. Further, the appellants cannot be presumed to have waived the right to object based on their alleged consent when adequate disclosure of the effects of Jones, Waldo's representation was not made.

In finding that conflict of interest existed by reason of Jones, Waldo's concurrent representation of the appellants and the Margulies family, the trial court noted: "The law has long recognized that an attorney is held to the highest duty of fidelity, honor, fair dealing and full disclosure to a client." We believe that the trial court's

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language is an excellent summary of the obligations imposed on counsel by the Utah Code of Professional Responsibility Canons 4, 5, 9 (1977): the duty to preserve the confidences and secrets of the client, Canon 4; the duty to exercise independent professional judgment on behalf of the client, Canon 5; and the duty to avoid even the appearance of professional impropriety, Canon 9.

#### CANONS 4 AND 5

The appellants contend that Jones, Waldo, as counsel in the federal action, obtained or had access to certain confidential financial information about them which might be used to their detriment in the malpractice action if Jones, Waldo continues to litigate that case. Canon 4's prohibitions against disclosure of client confidences and secrets<sup>[fn3]</sup> have generally been interpreted to forbid an attorney from representing a client against a former client in a matter substantially related to the former client's representation. *Trone v. Smith*, [621 F.2d 994, 998-99](#) (9th Cir. 1980); *General Electric Co. v. Valeron Corp.*, [608 F.2d 265, 267](#) (6th Cir. 1979), *cert. denied*, 455 U.S. 930, 100 S.Ct. 1318, 63 L.Ed.2d 763 (1980); *United States v. Standard Oil Co.*, [136 F. Supp. 345, 354](#) (S.D.N.Y. 1955). This rule is intended to prevent the possibility that an attorney might use information given in confidence by a former client in a later action against that client. Allowing later adverse representation when the former client's disclosures might be used against him could inhibit the free exchange of information between attorney and client which our legal system presupposes. We would be reluctant, however, to grant disqualification in the instant case solely on the basis of Canon 4. Case law on the degree of congruence necessary for two cases to be considered "substantially related" varies widely. *Compare Government of India v. Cook Industries, Inc.*, [569 F.2d 737, 739-40](#) (2d Cir. 1978) (disqualification granted only when issues identical or essentially the same) *with Melamed v. ITT Continental Baking Co.*, [592 F.2d 290, 292](#) (6th Cir. 1979) (matters embraced within suit need only be substantially related). There is in this case a dispute about the extent and confidential nature of information Jones, Waldo actually obtained by virtue of its employment in the federal action. Although the facts and issues involved may be so related that an attorney or firm will clearly be precluded from undertaking representation against a former client, the inevitable frequency with which large and departmentalized law firms will be asked to litigate against former clients suggests that disqualification pursuant to Canon 4 should not be granted lightly. We are not persuaded, however, by Jones, Waldo's argument that the financial information in question relates only to the prayer for punitive damages in the *Margulies* action and is, therefore, not relevant until after a demonstration of a basis for a punitive award. Even though it is true that Jones, Waldo could legitimately acquire such personal financial information on behalf of the Margulieses if there is a prima facie showing of grounds for punitive damages at trial, the premature possession of such information could well have substantial impact on settlement proposals and discussions and on trial strategy.

We believe, however, that this case is more easily resolved by considering, in conjunction with the Canon 4 problems, Canon 5. Disciplinary Rule 5-105 of the Code concerns situations where an attorney is representing two adverse clients simultaneously, rather than representing a current client against a former client. Although Jones, Waldo has discontinued its representation in *Diversified* as a condition to being allowed to continue in the *Margulies*

action, Jones, Waldo was counsel in both actions at the time the disqualification motion was filed. It is our strong view that an attorney who is simultaneously representing two clients with differing interests

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should not be able to avoid conforming to Canon 5 by simply dropping one of the clients at his option when a disqualification motion is filed. *See Unified Sewerage Agency v. Jelco Inc.*, [646 F.2d 1339, 1345](#) n. 4 (9<sup>th</sup> Cir. 1981); *see also Fund of Funds, Ltd. v. Arthur Andersen & Co.*, [435 F. Supp. 84, 95](#) (S.D.N.Y. 1977), *aff'd in part, rev'd in part on other grounds*, [567 F.2d 225](#) (2d Cir. 1977).

Otherwise, little incentive would exist for attorneys to avoid dual employment by adverse parties in the first place. Jones, Waldo's continued representation of the Margulieses must be judged by the standards applicable at the time the trial court's order was made, namely, at the time the firm was simultaneously representing appellants in the federal action.

Disciplinary Rule 5-105 of the Utah Code of Professional Responsibility states in part:

(B) A lawyer shall not continue multiple employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by his representation of another client, except to the extent permitted under DR 5-105(C).

(C) In the situations covered by DR 5-105(A) and (B), a lawyer may represent multiple clients *if it is obvious that he can adequately represent the interest of each and if each consents to the representation after full disclosure of the possible effect of such representation on the exercise of his independent professional judgment on behalf of each.*

(Emphasis added.) The first requirement of DR 5-105(C) is that it be "obvious" that the attorney be able to represent both clients adequately. Although adverse representation in itself might not frustrate fulfillment of this requirement, Jones, Waldo's receipt of financial information regarding the appellants' direct interests in the federal action should have raised some doubt in the minds of firm members as to the propriety of undertaking the federal action. At the very least, one has to wonder about the trust and confidence a physician will be able to repose in an attorney whose partners and associates are suing him for professional malpractice. The evidence before the trial court in this case demonstrated that Jones, Waldo was in fact aware that a conflict of interest problem did exist. The readily apparent nature of the problem indicates that it was not "obvious" that the firm could represent both clients adequately. *See* DR 5-105(C); *cf. Cinema 5, Ltd. v. Cinerama, Inc.*, [528 F.2d 1384, 1387](#) (2d Cir. 1976) (burden on firm to show that adverse representation not harmful).

The second requirement of DR 5-105(C) is that the attorney obtain consent to the dual representation after "*full disclosure of the possible effect of such representation.*" (Emphasis added.) The burden of showing full disclosure rests upon the attorney undertaking adverse employment. *In re Hansen*, Utah, [586 P.2d 413, 415](#) (1978).<sup>[fn4]</sup> Jones, Waldo contends that it obtained the requisite consent because it disclosed its relationship with the Margulies family to Sundstrom, the general partner in Diversified Energy, and to Ralston, the limited partner named as a party in the federal action. Jones, Waldo relies on the fact that the limited partnership gave its consent through Sundstrom and on the assertion that all the physicians expressly consented to the firm's representation of the limited partnership. Although there is a dispute about the details of appellants' alleged consent, there is no dispute about the fact that Jones, Waldo did not undertake "full disclosure of the possible effect of [the] representation on the exercise of [its] independent professional judgment on behalf of [appellants]," as required by the rule. DR 5-105(C). For client consent to be adequate in a conflict of interest situation, the attorney must not only inform

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both parties that he is undertaking to represent them, but must also explain the nature and implications of the conflict in enough detail so that the parties can understand why independent counsel may be desirable. *In re Boivin*, [271 Or. 419, 424, 533 P.2d 171, 174](#) (1975). No attorneys from Jones, Waldo spoke with appellants about the possible

conflict of interest; instead, the firm requested a layman, Sundstrom, to pass on the information and required no adequate assurances that he had done so properly. Reliance on a lay person is simply not sufficient to meet the standard of professional conduct. Sundstrom could not be supposed to understand the nuances of the ethical requirements of the situation and the alternatives available to the appellants. It does not even appear that he understood Jones, Waldo's dual representation to be possibly unethical. Nor can the fact that appellants paid a pro rata share of the limited partnership's legal fees to the firm vitiate the lack of full disclosure.

Although the trial court found that the requirements of DR 5-105(C) were not met, it allowed Jones, Waldo to continue as counsel for the Margulies family if the firm agreed to withdraw as counsel in the federal action and also agreed not to use any information obtained in the federal action. We believe that the trial court abused its discretion by not requiring Jones, Waldo to withdraw from employment in the malpractice case. Jones, Waldo's failure to comply with the standards set forth in Canon 5 may not be cured or rectified by an optional withdrawal in the case of its choice, for reasons we discuss hereafter.

#### CANON 9

Motions to disqualify opposing counsel present the court with two important but often opposing policy considerations: on the one hand, the undesirability of separating litigants from the counsel of their choice and, on the other, the necessity of ensuring that litigants and the public perceive lawyers and courts as possessing the integrity necessary for the disposition of justice. We are especially mindful of the latter consideration, as this Court is charged by law with approving and administering rules of conduct and discipline governing the practice of law in the State of Utah. U.C.A., 1953, §§ 78-51-14, -19 (1977). Among the guidelines for professional conduct which we have approved is Canon 9, which states: "A lawyer should avoid even the appearance of professional impropriety." The basis of this tenet is that society's perception of the integrity of our legal system may be as important as the reality, since it is the perception that engenders public confidence that justice will be dispensed. Litigants are highly unlikely to be able to maintain this confidence if their attorney in one matter is allowed simultaneously to sue them in another. As this Court said in another case involving an attorney representing two adverse parties concurrently:

The practice of law is a profession whose members are granted a special privilege of holding themselves out as having the education, the skills and the integrity to give help and guidance to others in their affairs. . . . This includes that the attorney will become unreservedly identified with his client's interests and protect his rights. It means not only in dealing with the client's adversary, but also that the attorney will adhere to the ideals of honesty and fidelity with the client himself; and that he will not use his position to take any unfair advantage of the special confidence which the client is entitled to repose in him.

*In re Hansen*, Utah, [586 P.2d 413, 416](#) (1978). Although *Hansen* was a disciplinary action rather than a disqualification motion, the principle that an attorney should become identified solely with the rights of his client and not use, or appear to use, his position to take advantage of his client's confidence in him is nonetheless valid here. We recognize that disqualification motions based on very slight appearances of impropriety have been misused for tactical advantage in litigation. See *Alexander v. Superior Court*, [141 Ariz. 157, 685 P.2d 1309, 1317](#) (1984). In this case,

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however, a serious appearance of impropriety is coupled with violations of the Code of Professional Responsibility which in and of themselves call for disqualification. The integrity of the court system as well as the integrity of the profession requires that Jones, Waldo withdraw from the malpractice action. We are aware that considerable hardship is thereby imposed on the Margulies family, the resolution of whose claim has been delayed by this unfortunate problem. We are hopeful, however, that the advanced state of discovery in their action and the availability of other counsel skilled in medical malpractice litigation in our bar will allow the case to proceed to trial relatively quickly. We urge the assistance of the district court in that regard. That portion of the order of the trial court allowing Jones, Waldo to remain as counsel in the malpractice action is reversed. The remainder of the order is affirmed.

HALL, C.J., and STEWART and HOWE, JJ., concur.

ZIMMERMAN, J., does not participate herein.

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[fn1] The affidavits submitted below show a conflict in the evidence respecting the consent question. Sundstrom's statement says: "Dr. Upchurch, based upon my personal conversations with him not only knew about the Firm's representation but consented to as well as paid for the Firm's representation of the Partnership." Upchurch stated that, after Sundstrom asked him to sign a letter of consent, he consulted with his attorney and was advised that a conflict existed and that he should not sign. No one talked directly to Chichester about this question.

The following facts, however, appear to be undisputed: first, none of the appellants affirmatively objected to the representation; second, no one from the partnership or Jones, Waldo disclosed or explained to them the possible effects of the representation or the ethical position of Jones, Waldo; and finally, no one from Jones, Waldo ever discussed the matter at all with any of the appellants before deciding to proceed.

[fn2] See *In re Banks*, [283 Or. 459, 471, 584 P.2d 284, 290](#) (1978), where the Oregon Supreme Court found that an attorney who was representing a closely held corporation was in fact representing both the corporation and its dominant shareholder because the interests of both were at stake.

[fn3] Utah Code of Professional Responsibility DR 4-101 (1977) forbids an attorney from using a confidence or secret of a client to the disadvantage of the client and bans revealing the information unless the client consents after full disclosure.

[fn4] *Hansen* appears to presume that any conflicting representation has the "adverse effect" required by DR 5-105(B) to invoke DR 5-105(C), as the subject matter of the two suits involved in *Hansen* was unrelated. *Id.* at 414; accord *I.B.M. v. Levin*, [579 F.2d 271, 280](#) (3d Cir. 1978); *Unified Sewerage Agency*, 646 F.2d at 1351.

*This opinion is subject to revision before final publication in the Pacific Reporter.*

IN THE SUPREME COURT OF THE STATE OF UTAH

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Samuel R. McLaughlin and  
John Does 1-10,  
Plaintiffs and Appellants,

No. 20070688

v.

Greg Schenk, Estate of Boyd  
Schenk, Anna Schenk, Cookietree,  
Inc., a Utah corporation,

F I L E D

Harold Rosemann, and Gayle Schenk,  
Defendants and Appellees.

October 2, 2009

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DURHAM, Chief Justice:

**INTRODUCTION**

¶1 In a public corporation, directors and officers owe the corporation and the shareholders collectively a duty to act in good faith and in the best interest of the corporation. In a partnership, each partner owes each of the other partners individually a duty to act with the utmost good faith. The appellant in this case, Samuel R. McLaughlin, a minority shareholder in a closely held corporation, asks this court to impose on shareholders in such corporations a duty to individual shareholders similar to the duty owed in a partnership. McLaughlin also asks us to reverse the district court’s holding that waivers of a provision of this closely held corporation’s shareholder agreement were valid, and reverse its order denying amendments to McLaughlin’s complaint. We hold that the appellee Greg Schenk, as a close corporation shareholder, owed McLaughlin individually a duty to act in the utmost good faith, but that he did not violate this duty because his actions did not thwart McLaughlin’s reasonable expectations. Additionally, we hold that waivers executed by the board and the shareholders of the corporation were contaminated by a conflict of interest, and we therefore remand for a determination of whether the waivers were fair. Finally, we hold that the district court did not abuse its discretion in denying McLaughlin’s motion to amend by finding that the amendment would be futile.

**BACKGROUND**

¶2 Because the trial court dismissed this case on summary judgment, “we review the facts and all reasonable inferences drawn therefrom in the light most favorable to the nonmoving party,” in this case, McLaughlin. GLFP, Ltd. v. CL Mgmt., Ltd., 2007 UT App 131, ¶ 5, 163 P.3d 636.

¶3 Cookietree, Inc. is a privately held Utah corporation that produces and retails baked goods. The company was formed in 1981, with Greg Schenk and his father, Boyd Schenk, among the original shareholders. Greg Schenk was named president at the corporation’s founding. He currently holds the same position. In 1992, Greg Schenk recruited Sam McLaughlin to work as the operations leader for Cookietree. McLaughlin’s previous experience at Pillsbury and Quaker Oats made him a valuable employee, and he was quickly promoted to vice president of operations and then chief operating officer and vice president of operations. As he invested more of his career in Cookietree, McLaughlin also invested his personal finances in the corporation by slowly purchasing increasing amounts of shares in the corporation.

¶4 As part of his agreement to join CookieTree as an employee, McLaughlin and the company agreed to certain terms, which were memorialized in an employment agreement. This agreement guaranteed McLaughlin a minimum salary that was supplemented with a bonus formula. It also provided him with the option of acquiring up to 200,000 shares of common stock in the company. Importantly, under the agreement, McLaughlin was an at-will employee. Thus, either party could terminate the employment relationship at any time so long as six-months notice was given.

¶5 In 1993, CookieTree and McLaughlin entered into an Incentive Stock Option Agreement that allowed McLaughlin to purchase an additional 200,000 shares of the company's common stock. This agreement also required McLaughlin to agree to a 1991 Shareholder Agreement. The 1991 Shareholder Agreement limited the ability of shareholders to sell, assign, or pledge their common stock. Under the agreement, selling shareholders had to first offer their shares, by written notice, to the corporation. If CookieTree did not elect to purchase any or all of the shares, the secretary of CookieTree was required to provide written notice to all shareholders identifying the number of shares available for purchase. Each shareholder was then entitled to purchase a portion of the shares equal to his or her ownership percentage of the outstanding common stock. If, at the close of the applicable option periods, not all available shares had been purchased, the selling shareholder could then sell the shares elsewhere. The agreement also provided that written consent from either the board of directors or the owners of at least two-thirds of the shares (excluding the shares owned by the selling shareholder) could waive the agreement's restrictions on share transfers. The 1991 Shareholder Agreement was replaced in 1999 with a new shareholder agreement, which contained the same terms.

¶6 In 1998, the majority shareholder of CookieTree, Boyd Schenck, passed away. Just before his death he transferred 818,000 shares to Greg Schenck.<sup>1</sup> Following this transfer Greg Schenck owned around 49 percent of CookieTree, with Boyd Schenck retaining around ten percent (545,200) of the company's shares. After Boyd's death, Boyd's wife, Anna,<sup>2</sup> sold Greg Schenck 545,200 shares, making Greg Schenck the majority shareholder, with about sixty-five percent of the company's stock. This transfer was not recorded in CookieTree's minutes or written records, and a right of first refusal was not provided to the corporation or the other shareholders. Stock certificates were nonetheless issued. At the time this transfer was made, it violated the 1991 Shareholder Agreement.

¶7 In 2003, Greg Schenck indicated that he was interested in selling CookieTree. McLaughlin wanted to purchase the company and sent a letter of intent, which conveyed this interest to CookieTree and its president, Greg Schenck. McLaughlin, however, was never able to raise the full amount of the purchase price. During this period, Greg Schenck began discussions with another cookie company, Otis Spunkmeyer, which was interested as a strategic buyer in purchasing CookieTree.

¶8 At this point, the relationship between McLaughlin and Greg Schenck, which previously had been not only professional but also personal and social, began to deteriorate. McLaughlin would not agree to various terms of the Otis Spunkmeyer transaction, including consent to a noncompete agreement. About this same time, McLaughlin learned of the prior stock transfer between Anna Schenck and Greg Schenck. During the discussions with Otis Spunkmeyer, McLaughlin insisted on his right of first refusal for any sold and transferred stock. McLaughlin was thereafter excluded from executive meetings. McLaughlin alleges that after he asserted his right to a bonus on the asset sale of CookieTree to Otis Spunkmeyer, Greg Schenck and Otis Spunkmeyer officers negotiated to instead structure the sale as a stock sale. McLaughlin continued to demand his right of first refusal and requested documentation regarding Anna Schenck's stock sale to Greg Schenck.

¶9 On August 4, 2004, Harold Rosemann, board member and chief financial officer for CookieTree, instructed Kim McLaughlin, McLaughlin's wife and also an employee of CookieTree, to tell McLaughlin to withdraw his claims or "there's going to be some organizational changes around here." On August 17, 2004, as a shareholder, McLaughlin made an additional request for information regarding the Schenck stock transaction. That same day Greg Schenck confronted McLaughlin and fired him. His notice of termination indicated that it was without cause. Pursuant to McLaughlin's employment agreement, the termination date was not effective for six months. Thus, McLaughlin continued to receive his salary and bonuses for six months, although this compensation was paid at his original contract rate rather than his current salary and bonus rate. McLaughlin was immediately relieved of all duties, blocked from company email, and excluded from the corporate premises. When McLaughlin refused to leave, police escorted him from the property. After McLaughlin's termination, CookieTree contacted McLaughlin's lawyer and indicated that

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<sup>1</sup> This transaction was not subject to the right of refusal provisions of the shareholder agreement because it was a transfer between immediate family members, which was allowed under the 1991 Shareholder Agreement.

<sup>2</sup> The parties disagree on whether Boyd's estate or Anna transferred the shares to Greg Schenck. The district court indicated in its order that Anna transferred the shares to Greg Schenck. We rely on this implicit factual finding

“everything [was] negotiable; [they] were looking for a global resolution.” Following his termination McLaughlin continued to receive dividends from his Cookietree holdings. This income, along with his wife’s stock dividends, comprised half of their family’s income. Kim McLaughlin continued to work at Cookietree for some time after McLaughlin’s termination.

¶10 In November 2004, McLaughlin sued Cookietree and Greg Schenck for breach of contract and breach of fiduciary duty based on Greg Schenck’s stock acquisition. In March 2005, McLaughlin filed another suit against Cookietree and Greg Schenck for breach of contract and breach of fiduciary duty based on McLaughlin’s termination. McLaughlin also filed a derivative action. All three cases were then consolidated in the district court. The district court referred McLaughlin’s claims relating to his employment contract to arbitration. McLaughlin was awarded damages for Cookietree’s breach of an implied duty of good faith and fair dealing for paying the 1992 contract salary rate for McLaughlin’s severance pay rather than his most recent salary and bonus rate. The arbitrator dismissed all other contract claims and deferred to the district court to resolve the breach of fiduciary duty claim relating to the termination.

¶11 In May 2005 during an unnoticed meeting, Cookietree’s board of directors--Greg Schenck; his wife, Gayle Schenck; and Harold Rosemann--ratified the 1999 stock transaction by waiving the corporation’s right of refusal. Around the same time, Greg Schenck contacted Jerry Smekal, a Cookietree shareholder, and requested that he also sign a consent and waiver ratifying the 1999 transaction. Smekal, who held 529,000 shares, agreed to sign the form. Additionally, Greg Schenck and Harold Rosemann also signed the shareholder consent and waiver forms, representing 2,181,200 and 316,000 respectively, or nearly ninety percent, of Cookietree’s shares.

¶12 Cookietree moved to dismiss McLaughlin’s claims on summary judgment. The district court granted the motion and dismissed all pending claims, finding that Greg Schenck did not owe any fiduciary duty to McLaughlin with respect to the “dealings related to McLaughlin in his role as an employee” and that Cookietree, not Greg Schenck, terminated McLaughlin from his employment. Additionally, with respect to the stock transaction, the district court found that “all of the actions taken by both Cookietree and Mr. Schenck were within the terms of the [1991 shareholder] agreement and, to the extent certain corporate actions were not undertaken at the time of the sale, the 2005 waiver and ratification actions were effective as a matter of law.” With these findings, the district court held that it was “unable to identify any factual claim . . . that would give rise to a claim for breach of fiduciary duty,” and thus dismissed all claims, but left McLaughlin with the option to “come forward with facts and evidence that would support a breach of fiduciary duty claim that has not already been addressed.” Shortly thereafter, McLaughlin moved for permission to amend his complaint by adding Gayle Schenck and Harold Rosemann as additional parties. The basis for his breach of fiduciary duty claims largely remained the same. The district court denied this motion holding that an amendment would be futile because McLaughlin failed to identify any evidence that was not addressed by the summary judgment. McLaughlin appealed the district court’s final order. We have jurisdiction pursuant to Utah Code section 78A-3-102(3)(j) (2008).

## ISSUES AND STANDARD OF REVIEW

¶13 McLaughlin asks this court to review the district court’s grant of summary judgment to the defendants on three grounds. First, McLaughlin asks the court to determine whether Cookietree shareholders owed McLaughlin fiduciary duties individually, and if so whether any such duty was violated. Second, McLaughlin requests that we review whether the board’s and shareholders’ 2005 ratifications were “valid and effective.” Finally, McLaughlin argues the district court abused its discretion in denying McLaughlin’s motion to amend his complaint.

¶14 Summary judgment “is appropriate only in the absence of any genuine issue of material fact and where the moving party is entitled to judgment as a matter of law.” S. Utah Wilderness Alliance v. Automated Geographic Reference Ctr., 2008 UT 88, ¶ 12, 200 P.3d 643. Accordingly, when “reviewing a district court’s grant of summary judgment, we review the facts and all reasonable inferences in the light most favorable to the nonmoving party.” Id. As to the underlying determinations, we review legal questions, such as the scope of a shareholder’s fiduciary duty and the validity of share transfers under the shareholder agreement, for correctness. We review a district court’s decision to deny a plaintiff’s motion to amend its complaint for abuse of discretion. See Swan Creek Vill. Homeowners Ass’n v. Warne, 2006 UT 22, ¶ 15, 134 P.2d 1122. We note, however, that this discretion is not unlimited. Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc., 970 P.2d 1273, 1281-82 (Utah 1998).

## ANALYSIS

### I. SHAREHOLDERS IN CLOSELY HELD CORPORATIONS OWE EACH OTHER ENHANCED FIDUCIARY DUTIES, BUT SCHENCK DID NOT VIOLATE ANY DUTY OWED TO MCLAUGHLIN

¶15 This case presents the question of whether shareholders of closely held corporations<sup>3</sup>--also commonly known as close corporations--should be treated differently than shareholders of publicly traded corporations when applying the provisions of the Utah Revised Business Corporation Act (the Corporation Act), Utah Code Ann. §§ 16-10a-101 to -1705 (2005 & Supp. 2008), and the accompanying interpretive and common law case law. We previously acknowledged that in close corporations it is “unlikely that there is a disinterested board,” Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc., 970 P.2d 1273, 1280 (Utah 1998), and that such corporations are more vulnerable to malfeasance because of the overlapping identity of board members and majority shareholders. Angel Investors, LLC v. Garrity, 2009 UT 40, ¶ 21, \_\_\_ P.3d \_\_\_. For these reasons, we have treated close corporations differently by allowing shareholders in these corporations to proceed as a class of one in derivative actions. Id. ¶ 22. We also have allowed close corporation shareholders to proceed both derivatively and directly against corporate officers for breaches of duties owed to the corporation and to minority shareholders. Aurora Credit Servs., Inc., 970 P.2d at 1280-81. In this case we now consider whether the duties owed by shareholders differ in closely held corporations and publicly traded corporations, and if so, whether these duties were breached on those facts.

#### A. The Fiduciary Duty of Shareholders in Closely Held Corporations Is Similar to the Duty of Partners in a Partnership

¶16 Under the revised business code, directors and officers are required to carry out their corporate duties in good faith, with prudent care, and in the best interest of the corporation. Utah Code Ann. § 16-10a-840 (2005). These corporate duties have been interpreted to coincide with the common law understanding that officers and directors owe these duties to the corporation and shareholders collectively, not individually. Aurora Credit Servs., 970 P.2d at 1280 (indicating that actions for breach of a fiduciary duty generally belong to the corporation). In this case, however, McLaughlin urges us to apply a different standard--the partnership standard. In contrast to the general standard for corporate duties, the statutory partnership standard of care has been interpreted to require the utmost good faith between individual partners. Ong, Int'l (U.S.A.), Inc. v. 11th Ave. Corp., 850 P.2d 447, 453-54 (Utah 1993) (“Normally partners ‘occupy a fiduciary relationship and must deal with each other in the utmost good faith.’” (quoting Burke v. Farrell, 656 P.2d 1015, 1017 (Utah 1982)); Nelson v. Matsch, 110 P. 865, 868 (Utah 1910) (“[P]artners stand in a fiduciary relation to each other, and that [ ] is the duty of each partner to observe the utmost good faith towards his copartners in all dealings and transactions that come within the scope of the partnership business.”); Utah Code Ann. § 48-1-18 (2007).

¶17 Whether to modify the fiduciary duty standard in closely held corporations is an issue of first impression for this court. Numerous other states have considered the question, and; we look to their analyses and to the Corporation Act’s language and structure to guide our determination. See Arndt v. First Interstate Bank of Utah, N.A., 1999 UT 91, ¶ 17, 991 P.2d 584 (indicating that in the absence of Utah precedent, the court looks to Utah statutes and “case law from other jurisdictions for guidance”).

¶18 McLaughlin urges us to follow the partnership-like duty standard originally articulated by Massachusetts courts and subsequently adopted by several other states. Beginning with Donahue v. Rodd Electrotype Co. of New England, 328 N.E.2d 505 (Mass. 1975), Massachusetts changed the landscape of duties owed by shareholders in close corporations. Relying on (1) the resemblance between close corporations and partnerships, (2) the need for trust and confidence in such companies, and (3) the inherent risk of loss due to shareholders’ inability to recoup their investments, the Massachusetts court imposed on close corporation shareholders the same duties owed by partners--utmost good faith and loyalty to all shareholders of the corporation. Id. at 515. Compared to the fiduciary duty owed by directors and stockholders of public corporations, the court found this duty to be “more rigorous” than the “somewhat less stringent” corporate duty of “good faith and inherent fairness.” Id. at 515-16. The Donahue court explained, “stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They

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<sup>3</sup> In Utah, we consider a closely held corporation to be a company in which there is ““(1) a small number of shareholders; (2) no ready market for corporate stock; and (3) active shareholder participation in the business.”” Angel Investors, LLC v. Garrity, 2009 UT 40, ¶ 21 \_\_\_ P.3d \_\_\_ (quoting Dansie v. City of Herriman, 2006 UT 23, ¶ 17, 134 P.3d 1139).

may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.” Id. at 515. The Massachusetts courts have repeatedly upheld and applied this standard. See O’Brien v. Pearson, 868 N.E.2d 118, 124 (Mass. 2007); Zimmerman v. Bogoff, 524 N.E.2d 849, 853 (Mass. 1988); Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976). The Donahue standard has also been adopted by other jurisdictions. Hollis v. Hill, 232 F.3d 460, 468 (5th Cir. 2000) (noting that Donahue’s “recognition of special rules of fiduciary duty applicable to close corporations has gained widespread acceptance.”); Orchard v. Covelli, 590 F. Supp. 1548, 1559 (W.D. Pa. 1984). (“The duty of utmost good faith and loyalty in the context of closely[]held corporations has been recognized by a number of courts confronting similar fact situations.”).

¶19 The defendants, however, urge this court to follow the minority position, which has been adopted by Delaware and Texas. The minority position narrowly construes the duties of shareholders in a closely held corporation and differentiates between a person’s status as employee and shareholder. In Riblett Products Corp. v. Nagy, for example, the Delaware Supreme Court noted that Delaware had not adopted Massachusetts’ approach to fiduciary duties, but instead imposed identical duties on shareholders of closely held corporations and public corporations. 683 A.2d 39 n.2 (Del. 1996); accord Hoggett v. Brown, 971 S.W.2d 472, 488 (Tex. App. 1997) (“[A] co-shareholder in a closely held corporation does not as a matter of law owe a fiduciary duty to his co-shareholder.”). Additionally, the Delaware Supreme Court distinguished between the plaintiff’s rights as a stockholder and his contractual rights as an employee. Riblett Prods. Corp., 683 A.2d at 40. While the court noted the Riblett plaintiff had not alleged that his termination amounted to a wrongful freeze-out of his stock interest, in subsequent cases where the plaintiff has made such allegations, other courts following Delaware’s approach have determined that any injury caused by a termination decision would only be an injury to an individual’s employment interests and not to his interests as a stockholder. Berman v. Physical Med. Assocs., Ltd., 225 F.3d 429, 433 (4th Cir. 2000). At least one court has described this approach as being more predictable because it treats all corporations the same way. Bagdon v. Bridgestone/Firestone, Inc., 916 F.2d 379, 383-84 (7th Cir. 1990) (comparing Ohio’s Donahue fiduciary duty standard for close corporations to Delaware’s traditional standard). The Delaware approach thus stands in sharp contrast to the fiduciary duty standard followed by the majority of states.

¶20 Presented with two divergent approaches, we must assess which approach best suits Utah’s corporate law scheme. Our Corporation Act does not provide explicit guidance, as it does not directly address close corporations or duties between shareholders. However, considering the Act as a whole and its specific provisions together, such as the duties imposed on directors and the dissolution remedy explicitly outlined, Utah Code Ann. §§ 16-10a-840, -1430(b), we believe it is apparent that the legislature intended to protect shareholders from oppression and misconduct by those in control. To construe the Act’s provisions to require the same fiduciary duties for publicly held and closely held corporate shareholders would not adequately protect close corporation shareholders. This is because the Model Business Code, on which the Utah Corporation Act was based, was developed largely in the context of publicly held corporations and the common law surrounding their governance. See Model Bus. Corp. Act Ann. Introduction (2009) (“[T]he Model Act does not generally distinguish between publicly held and privately held corporations.” Additionally, the Model Act “was amended in 1990 and 2006 “to provide greater certainty and more flexibility to non-public corporations.”); See also F. Hodge O’Neal, Robert B. Thompson, & Blake Thompson, O’Neal & Thompson’s Close Corporations and LLCs: Law and Practice § 9:21 (3d ed. 2004) (“Courts recognize that the usual default rules of corporate law affect close corporations differently from large publicly held corporations . . .”). Close corporations differ, however, in significant ways, and when these differences result in undesired outcomes, we have interpreted the Corporation Act in a way that achieves the intent and goal of the Act as a whole. This is a trend followed by many courts. See Melrose v. Capital City Motor Lodge, Inc., 705 N.E.2d 985, 990 (Ind. 1998) (“Courts have traditionally interpreted fiduciary duties differently for closely[] held corporations as opposed to publicly held corporations for which most of the statutory norms were established.”).

¶21 As discussed in Angel Investors and Aurora, the form of closely held corporations subjects shareholders to distinct challenges in protecting their investment. These core characteristics, and other common elements, lead to what has been referred to as the close corporation trap. James M. Van Vliet, Jr. & Mark D. Snider, The Evolving Fiduciary Duty Solution for Shareholders Caught in a Closely Held Corporation Trap, 18 N. Ill. U. L. Rev. 239, 242 (1998); see also F. Hodge O’Neil, Robert B. Thompson, & Blake Thompson, O’Neal and Thompson’s Close Corporations and LLCs: Law and Practice § 9:2 (3d ed. 2004) (noting that a close corporation shareholder “does not have a partner’s power to dissolve the enterprise and get out” and similarly does not have the “exit option” of selling her shares in a securities market available to shareholders of publicly held corporations). Shareholders in close corporations lack a ready market for their shares. This means that closely held corporation shareholders have no liquidity in their shares, see Donahue, 328 N.E.2d at 515 (“No outsider would knowingly assume the position of the disadvantaged minority.”), and have no avenue for price discovery other than the costly process of acquiring an independent valuation for the company. Without an available market in which to sell their interest in a company, minority shareholders who disagree with the direction or governance of the close corporation must rely on contractual or statutory remedies, which are often nonexistent, impractical, or inadequate. Id. This, in effect, leaves the shareholder with no remedy for the abuses and oppression that may result due

to the small number of shareholders, the frequency of familial and other personal relationships, and the likelihood that majority shareholders control the board in close corporations. Though the Act provides for dissolution, this is often a drastic remedy that may not serve the interest of the complaining shareholder and certainly not the corporation of which he is a part owner.

¶22 Without a market remedy, shareholders in close corporations are easily subjected to freeze outs, squeeze outs, and other forms of oppression, which the Corporation Act aims to prevent. Thus, the Massachusetts approach of recognizing broader fiduciary duties in closely held corporations better achieves the goals of the Act by stemming shareholder oppression and is the appropriate standard for evaluating fiduciary relationships among shareholders in a closely held corporation. Our adoption of the Massachusetts standard is a logical extension of our existing case law regarding close corporations, which acknowledges the unique nature of such corporations and seeks to protect their shareholders by interpreting the Corporation Act with different corporate circumstances in mind. By adopting this broader fiduciary obligation for close corporation shareholders, alternative remedies exist for oppressed shareholders,<sup>4</sup> such as an equitable claim for dissolution or a claim for breach of fiduciary duty.

¶23 Having concluded that shareholders in closely held corporations owe their coshareholders fiduciary obligations, we now consider whether the Defendants breached these duties in this case.

B. A Shareholder Violates His Duty of Utmost Good Faith  
When He Thwarts Another Shareholder's Reasonable  
Expectations of Benefits Derived From  
Ownership in the Corporation

¶24 Breaches of the fiduciary duty owed by close corporation shareholders arise in several circumstances, the facts of which commonly overlap. These circumstances have been identified as unequal treatment, frustration of reasonable expectations of involvement, and a freezeout or squeezeout. James M. Van Vliet, Jr. & Mark D. Snider, The Evolving Fiduciary Duty Solution for Shareholders Caught in a Closely Held Corporation Trap, 18 N. Ill. U. L. Rev. 239, 252 (1998). In all cases there is a common element--a shareholder's investment expectation in a close corporation is frustrated by another shareholder's actions. Brodie v. Jordan, 857 N.E.2d 1076, 1079- 80 (Mass. 2006) (noting that examples of breaches of duty share the common element of majority shareholders frustrating minority shareholders' reasonable expectation of benefit from their ownership of shares); Douglas K. Moll, Shareholder Oppression v. Employment At Will in the Close Corporation: The Investment Model Solution, 1999 U. Ill. L. Rev. 517, 520-21 (1999) (arguing that investment model "reconciles the doctrines of shareholder oppression and employment at will"); James M. Van Vliet, Jr. & Mark D. Snider, The Evolving Fiduciary Duty Solution for Shareholders Caught in a Closely Held Corporation Trap, 18 N.Ill. U. L. Rev. 239, 252 (1998).

¶25 Analyzing breach of fiduciary claims in this light, courts have narrowed the potentially broad duty espoused by Donahue to a more investment-based analysis. Brodie, 857 N.E.2d at 1079 (Mass. 2006) ("A number of other jurisdictions . . . also look to shareholders' 'reasonable expectations' in determining whether to grant relief to an aggrieved minority shareholder in a close corporation."). For example, beginning again with Massachusetts, in Wilkes v. Springside Nursing Homes, Inc., the Massachusetts Supreme Court described the termination of an officer from the close corporation as a squeezeout that "effectively frustrate[d] the minority stockholder's purpose in entering on the corporate venture and also den[ie]d him an equal return on his investment." 353 N.E.2d 657, 663 (Mass. 1976). The Wilkes court then explained the importance of balancing a shareholder's expectations with the reasonable and legitimate business interests of the other shareholders. Id. "Therefore, when minority stockholders in a close corporation bring suit . . . alleging a breach of the strict good faith duty," courts "must carefully analyze the action taken by the controlling stockholders in the individual case" and ask "whether the controlling group can demonstrate a legitimate business purpose for its action." Id.

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<sup>4</sup> At the time Donahue was decided, Massachusetts did not have a statutory remedy for oppression. Many of the states that have followed suit have enacted minority oppression statutory remedies--usually dissolution--but allow distinct actions for breaches of the Donahue duties. See e.g., Walta v. Gallegos Law Firm, P.C., 40 P.3d 449, 457 (N.M. Ct. App. 2001) ("[D]rawing on our partnership case law, we hold that breach of this fiduciary duty can be asserted as an individual claim separate from the remedies available under our statutory corporate law for oppressive conduct."); Balvik v. Sylvester, 411 N.W.2d 383, 388- 89 (N.D. 1987) (holding that statute governing corporations allowed "alternative equitable remedies not specifically stated in the statute"); Baker v. Commercial Body Builders, Inc., 507 P.2d 387, 395 (Or. 1973) ("[C]ourts are not limited to the remedy of dissolution, but may, as an alternative, consider other appropriate equitable relief.").

¶26 Under this standard for fiduciary duty protection, the termination of an employee is not always a breach of fiduciary duty. See Merola v. Exergen Corp., 668 N.E.2d 351, 354-55 (Mass. 1996). In Merola the court found the plaintiff's termination was not a breach of fiduciary duty because the plaintiff's investment in the corporation was not tied to employment in any formal way. Id. Comparing the facts in Merola to the facts in Wilkes, the court noted that in Wilkes the policy and practice of the corporation was to divide the profits of the corporation equally by way of salaries to the shareholders who participated in the operation of the corporation. This distribution of the company's resources was based on the fact that under the corporation's long-standing policy, employment with the corporation went "hand in hand with stock ownership." Id. at 354. The corporation in Merola, on the other hand, had no such policy. And, while the plaintiff may have expected continued employment, the value of his shares were independent of his employment status. Id. This was evidenced by the fact of the increase in the value of his stock and a lack of indication that he was required to purchase stock to keep his job. Id. The court also noted the plaintiff was not a founding member of the corporation, a fact considered by other courts as well. Id.

¶27 "Not every discharge of an at-will employee of a close corporation who happens to own stock in the corporation gives rise to a successful breach of fiduciary duty claim." Id. at 355. Instead, the court must consider the formal policies and practices of the close corporation, and how these policies and practices are interpreted by and impact all shareholders to determine whether or not a shareholder's reasonable expectations were thwarted. As the North Dakota Supreme Court has explained, when considering an allegation of oppressive conduct, a court should review

what the majority shareholders knew, or should have known, to be the petitioner's expectations in entering the particular enterprise. Majority conduct should not be deemed oppressive simply because the petitioner's subjective hopes and desires in joining the venture are not fulfilled. Disappointment alone should not necessarily be equated with oppression.

Balvik v. Sylvester, 411 N.W.2d 383, 387 (N.D. 1987) (quoting Matter of Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. App. Div. 1984)); see also Fox v. 7L Bar Ranch Co., 645 P.2d 929, 933 (Mont. 1982). This close consideration of shareholders' expectations is necessary to ensure that corporations are not crippled and kept from efficiently operating their business; it is well accepted that corporate officers "must have a large measure of discretion . . . in declaring or withholding dividends, deciding whether to merge or consolidate, establishing the salaries of corporate officers, dismissing directors with or without cause, and hiring and firing corporate employees." Wilkes, 353 N.E.2d at 663.

¶28 Applying the foregoing principles to this case, we conclude that CookieTREE did not thwart McLaughlin's investment expectation. McLaughlin was not a founding member who created the company with the expectation of employment. Instead, after the corporation was well established, McLaughlin was recruited for his specialized experience in similar industries. His primary reason for joining CookieTREE was employment. This employment allowed him to purchase stock in CookieTREE, but he was not required to do so. And, while it is likely that his initial stock purchase allowance and the later stock purchase agreement were offered as an incentive or reward for McLaughlin's work performance, the purchase allowances were not inextricably tied to his employment; they were a separate investment in the company. In addition to his stock purchases, and unlike the plaintiff in Wilkes, McLaughlin was paid a competitive salary for his contributions to the company. His investment in the company was separately rewarded through the payment of dividends, which he continued to receive after his termination. Therefore, in terminating McLaughlin, Schenck<sup>5</sup> did not thwart McLaughlin's investment expectations in the company and therefore did not violate any duty owed to McLaughlin.

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<sup>5</sup> The district court found that CookieTREE, not Schenck, terminated McLaughlin's employment, and therefore, Schenck was not liable for any damages caused by terminating McLaughlin. This was incorrect. Schenck terminated McLaughlin as the president of CookieTREE and is liable if in doing so he breached a fiduciary duty, including his duty to discharge both his "management and stockholder responsibilities in conformity with this strict good faith standard." Wilkes, 353 N.E.2d 657, 662 (Mass. 1976) (quoting Donahue, 328 N.E.2d at 515)); see also Armed Forces Ins. Exch. v. Harrison, 2003 UT 14, ¶ 19, 70 P.3d 35 ("[A]n officer or director of a corporation is not personally liable for torts of the corporation or of its other officers and agents merely by virtue of holding corporate office, but can only incur personal liability by participating in the wrongful activity.") (quoting 3A William Meade Fletcher, Fletcher Encyclopedia of the Law of Private Corporations § 1137, at 209 (rev. ed. 2002)).

¶29 McLaughlin also argues that Rosemann and Schenck breached the fiduciary duty they owed to McLaughlin by transferring and later ratifying the stock transaction between Anna Schenck and Greg Schenck. This allegation is dependent, however, on McLaughlin's claim that the transfer was unlawful; all stock transactions promote the parties' interests, and therefore only breach a duty when they are accomplished in an unfair or unlawful manner. Therefore, we next consider whether the stock transaction violated Cookietree's corporate charter or the Corporation Act.

## II. THE SCHENCK TRANSACTION DID NOT VIOLATE THE CORPORATE CHARTER OR THE CORPORATION ACT, BUT THE WAIVERS WERE TAINTED BY A CONFLICT OF INTEREST

¶30 The 1991 and 1999 shareholder agreements limit the transfer of shares by imposing first rights of refusal on any share transfer. If a shareholder wishes to sell or otherwise transfer his shares, the shareholder must first offer Cookietree the opportunity to purchase the shares. If Cookietree declines to purchase the stock, then the corporation's shareholders have a right to purchase a portion of the offered shares equal to the percentage of the company's shares they already own. Under the agreements, "[a]ny sale or transfer . . . shall be null and void unless the terms, conditions, and provisions of this Agreement are strictly observed and followed." The limitation on share transfers may be waived by a "duly authorized action of [Cookietree's] Board of Directors, or by the Shareholders, upon the express written consent of the owners of at least two-thirds of the Shares . . . (excluding those Shares owned by the selling shareholder)."

¶31 The transfer of shares from Anna Schenck to Greg Schenck did not conform to the first right of refusal provision; therefore it was void unless the waivers by the Board and three of Cookietree's shareholders were valid. McLaughlin argues that the ratification of the Schenck transaction was invalid because the waivers were based on an expired Shareholder Agreement, were untimely, violated Cookietree's bylaws, and, in the case of the Board waiver, was a conflicting interest transaction under the Corporation Act. We disagree that the waivers were enacted without authority, were untimely, or were in violation of Cookietree's bylaws or of statutory conflict of interest provisions. However, we acknowledge the waivers were tainted by a conflict of interest and thereby remand for a determination of whether they were fair.

¶32 First, the stock transaction between Anna and Greg Schenck is subject to the 1991 Shareholder Agreement. McLaughlin argues that the waivers were invalid because the initial transaction occurred when the 1991 Shareholder Agreement was in effect but the waiver occurred after the Agreement was superseded by the 1999 Agreement. Where there was no lapse between the two agreements, there was no such contractual no-mans land. The share transfer and waiver were part of the same transaction and are governed by either the 1991 Agreement or the 1999 Agreement, both of which provide for a waiver of the agreement's limitations on share transfers. In this case, the transaction occurred in August 1999 and the 1999 Shareholder Agreement became effective in November 1999. Therefore, the 1991 Agreement is the controlling document. Whether the waiver was invalid because it was acquired so long after the share transfer is an issue of timeliness, not authority.

¶33 Pursuant to the Corporation Act, the waiver was timely. McLaughlin argues the waivers, obtained over six years after the stock transfer, could not have been timely as a matter of law, and therefore the issue should have been submitted to a jury. McLaughlin is correct that whether or not ratification actually occurred is a question of fact. However, he fails to cite any disputed issues of fact that would have prevented the district court from determining the question as a matter of law on summary judgment. There is no dispute that the waivers were obtained, nor is there a challenge to the date of the waivers or the involved parties. Under the Corporation Act, the waivers are effective as of the date indicated by the board of directors in the waiver and consent. Utah Code Ann. § 16-10a-821(2); see also 2A William Meade Fletcher, Cyclopedia of the Law of Private Corporations § 782 (rev. ed 2009). McLaughlin relies on agency law to argue that the Board should not be allowed to execute the waiver and consent after so much time had elapsed because it would be unfair and disadvantageous to him. To persuade this court to adopt such an equitable principle, McLaughlin must present a developed common law principle or a strong policy reason to support its adoption. He has not argued either. Therefore, we rely on the plain language of the Corporation Act, which allows the board to act retroactively by assigning ex post-facto effective dates to their actions. As presented to the district court, McLaughlin did not present any disputed fact that would foreclose the district court from determining as a matter of law that the waivers were timely.

¶34 Additionally, the waivers did not violate Cookietree's bylaws. McLaughlin argues the shareholder waiver violated Cookietree's bylaws because the shareholders signed the waivers without a noticed shareholder meeting, and that an action taken without a meeting must be signed by all the shareholders entitled to vote, whereas he and his wife were not asked to sign. The shareholder waiver, however, is governed by the 1991 Shareholder Agreement, which does not require the votes of all shareholders entitled to vote, but instead only two-thirds of the

shareholders. While this may conflict with the bylaws, the Corporation Act allows a corporation to enter a separate shareholder agreement that governs the management and affairs of the corporation and the relationships among the shareholders despite a conflict with the bylaws so long as it does not violate public policy. Utah Code Ann. § 16-10a-732. Therefore, because the shareholder agreement allowed two-thirds of Cookietree’s shareholders to waive provisions of the shareholder agreement without a shareholder meeting, the waivers did not violate Cookietree’s bylaws.

¶35 Turning to the Corporation Act, we hold the waivers were not statutory conflict of interest transactions within its terms. McLaughlin argues the waivers were conflict of interest transactions because each of the board members that signed the waiver had a conflict of interest. We agree with Greg Schenk’s argument that the statute does not apply. Under the Corporation Act, a person is considered to have a conflict of interest if he has an interest in “a transaction effected or proposed to be effected by the corporation or by any entity in which the corporation has a controlling interest.” Id. § 16-10a-850(1) (emphasis added). In this case, the statute does not apply to the waiver because it was not itself a transaction. As explained by the comments to the Model Business Corporation Act, which the Utah Revised Business Corporation Act adopted, a transaction is a two-sided deal, not a unilateral action by the corporation. Model Bus. Corp. Act Ann. ch. 8-F, introductory cmt. (2009). The waiver, as enacted by the board of directors, was a unilateral action by Cookietree, not a “deal”; therefore, it is not subject to the conflict of interest statute. Id.

¶36 This conclusion, however, does not end our analysis. “Many situations arise in which a director’s [or shareholder’s] personal economic interest is or may be adverse to the economic interest of the corporation, but which do not entail a ‘transaction’ by or with the corporation.” Id. These situations are no less concerning because on the surface they appear to suffer from the same lack of probity and fair dealing as statutory conflict of interest transactions. The law does not ignore such troubling circumstances, but instead leaves the treatment of such situations “for development under the common law.” Id. The Model Act suggests the procedures designed to deal with statutory conflicts of interest provide a useful strategy for dealing with such situations as a matter of common law. Id. We agree.<sup>6</sup>

¶37 The procedures provided in the conflict of interest statute most appropriately address nontransaction-related conflict situations because they do not automatically invalidate conflict of interest transactions but instead require the party with a conflict to show the transaction was fair, or require the vote of disinterested board members or disinterested shareholders to ratify the transaction. Utah Code Ann. § 16-10a-851 (2005). In adopting these procedures for nontransaction-related conflicts, we recognize that many aspects of corporate governance are unfair. However, as close corporation case law repeatedly notes, close corporations are ripe for abuse and oppression of minority shareholders, especially when majority shareholders are commonly both directors and board members. The conflict of interest statute protects against such abuse, but still preserves the ability of close corporations to operate by not invalidating every transaction with a conflict of interest.

¶38 Applying this standard, we conclude the waivers ratifying the 1999 share transfer were tainted by a conflict of interest because they were both executed by Greg Schenck, who clearly had an economic interest in waiving the share transfer restrictions of the shareholder agreement that were ignored when he received the shares by which he gained majority control of Cookietree. By waiving the restrictions on the share transfers, Schenck and the other board members and voting shareholders deprived the company and the nonvoting shareholders of the economic opportunity to increase their investment in the corporation. Corporate law is wary of such self-dealing. Cookietree’s shareholder agreement also was wary of such activities and excluded sellers from voting on waiving the restrictions on share transfers. The agreement failed, however, to foresee the possible conflicts presented when a buyer is already a corporate shareholder and votes to waive the restrictions on share transfers. We therefore remand for a determination of whether the waivers were fair within the meaning of Utah Code section 16-10a-851, which is a fact-intensive inquiry focusing on whether the waivers were beneficial to the corporation and the shareholders and whether they satisfied the standard of fair dealing. See Model Bus. Corp. Act Ann. ch.8-F, § 8.60.

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<sup>6</sup> The statutory conflict of interest provisions address the same concerns presented by nontransaction conflicts of interest. Nontransaction conflicts of interest, however, are much less common in publicly held corporations and therefore because the Corporation Act was drafted in the context of such corporations, see supra ¶ 20, it fails to address such situations.

### III. A TRIAL COURT MAY DENY A MOTION FOR LEAVE TO AMEND WHEN THE AMENDMENT WAS FUTILE

¶39 In its Ruling and Order, the district court did not dismiss McLaughlin's fiduciary duty claim but rejected the grounds on which he pled the claim, leaving open the opportunity to amend the complaint so long as he met the burden of alleging new facts and evidence that would support a claim of breach of fiduciary duty that had not already been addressed by the court. When McLaughlin submitted an amended complaint that added two additional parties but relied on largely the same facts, the district court denied this motion.

¶40 When considering a motion to amend, the district court should primarily consider whether the motion would cause unavoidable prejudice to the opposing party. Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc., 970 P.2d 1273, 1282 (Utah 1998). In addition, the district court may also consider "delay, bad faith, or futility of the amendment." Id. In this case, the district court correctly held that McLaughlin's proposed amended complaint would have been futile as the court already determined that interparty contracts barred the existence of any duty owed to McLaughlin in relation to the complained of acts. A party cannot obtain a different outcome by adding to the parties or rephrasing claims.

¶41 McLaughlin argues the district court had only ruled on fiduciary duties arising out of existing contracts and that his amended complaint raised tort-based theories of fiduciary duties. This is an inaccurate characterization of the district court's determination and, moreover, a distinction without a difference. Regardless of how McLaughlin phrases his claims, they are the same theory: Cookie tree shareholders breached their fiduciary duty to McLaughlin by waiving the right of refusal for the 1999 stock transaction and by terminating his employment. Whether this theory is characterized as arising out of contract or tort, it is the same theory--a tort for breach of duty. Thus, we hold the district court did not abuse its discretion because McLaughlin's amendment failed to state new facts or a new theory that had not already been addressed by the court; an amendment would have been futile.

### CONCLUSION

¶42 We agree with McLaughlin that shareholders in close corporations stand in fiduciary positions to one another and are required to act with the utmost good faith. However, we also note this duty is not unlimited but instead must be balanced with the legitimate business interest of the corporation and the reasonable expectations of individual shareholders. In this case, however, we hold that McLaughlin's reasonable expectations were not thwarted when he was terminated from Cookie tree, and therefore, the defendants did not breach any fiduciary duties owed him. The district court's decision on this issue is affirmed. Additionally, we affirm the district court's decision to deny McLaughlin's attempt to amend his complaint to add additional parties as futile because he could not prove his legal theory by adding individuals to the litigation. Finally, we conclude that the waivers ratifying the 1999 share transfer were contaminated by a conflict of interest and remand for a determination of whether the waivers were fair.

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¶43 Associate Chief Justice Durrant, Justice Wilkins, Justice Parrish, and District Judge Hadfield concur in Chief Justice Durham's opinion.

¶44 Having disqualified himself, Justice Nehring does not participate herein; District Judge Ben H. Hadfield sat.

**AMENDED OPINION\***

*This opinion is subject to revision before final publication in the Pacific Reporter.*

IN THE SUPREME COURT OF THE STATE OF UTAH

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Angel Investors, LLC, a Utah  
limited liability company,  
suing derivatively on behalf  
of XanGo, LLC,  
Plaintiffs and Appellants,

No. 20080111

v.

Aaron Garrity, Bryan Davis,  
Gary Hollister, Gordon Morton,  
Joseph Morton, and Kent Wood,  
Defendants and Appellees.

F I L E D

July 21, 2009

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DURRANT, Associate Chief Justice:

**INTRODUCTION**

¶1 In the district court, Angel Investors, LLC, brought a derivative suit on behalf of XanGo, LLC, against Aaron Garrity, Bryan Davis, Gary Hollister, Gordon Morton, Joseph Morton, and Kent Wood, who are the managing members and majority owners of XanGo (collectively, the “Majority Owners”). Prior to initiating the derivative suit, Angel Investors brought a direct suit against XanGo, seeking the dissolution of the company, among other relief. In the derivative suit, the district court ruled that Angel Investors lacked standing to bring the action because

\*The Court has rewritten paragraph numbers 9, 10, 23. Angel Investors could not “fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing” XanGo’s rights, as required by Utah Rule of Civil Procedure 23A.<sup>1</sup> The district court reached this conclusion after finding that (1) Angel Investors is similarly situated to other minority shareholders and (2) Angel Investors cannot fairly and adequately represent the interests of those similarly situated shareholders because (A) the shareholders each indicated that they do not support Angel Investors as a derivative plaintiff and (B) Angel Investors’ direct suit causes a conflict of interest.

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<sup>1</sup> Utah Rule of Civil Procedure 23A was amended and renumbered effective November 1, 2007. Previously, it was identified as rule 23.1. Rule 23A is substantively identical to the original rule 23.1. Throughout this opinion, we cite to the current version of the Utah rule.

¶2 Angel Investors requested time to conduct discovery in order to demonstrate that it is not similarly situated to any other XanGo shareholder. The district court denied Angel Investors' request.

¶3 Angel Investors now challenges the district court's rulings on appeal, arguing that it should be allowed to proceed with the derivative action as a class of one and that the district court erred in denying its request to conduct discovery.

¶4 The Majority Owners argue that we should affirm the district court, if not on the original grounds then on the alternative grounds that Angel Investors cannot be a fair and adequate representative because it never signed the operating agreement or because Angel Investors stands to gain relatively little from the derivative suit given its small, one percent, interest in XanGo. We find the Majority Owners' arguments unpersuasive.

¶5 Particularly, we hold that (1) Angel Investors is not similarly situated to any other XanGo shareholders and, therefore, qualifies as a class of one; and (2) the Majority Owners have not met their burden of proving that Angel Investors is an inadequate representative under rule 23A. We address the Majority Owners' fair and adequate representation arguments as follows. We first determine that the dissent of dissimilar shareholders is not relevant to the fair and adequate representation inquiry when a derivative plaintiff qualifies as a class of one. We next determine that Angel Investors' direct and derivative suits are not in actual conflict and, therefore, the direct suit does not disqualify Angel Investors as a derivative plaintiff. Finally, we decline to address the Majority Owners' alternative grounds for affirming the district court's determination because they were not preserved in the district court. We also do not address the district court's ruling on Angel Investors' discovery request because our standing determination grants Angel Investors all of the relief it seeks in this appeal.

## BACKGROUND

¶6 Angel Investors is a limited liability company that owns one percent of XanGo, which is also a limited liability company. The Majority Owners own eighty-six percent of XanGo. In addition to Angel Investors, there are nineteen individual entities that have an ownership interest in XanGo.

¶7 Prior to initiating a derivative suit on behalf of XanGo, Angel Investors brought a direct suit against XanGo. In the direct suit, Angel Investors alleged that (1) XanGo loaned funds to the Majority Owners so that they could personally acquire minority interests in XanGo and (2) XanGo denied Angel Investors the right to inspect XanGo's financial records. In the direct action, Angel Investors sought both monetary damages from XanGo and the dissolution of XanGo.

¶8 While the direct suit was pending, Angel Investors initiated a derivative suit against the Majority Owners. The derivative suit is the subject of this appeal. In the derivative suit, Angel Investors alleged that the Majority Owners had taken millions of dollars in personal loans from XanGo; purchased minority interests in XanGo with the loaned funds, thus appropriating to themselves opportunities belonging to XanGo and all of its shareholders; and paid themselves excessive compensation while wasting corporate assets.

¶9 The Majority Owners responded to Angel Investors' complaint by filing a motion to dismiss pursuant to Utah Rule of Civil Procedure 12(b)(1). In their motion to dismiss, the Majority Owners argued that Angel Investors lacked standing to bring a derivative suit. To support their argument, the Majority Owners attached affidavits from each of XanGo's minority shareholders, other than Angel Investors. All of the affiants stated that they did not support Angel Investors as a representative of XanGo in the derivative suit.

¶10 Angel Investors, in opposition to the motion to dismiss, requested time to conduct discovery and argued that it met the standing requirements of Utah Rule of Civil Procedure 23A. Angel Investors contended that through discovery it could prove that it was not similarly situated to any other XanGo shareholder. Specifically, Angel Investors alleged that it is the only minority owner "which is not in a position to be coerced or bribed by [the Majority Owners]."

¶11 The district court heard oral argument on the motion to dismiss. Two months later, the court issued its ruling, wherein the court granted the motion to dismiss, stating first that Angel Investors is not a class of one because there are other XanGo owners that are similarly situated. Describing the situation of the remaining nineteen XanGo owners, the court stated:

[S]ix of the nineteen [owners] are the Defendants and two have a family relationship with a Defendant. . . . Seven other [owners] are employees of XanGo. Only four of the [owners] do not have an employee or family relationship to the Defendants or the company of which the Defendants are the majority owners. While Defendants, their family members, and the XanGo employees may not be similarly situated to [Angel Investors], the Court finds that the four remaining [owners] are similarly situated . . . .

The four remaining owners that the court found to be similarly situated to Angel Investors were among the affiants declaring their opposition to the derivative suit.

¶12 The court further stated that Angel Investors cannot fairly and adequately represent the interests of these similarly situated XanGo owners because “there may be some actual conflict between [Angel Investors’ interests] in the Direct Lawsuit and its representation in the derivative suit” and because the other XanGo owners have asserted by affidavit that they oppose the derivative suit. The court observed that the minority shareholders “are independent actors and have the ability and right to take a position that may be against their best interests.” Accordingly, the district court concluded that Angel Investors “would not be a fair and adequate representative of the non-defendant owners in the derivative suit.”

¶13 We now review the district court’s standing rulings on appeal. We have jurisdiction pursuant to Utah Code section 78A-3-102(3)(j) (2008).

#### STANDARD OF REVIEW

¶14 A standing determination “is primarily a question of law, although there may be factual findings that bear on the issue.”<sup>2</sup> Therefore, we review the district court’s legal determinations for correctness but review its factual determinations with some deference to its findings.<sup>3</sup>

#### ANALYSIS

¶15 Utah Rule of Civil Procedure 23A(a) permits “a derivative action [to be] brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association.”<sup>4</sup> But rule 23A(b) prevents the maintenance of a derivative action “if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association.” Rule 23A further requires a court to dismiss a derivative action if the defendant demonstrates that the plaintiff does not meet the rule’s requirements.<sup>5</sup>

¶16 If, as in this case, the plaintiff’s pleadings allege that the plaintiff fairly and adequately represents the interests of similarly situated shareholders, then “the burden is on the defendant to show that the plaintiff is an inadequate representative under rule 23.1 . . . and, therefore, does not have standing.”<sup>6</sup> We reverse the district court’s determination that the Majority Owners met their burden. Specifically, we hold that (1) Angel Investors is not similarly situated to any other XanGo owner and may proceed as a class of one, and (2) the Majority Owners have not met their burden of proving that Angel Investors is an inadequate representative under rule 23A.

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<sup>2</sup> LeVanger v. Highland Estates Props. Owners Ass’n, 2003 UT App 377, ¶ 8, 80 P.3d 569 (quoting Kearns-Tribune Corp. v. Wilkinson, 946 P.2d 372, 373-74 (Utah 1997)).

<sup>3</sup> See id.

<sup>4</sup> Although rule 23A speaks in terms of derivative actions brought on behalf of corporations and unincorporated associations, the rule governs derivative actions brought on behalf of limited liability companies as well. See GLFP, Ltd. v. CL Mgmt., Ltd., 2007 UT App 131, ¶ 2 n.1, 163 P.3d 636 (applying rule 23A to a limited partnership that became a limited liability company after the derivative suit was filed).

<sup>5</sup> See LeVanger, 2003 UT App 377, ¶ 18.

<sup>6</sup> Id.

## I. ANGEL INVESTORS QUALIFIES AS A CLASS OF ONE

¶17 The district court found that there are other XanGo shareholders who are similarly situated to Angel Investors. The court, relying in part on a Sixth Circuit decision,<sup>7</sup> considered the following factors in determining that Angel Investors is similarly situated to other shareholders: the benefit that the suit could confer, familial relationships between the defendants and minority shareholders, and employer/employee relationships between the defendants and the minority shareholders. After considering these factors, the court determined that the “four remaining [minority shareholders] are similarly situated to [Angel Investors].”

¶18 Angel Investors contends that the court should have included in its analysis one other pertinent factor--the shareholders’ motivations for opposing the derivative suit. Angel Investors argues that if the court had considered and applied this factor, it would have found that Angel Investors is not similarly situated to any other XanGo shareholder. Specifically, Angel Investors alleges that all XanGo shareholders except for itself oppose the derivative suit because the shareholders are “motivated by individual interests, rather than the good of the corporation.”<sup>8</sup>

¶19 To support its contention that the district court should have considered in its analysis the shareholders’ motivations for opposing the derivative suit, Angel Investors cites Larson v. Dumke.<sup>9</sup> In Larson, the Ninth Circuit concluded that a plaintiff may proceed with a derivative suit as a class of one where every other “non-defendant shareholder has an economic interest in supporting the current management.”<sup>10</sup> In Larson, all of the non-defendant shareholders except for the plaintiff benefitted from the alleged corporate misfeasance.<sup>11</sup>

¶20 Angel Investors also cites Eye Site, Inc. v. Blackburn, a Texas Supreme Court decision, for the proposition that a minority shareholder in a closely held corporation can qualify as a class of one.<sup>12</sup> In Eye Site, a sole dissenting shareholder brought a derivative action against all other shareholders of the corporation.<sup>13</sup> The defendants argued that derivative plaintiffs cannot proceed without representing similarly situated shareholders.<sup>14</sup> The Texas Supreme Court reasoned that the requirement for a plaintiff in a derivative suit to adequately represent similarly situated shareholders “does not place any minimum numerical limits on the number of shareholders who must be ‘similarly situated.’ It follows that if the plaintiff is the only shareholder ‘similarly situated,’ he is in compliance with both the letter and the purpose of the rule.”<sup>15</sup> The court further reasoned that any other interpretation of the requirement “could deprive the

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<sup>7</sup> Nolen v. Shaw-Walker Co., 449 F.2d 506, 508 n.4 (6th Cir. 1971) (stating that shareholders are not similarly situated if they are “(1) the defendants; (2) employees of the Company; [or] (3) the . . . defendant’s” family members).

<sup>8</sup> Larson v. Dumke, 900 F.2d 1363, 1368 (9th Cir. 1990).

<sup>9</sup> Id.

While in this case we are analyzing Utah Rule of Civil Procedure 23A, this rule is “substantively identical” to its federal counterpart. LeVanger, 2003 UT App 377, ¶ 17. Accordingly, we “freely refer to authorities which have interpreted the federal rule.” Id. (quoting Gold Standard, Inc. v. Am. Barrick Res. Corp., 805 P.2d 164, 168 (Utah 1990).

<sup>10</sup> 900 F.2d at 1368.

<sup>11</sup> Id.

<sup>12</sup> 796 S.W.2d 160, 161-63 (Tex. 1990).

<sup>13</sup> Id. at 163.

<sup>14</sup> Id. at 161.

<sup>15</sup> Id. at 162-63.

corporation of any remedy it might have as the result of wrongs done it by the major shareholders.”<sup>16</sup> Both federal and state courts have subscribed to this view.<sup>17</sup>

¶21 We begin our analysis by recognizing that the purpose of a derivative suit is to advance the interests of the corporation,<sup>18</sup> which is an entity distinct from its individual shareholders. Despite this distinction, we recognize that in closely held corporations, it becomes easy for the majority shareholders to identify themselves as the corporation. These shareholders not only receive the majority of the profits the corporation generates, but they often serve on the board and make operating decisions for the corporation.<sup>19</sup> We have previously described the characteristics of closely held corporations as:

“(1) a small number of shareholders; (2) no ready market for corporate stock; and (3) active shareholder participation in the business.”<sup>20</sup> Considering these characteristics, we recognize that closely held corporations may be more vulnerable to malfeasance. Majority shareholders of closely held corporations have increased control over the corporation because they likely serve on the corporation’s board; their dual roles can make malfeasance easier to conduct as well as justify. Likewise, the nature of a closely held corporation, where there is often a small number of shareholders and many of those may have close ties to each other, lessens the likelihood that a minority shareholder will speak out against corporate malfeasance.

¶22 In light of the greater vulnerability to malfeasance that is present in closely held corporations, we hold that a sole dissenting shareholder in a closely held corporation qualifies as a class of one for purposes of derivative standing when that shareholder (1) seeks by its pleading to enforce a right of the corporation and (2) does not appear to be similarly situated to any other shareholder. Further, we hold that shareholders’ motivation for opposing the derivative action is relevant to determining the question of whether any shareholder is similarly situated to the derivative plaintiff. To conclude otherwise would be to permit corporate looting and malfeasance in circumstances where all but one shareholder benefit personally from the illegality or are at risk of personal detriment were the malfeasance brought to light.

¶23 Angel Investors, as a sole dissenting shareholder in a closely held corporation, has brought a derivative suit alleging corporate malfeasance by the Majority Owners. Angel Investors has also alleged that all XanGo shareholders other than itself stand to gain from the Majority Owners’ continued corporate malfeasance. The Majority Owners have not refuted this allegation. Accordingly, Angel Investors, as a sole dissenting shareholder of a closely held corporation, having pled corporate malfeasance, and having alleged that all other minority shareholders stand to gain from continued malfeasance, qualifies as a class of one.

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<sup>16</sup> Id. at 163.

<sup>17</sup> See, e.g., Jordan v. Bowman Apple Prods. Co., 728 F.Supp. 409, 413 (W.D. Va. 1990) (allowing a derivative action after finding that the plaintiff was not similarly situated to any other shareholder); Halsted Video, Inc. v. Guttillo, 115 F.R.D. 177, 179-80 (N.D. Ill. 1987) (holding that a plaintiff who brought a derivative action against all other shareholders constituted a legitimate class of one); Clemons v. Wallace, 592 P.2d 14, 15-16 (Colo. Ct. App. 1978) (also holding that a plaintiff who brought a derivative action against all other shareholders may constitute a legitimate class of one); Brandon v. Brandon Constr. Co., 776 S.W.2d 349, 351-54 (Ark. 1989) (holding that the plaintiff shareholder could bring a derivative action as a “class of one,” although the other minority shareholders stated that plaintiff did not represent their interests).

<sup>18</sup> See Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 373-74 (1966) (“We cannot construe Rule 23 or any other one of the Federal Rules as compelling courts to summarily dismiss, without any answer or argument at all, cases like this where grave charges of fraud are shown by the record to be based on reasonable beliefs growing out of careful investigation. The basic purpose of the Federal Rules is to administer justice through fair trials, not through summary dismissals as necessary as they may be on occasion. These rules were designed in large part to get away from some of the old procedural booby traps which common-law pleaders could set to prevent unsophisticated litigants from ever having their day in court. If rules of procedure work as they should in an honest and fair judicial system, they not only permit, but should as nearly as possible guarantee that bona fide complaints be carried to an adjudication on the merits. Rule 23(b), like the other civil rules, was written to further, not defeat the ends of justice. The serious fraud charged here, which of course has not been proven, is clearly in that class of deceitful conduct which the federal securities laws were largely passed to prohibit and protect against.”); see also GLFP, Ltd. v. CL Mgmt., Ltd., 2007 UT App 131, ¶ 8, 163 P.3d 636.

<sup>19</sup> Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc., 970 P.2d 1273, 1280 (Utah 1998).

<sup>20</sup> Dansie v. City of Herriman, 2006 UT 23, ¶ 17, 134 P.3d 1139 (quoting Fletcher Cyclopedia of the Law of Private Corporations § 70.10 (2002)).

## II. THE MAJORITY OWNERS HAVE NOT MET THEIR BURDEN OF PROVING THAT ANGEL INVESTORS IS AN INADEQUATE REPRESENTATIVE OF XANGO

¶24 Having determined that Angel Investors qualifies as a class of one, we need not determine whether Angel Investors can “fairly and adequately represent the interests of the shareholders or members similarly situated”<sup>21</sup> because by definition a class of one is not similarly situated to any other shareholders or members. Instead, we must determine what, if any, requirements remain with respect to the adequacy of Angel Investors’ representation and whether the Majority Owners have met their burden of proving that Angel Investors is inadequate to achieve standing as a derivative plaintiff.

### A. A Derivative Plaintiff Must Fairly and Adequately Represent the Interests of the Corporation

¶25 Although rule 23A does not explicitly state that a derivative plaintiff must be able to fairly and adequately represent the corporation, this requirement is inherent in the nature of the derivative action. When bringing a derivative action, a derivative plaintiff stands in the stead of the corporation, which is the real party in interest. Accordingly, the derivative plaintiff must be able to fairly and adequately represent the real party’s interests, otherwise the plaintiff is acting on its own behalf and not that of the corporation. The United States Supreme Court, interpreting the federal rule, which is virtually identical to our rule,<sup>22</sup> stated that the purpose of rule 23.1 is “to prevent shareholders from suing in place of the corporation in circumstances where the action would disserve the legitimate interests of the company or its shareholders.”<sup>23</sup> Accordingly, lower federal courts have interpreted rule 23.1 to include the requirement that a derivative plaintiff fairly and adequately represent the corporation.<sup>24</sup> We do likewise.

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<sup>21</sup> Utah R. Civ. P. 23A(b) (2008).

<sup>22</sup> Compare Utah R. Civ. P. 23A (“The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association.”) with Fed. R. Civ. P. 23.1 (“The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association.”).

<sup>23</sup> Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 532 n.7 (1984) (emphasis added).

<sup>24</sup> See, e.g., Pisnoy v. Ahmed, 499 F.3d 47, 64 (1st Cir. 2007) (stating that “the [derivative] shareholder must fairly and adequately represent the corporation”); Owen v. Modern Diversified Indus., Inc., 643 F.2d 441, 443 (6th Cir. 1981) (stating that under rule 23.1 a derivative shareholder must be able to fairly and adequately represent both the corporation as well as similarly situated shareholders); Halsted Video, Inc. v. Guttillo, 115 F.R.D. 177, 179 (N.D. Ill. 1987) (“The burden is on the defendants to show that the plaintiff will not fairly and adequately represent the corporation and its shareholders.” (emphasis added)); Lee v. Andersen, No. 4-72 Civil 388, 1975 U.S. Dist. LEXIS 12035, at \*10-12 (D. Minn. 1975) (“The representative plaintiff must pursue the action in the interest of and solely for the benefit of the corporation; plaintiff’s honesty, integrity, conscientiousness, skill and competent counsel are also to be considered as relevant components of adequate representation, and one of the most important factors to consider in making the determination as to who is or is not a proper party to fairly and adequately represent the corporation is to determine whether in fact the representative plaintiff’s interests are the same as the corporation’s and whether or not the representative plaintiff or his counsel have other interests conflicting with the interest of the corporation.”); see also Ferer v. Erickson & Sederstrom, P.C., 718 N.W.2d 501, 507 (Neb. 2006) (“A shareholder may not commence or maintain a derivative proceeding unless the shareholder adequately represents the interests of the corporation in enforcing the right of the corporation.”); McLeod v. Albanese, 815 So. 2d 472, 476 (Miss. Ct. App. 2002) (stating that a shareholder’s ability to proceed with a derivative action “turn[s] on whether he could ‘fairly and adequately’ represent the company’s interest in the suit”).

¶26 To be a fair and adequate representative of the corporation, a derivative plaintiff must not have a personal interest that competes with the interests of the corporation or prevents the plaintiff from acting in the corporation's best interest. Determining whether a derivative plaintiff fairly and adequately represents the corporation is a fact-intensive inquiry.

¶27 The Majority Owners argue that the following facts demonstrate that Angel Investors cannot be a fair and adequate representative: (1) Angel Investors has a conflict of interest with XanGo due to Angel Investors' direct suit against XanGo; (2) Angel Investors did not sign XanGo's operating agreement; and (3) Angel Investors stands to gain a relatively small amount of damages due to its minimal ownership interest in XanGo. We consider the Majority Owners' arguments in light of our conclusions that Angel Investors is a class of one and must, as a derivative plaintiff, fairly and adequately represent XanGo's interests.

1. Angel Investors' Direct Suit Does Not Create a Conflict of Interest Such That Angel Investors Cannot Fairly and Adequately Represent XanGo's Interests

¶28 In this case, the Majority Owners argue that Angel Investors is not a fair and adequate representative of XanGo because Angel Investors has a direct action pending against XanGo. Particularly, the Majority Owners argue that the relief Angel Investors' seeks in its direct action is incompatible with the relief it seeks in its derivative action. We disagree.

¶29 Although we have not squarely decided the issue of whether a plaintiff's direct action against a corporation disqualifies that plaintiff from bringing a derivative action on behalf of the corporation, our case law demonstrates that Utah does not have a per se rule barring simultaneous direct and derivative actions.<sup>25</sup> Rather, we have stated that "a court may allow a minority shareholder in a closely held corporation to proceed directly against corporate officers," and that same minority shareholder is not per se barred from bringing a derivative action on behalf of that same corporation.<sup>26</sup> To determine whether a direct and derivative suit may be brought by the same shareholder, a court must determine if the two actions create a conflict of interest such that the shareholder cannot act in the best interest of the corporation or similarly situated shareholders.<sup>27</sup> A possible conflict, as the district court found in this case, is insufficient to disqualify a derivative plaintiff.<sup>28</sup> The conflict must be actual.

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<sup>25</sup> Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc., 970 P.2d 1273, 1282 (Utah 1998) (overturning a district court decision that granted summary judgment in favor of the defendant as to the plaintiff's derivative claim and dismissed the plaintiff's direct claim).

Other jurisdictions agree that simultaneous direct and derivative actions are not per se barred. See, e.g., Rothenberg v. Sec. Mgmt. Co., 667 F.2d 958, 961 (11th Cir. 1982); Davis v. Comed, Inc., 619 F.2d 588, 594 (6th Cir. 1980) (noting that "other litigation pending between the plaintiff and defendants" is only a factor to be considered in determining whether a derivative plaintiff is a fair and adequate representative); Bertozi v. King Louie Int'l, Inc., 420 F. Supp. 1166, 1180 (D. R.I. 1976) (recognizing that a court may take into account the possibility that other litigation or outside entanglements may, but does not necessarily, render a derivative plaintiff an inadequate representative); see also 19 Am. Jur. 2d Corporations § 1934 ("[A] shareholder may bring a derivative action and an individual claim at the same time if he or she has suffered a different injury than the other shareholders."). But see Ryan v. Aetna Life Ins. Co., 765 F. Supp. 133, 136 (S.D.N.Y. 1991) (Although "it was not yet clear whether any actual conflict would arise" between the direct and derivative suits, the court found "early intervention to be the more prudent, and, ultimately, the more efficient course" and concluded that the plaintiff "must elect a single representative role.").

<sup>26</sup> Aurora Credit Servs., Inc., 970 P.2d at 1281.

<sup>27</sup> See 13 Fletcher Cyclopedia of the Law of Private Corporations § 5981.42 (2004) (stating that a conflict of interest that bars a plaintiff from bringing a derivative suit is a conflict wherein the plaintiff "cannot be expected to act in the interests of others because doing so would harm the derivative plaintiff's other interests").

<sup>28</sup> The district court explained its finding as follows, It is possible that the Direct Lawsuit will not decrease Plaintiff's interest in pursuing the derivative claims for the benefit of all non-defendant XanGo owners, because any distribution to Plaintiff upon dissolution would be increased if Plaintiff is successful in the derivative suit. However, the interests of Plaintiff and the other non-defendant owners are not aligned regarding the Direct Lawsuit. The Court finds that there may be some actual conflict between Plaintiff's interest in the Direct Lawsuit and its representation in the derivative suit.

¶30 An actual conflict of interest exists, for example, when the relief sought in the direct action is “incompatible” with the relief sought in the derivative action.<sup>29</sup> When, however, both suits are contingent “upon the proof of the same nucleus of facts,” then it is presumed that the plaintiff will advance both actions with the same vigor.<sup>30</sup> In such a case, the plaintiff presumably will fairly and adequately represent the interests of the corporation and any similarly situated shareholders in the derivative action because doing so would serve the plaintiff’s interests in the direct action. In the case now before us, we hold that the Majority Owners have failed to meet their burden of proving the existence of an actual conflict of interest that would prevent Angel Investors from fairly and adequately representing XanGo in a derivative action against the Majority Owners because (1) the relief Angel Investors seeks from its direct action is not incompatible with the relief it seeks in the derivative action and (2) Angel Investors must prove the same nucleus of facts to prevail in both actions.

¶31 The relief Angel Investors seeks from its separate actions is not necessarily incompatible. In the direct suit, Angel Investors seeks monetary damages and the dissolution of XanGo. In the derivative suit, Angel Investors seeks to represent XanGo in recovering for the Majority Owners’ malfeasance. If Angel Investors prevails in both actions, then the damages that the individual Majority Owners would pay as a result of the derivative action would be paid out to all XanGo shareholders in the winding up after dissolution, as sought for in the direct action. Further, in a situation of corporate looting from a closely held corporation, as Angel Investors alleges has been taking place here, dissolution of the corporation is not necessarily against the corporation’s best interest. Dissolution would not only stop the looting but would also allow for a reorganization of the enterprise, such that all shareholders could receive a fairer return on their investment.

¶32 Further, Angel Investors is presumed to fairly and adequately represent XanGo in the derivative action because Angel Investors must prove the same nucleus of facts to prevail in the derivative action that it must prove in order to prevail in the direct action. In the direct action, Angel Investors alleges, in part, that XanGo loaned funds to the Majority Owners so that they could personally acquire minority interests in XanGo. In the derivative action, Angel Investors, on behalf of XanGo, makes, in part, the following allegations: that the Majority Owners have taken personal loans from XanGo, aggregating millions of dollars; purchased minority interests in XanGo with the loaned funds, thus appropriating to themselves opportunities belonging to XanGo and all of its shareholders; and paid themselves excessive compensation while wasting corporate assets. We see no allegations in the direct action that would prevent Angel Investors from vigorously pursuing the allegations in the derivative action. Rather, proof of the facts alleged in the direct action, namely that XanGo loaned funds to the Majority Owners to enable them to acquire minority interests in XanGo, would only aid Angel Investors in prevailing in the derivative action.

¶33 Accordingly, we conclude that Angel Investors’ direct action does not create a personal interest such that Angel Investors’ pursuit of that interest would prevent Angel Investors from acting in the best interest of XanGo in the derivative action. Rather, the remedies sought in the two actions are compatible, and Angel Investors must prove the same nucleus of facts to succeed in both cases.

## 2. Because It Is Inadequately Briefed, We Decline to Address the Issue of Whether Angel Investors’ Refusal to Sign the Operating Agreement Prevents Angel Investors From Fairly and Adequately Representing XanGo’s Interests

¶34 The following statement constitutes the entirety of the Majority Owners’ argument that Angel Investors’ failure to sign the operating agreement precludes Angel Investors from fairly and adequately representing XanGo in a derivative suit:

[Angel Investors’] refusal to sign an operating agreement with XanGo is a factor to be considered in this Court’s determination of whether [Angel Investors] can fairly and adequately represent XanGo’s other owners. In their affidavits opposing

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<sup>29</sup> See Ryan, 765 F. Supp. at 135-37 (finding incompatibility between relief sought in a derivative suit and that sought in a direct suit where in the derivative suit the plaintiff sought additional payments for the sale of a portion of a company and in the direct suit sought punitive damages and the imposition of a constructive trust on the funds received for the sale of a portion of the company).

We do not foreclose the possibility that other facts may exist to demonstrate a conflict of interest between a direct and a derivative suit. In this case, however, the Majority Owners only argue a conflict based upon the incompatibility of the relief sought.

<sup>30</sup> Bertozi, 420 F. Supp. at 1180.

[Angel Investors] as their representative in this case, all but one XanGo owner cited the fact that [Angel Investors] had not signed an operating agreement with XanGo as demonstrating [Angel Investors'] inadequacy as a representative.

This argument lacks the detail and citations to the record that are necessary before we will consider an argument on appeal.

¶35 We have long held that we have discretion to not address an inadequately briefed argument.<sup>31</sup> Rather, a party “must plead his claims with sufficient specificity for this court to make a ruling on the merits.”<sup>32</sup> “[W]e will not assume [a party’s] ‘burden of argument and research.’”<sup>33</sup> In addition to sufficient development of the argument and citation to legal authority, a party must also “provide the appellate court with the parts of the record that are central to the determination of” the issue.<sup>34</sup> Relevant parts of the record may include “findings of fact and conclusions of law [or] the transcript of the court’s oral decision.”<sup>35</sup>

¶36 The argument that Angel Investors is not a fair and adequate representative because it failed to sign the operating agreement is asserted without the support of legal reasoning or authority. Further, the Majority Owners fail to provide any record citations to demonstrate preservation of the argument and the district court’s determination of the issue.<sup>36</sup> For these reasons, we do not address this issue on appeal.

### 3. We Decline to Address Whether the Relatively Small Benefit That Angel Investors Stands to Gain From the Derivative Action Impacts Angel Investors’ Ability to Represent XanGo’s Best Interest

¶37 The Majority Owners argue on appeal that because Angel Investors stands to gain relatively little from any recovery in the derivative action Angel Investors cannot be considered a fair and adequate representative under rule 23A. While the Majority Owners do develop this argument and provide legal authority for their position, they fail to demonstrate preservation of the argument in the district court.<sup>37</sup>

¶38 We may affirm a judgment on an unpreserved alternate ground “where the alternate ground is apparent on the record” and when “the facts as found by the trial court are sufficient to sustain the decision of the trial court on the alternate ground.”<sup>38</sup> On appeal, we are “limited to the findings of fact made by the trial court and may not find new facts or reweigh the evidence in light of [a] new legal theory or alternate ground.”<sup>39</sup>

¶39 In this case, the findings of the district court are insufficient for us to affirm the district court’s decision that Angel Investors is not a fair and adequate representative on the alternate ground that Angel Investors stands to recover so little that it cannot be a fair and adequate representative of XanGo. The Majority Owners contend that because Angel Investors owns just one percent of XanGo and that therefore only \$1 million is at stake in this case, Angel Investors stands to gain too little to be considered a fair and adequate representative. However, the district court made no findings regarding the potential recovery in this case. Angel Investors’ counsel asserted to the court that “even on first blush” the recovery if Angel Investors prevails is “more than \$1,000,000, and probably substantially more than that.” Further, the district court made no specific finding regarding Angel Investors’ ownership interest. Rather, the court stated, “Defendants assert that . . . Plaintiff owns 1% of XanGo . . . .” Stating the Majority Owners’ assertion without ruling on

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<sup>31</sup> See, e.g., Loveland v. Orem City Corp., 746 P.2d 763, 770 (Utah 1987).

<sup>32</sup> Allen v. Friel, 2008 UT 56, ¶ 9, 194 P.3d 903.

<sup>33</sup> Id. (quoting Treff v. Hinckley, 2001 UT 50, ¶ 11, 26 P.3d 212).

<sup>34</sup> Id. ¶ 10.

<sup>35</sup> Utah R. App. P. 24(a)(11)(C).

<sup>36</sup> The Majority Owners do provide a record cite to the argument that because Angel Investors failed to sign the operating agreement it lacks the ownership interest necessary to bring a derivative suit. But the Majority Owners do not directly raise this argument on appeal. As to this argument, the district court ruled that factual issues remain as to whether Angel Investors is a member of XanGo; therefore, the court did not grant the Majority Owners’ motion to dismiss based upon this argument. We do not disturb the district court’s determination as to this issue.

<sup>37</sup> Utah R. App. P. 24(a)(5)(A) (requiring that parties demonstrate preservation of an issue by providing a citation to the record showing that the issue was presented to the district court).

<sup>38</sup> Bailey v. Bayles, 2002 UT 58, ¶ 20, 52 P.3d 1158.

<sup>39</sup> Id.

the validity of the assertion does not constitute a finding of fact. Accordingly, we decline to consider this alternate ground because the district court's findings of fact are insufficient to sustain a decision regarding the theory.

### **CONCLUSION**

¶40 We hold that Angel Investors is not similarly situated to any other XanGo shareholder and, accordingly, qualifies as a class of one. We further hold that the Majority Owners have failed to meet their burden of proving the existence of an actual conflict of interest that would prevent Angel Investors from fairly and adequately representing XanGo in a derivative action against the Majority Owners. We therefore remand this case to the district court for further proceedings consistent with this opinion.

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¶41 Chief Justice Durham, Justice Wilkins, Justice Parrish, and Justice Nehring concur in Associate Chief Justice Durrant's opinion.