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Recommended Citation
Bradley, Craig M., "When Clients Do Bad Things: The Lawyer's Response to Corporate Wrongdoing" (2003). Articles by Maurer Faculty. 2498.
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When Clients Do Bad Things

The Lawyer’s Response to Corporate Wrongdoing

By C. Craig Bradley, Jr.

The high profile meltdowns of Enron, WorldCom, Tyco, Adelphia, Global Crossing and other well-known companies have focused attention on the responsibilities of corporate gatekeepers, including attorneys, to deter or expose fraudulent conduct by their clients and associated persons. Attorneys have been the subject of investigation and criticism by Congress and federal regulators for failing to adequately respond to their clients’ fraudulent (and, possibly, criminal) conduct. The lawyer who learns that his or her client or persons acting on its behalf are engaged in a course of fraudulent or criminal conduct which threatens economic losses to non-client third parties faces both an ethical and a moral dilemma. On the one hand, the lawyer owes a professional duty to his or her client to protect the confidentiality of information communicated to the lawyer during the representation. At the same time, what responsibility does the lawyer have to investors and others who may suffer significant financial losses as a result of the client’s undisclosed fraud?

This article summarizes the relevant rules of professional conduct which guide a business lawyer’s response to evidence of corporate wrongdoing and discusses recent reform initiatives by the federal government and the organized bar to improve systems of corporate responsibility and accountability. It concludes with a discussion of a recent ruling in the securities fraud case brought by investors against Enron’s outside counsel and the company’s other professional and financial advisers for their participation in structuring and concealing Enron’s allegedly fraudulent financing transactions.

Rules of Professional Conduct

The principal ethics rules governing a lawyer’s response to suspected fraud by an organizational client are Model Rules 1.2 (Scope of Representation), 1.6 (Confidentiality of Information), 1.13 (Organization as Client), 1.16 (Declining or Terminating Representation) and 4.1 (Truthfulness in Statements to Others). Each of these rules is discussed below.

The Entity as Client

Model Rule 1.13 contains the basic core principle that the entity, and not its various constituencies, is the client. The rule states that a lawyer employed or retained by an organization represents the entity (that is, the organization acting through its duly authorized constituents). The lawyer’s duty is to serve the interests of the organization and not the personal interests of its officers, directors, employees and shareholders. Although the lawyer for the organization takes direction from its officers, directors and employees acting within the scope of their authority on behalf of the organization, the lawyer owes his or her professional duties only to the organization.

Rule 1.13 guides the corporate lawyer who learns of possible misconduct by an officer or employee of his or her client. The rule provides that the lawyer shall proceed “as is reasonably necessary in the best interest of the organization” if the lawyer knows that an officer, employee or other person associated with the organization is engaged in action related to the representation that is a violation of a legal obligation to the organization or a violation of law which is likely to result in substantial injury to the organization. Rule 1.13(b) provides a range of options that the lawyer may (but is not required to) pursue to prevent harm to the organization. The lawyer may ask for reconsideration of the matter, recommend that a separate legal opinion be sought on the matter, or refer the matter to a higher authority within the organization. If the lawyer has exhausted his or her remedial options under Rule 1.13(b) and the highest authority within the organization “insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer may resign in accordance with Rule 1.16.” Only misconduct that is related to the representation triggers the lawyer’s duties under Rule 1.13.
The requirements of Rule 1.13 apply only if the lawyer "knows" of the actual or intended misconduct on the part of an officer, employee or agent of the corporation. Under the model rules, a lawyer "knows" a particular fact if he or she has actual knowledge of its existence. This falls short of the "reasonably should know" standard found elsewhere in the rules.

**Scope of Representation**

Rule 1.2 states that a lawyer shall abide by a client's decision concerning the objectives of representation. However, the lawyer must not, within the requested scope of representation, counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent. Comment [6] to Model Rule 1.2 addresses the distinction between permissible advice and legal analysis and improper assistance by the lawyer in the conduct of a client's crime or fraud. It states in part:

The fact that a client uses advice in a course of action that is criminal or fraudulent does not, of itself, make a lawyer a party to the course of action. However, a lawyer may not knowingly assist a client in criminal or fraudulent conduct. There is a critical distinction between presenting an analysis of legal aspects of questionable conduct and recommending the means by which a crime or fraud might be committed with impunity.

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**Confidentiality of Client Information**

Rule 1.6 generally prohibits the disclosure of information relating to the representation of a client unless the client gives an informed consent. Paragraph (b) of Model Rule 1.6 and the corresponding Kentucky ethics rule identify certain narrow exceptions to the general rule of non-disclosure. The lawyer may (but is not required to) reveal information relating to the representation if reasonably necessary to prevent reasonably certain death or substantial bodily harm or to establish a claim or defenses in a dispute between the lawyer and the client or in a civil action or disciplinary proceeding against the lawyer involving the representation. Additionally, disclosure of client information is permitted to comply with other law or a court order. It is not clear from a reading of the rules or the comments what is meant by "other law" or the circumstances under which disclosure would be allowed in those instances. Comment [21] to Kentucky Rule 1.6 notes that "a lawyer may be obligated or permitted by other provisions of law to give information about a client. Whether another provision of law supersedes Rule 1.6 is a matter of interpretation beyond the scope of these Rules, but a presumption should exist against such a supersession." This exception for laws outside the scope of the professional ethics rules provides an important option for lawyers in states like Kentucky which don’t specifically allow disclosures necessary to prevent or rectify financial harm to non-clients such as shareholders or other investors. One expert on legal ethics suggests that the lawyer may elect, in the face of potential civil or criminal liability for assisting a client's fraud, to preemptively invoke the self-defense exception in Rule 1.6(b) and blow the whistle on the client's wrongdoing before being implicated personally.

Kentucky is among a small minority of states that do not permit disclosure to third parties to prevent financial or economic harm to others. Over forty states currently permit or require some form of disclosure to third parties to prevent a client from committing a criminal fraud. In its present form, then, Kentucky Rule 1.6 significantly limits the options available to a lawyer who learns of actual or potential corporate fraud in the course of his or her representation of the organization.

The final report of the ABA Commission on Evaluation of the Rules of Professional Conduct (Ethics 2000), presented to the ABA House of Delegates in August 2001, proposed to amend Model Rule 1.6(b) to expand the grounds for permissive disclosure of client information. Under the changes recommended by the Ethics 2000 Commission, disclosure would be permitted to prevent the client from committing a crime or fraud reasonably certain to result in substantial financial injury, if it involves the lawyer's services, and to prevent, mitigate or rectify the consequences of a client's financial fraud or crime in furtherance of which the lawyer's services were used. These proposals were consistent with corresponding provisions of the American Law Institute's Restatement (Third) of the...
Law Governing Lawyers. The Ethics 2000 recommendations were rejected by the House of Delegates.

Withdrawal from Representation

Model Rule 1.16 and the corresponding Kentucky ethics rule require the lawyer to withdraw from representation of a client if the representation will result in a violation of law or the rules of professional conduct. The lawyer may withdraw if the client persists in conduct involving the lawyer’s services that the lawyer reasonably believes is criminal or fraudulent, or if the client has used the lawyer’s services to perpetrate a crime or fraud.

Comments to the rules of professional conduct indicate that, after withdrawal, the lawyer is not prohibited from giving notice to third parties of the fact of withdrawal, and may also withdraw or disaffirm any opinion, document, affirmation or the like to prevent its use in the client’s continuing or intended future fraud (a “noisy withdrawal”). ABA Formal Opinion 92-366 confirms that the lawyer may withdraw or disaffirm work product even though this may have the collateral effect of disclosing inferentially confidential client information. The lawyer may not, however, effect a noisy withdrawal and disaffirm work product if the client’s fraud is completed and the lawyer doesn’t know or reasonably believe that the client intends to continue the fraud by use of the lawyer’s services.

Statements to Third Parties

Rule 4.1 prohibits a lawyer from knowingly making a false statement of material fact or law to a third person, or failing to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

Comment [3] to Rule 4.1 addresses the relationship between Rule 1.2(d) and Rule 4.1. The comment notes that, in cases where the client’s crime or fraud takes the form of misrepresentations, substantive law may require a lawyer to disclose information relating to the representation to avoid being deemed to have assisted the client’s crime or fraud. “If the lawyer can avoid assisting a client’s crime or fraud only by disclosing this information, then under [Rule 4.1(b)] the lawyer is required to do so, unless the disclosure is prohibited by Rule 1.6.”

Knowledge Standard and Duty of Inquiry

What duty does an organization’s attorney have to investigate facts suggesting that an officer or employee of the organization is engaged in improper or illegal activity that could result in significant harm to the interests of the organization or third parties? Under Rule 1.13, the organization’s lawyer must pursue up-the-ladder reporting or other appropriate responses if the lawyer “knows” that an agent of the organization is engaged in conduct that violates a legal obligation owed to the organization or constitutes a violation of law which reasonably might be imputed to the organization. Also, Rule 1.2(d) prohibits a lawyer from assisting a client in conduct that the lawyer “knows” is criminal or fraudulent. The permissive withdrawal provisions of Rule 1.16 apply if the lawyer “reasonably believes” that a client is engaged in criminal or fraudulent conduct. The model rules define “knowledge” and “knows” as “actual knowledge of the fact in question,” although knowledge may be inferred from circumstances. A “reasonable belief” means that the lawyer “believes the matter in question and that the circumstances are such that the belief is reasonable.” Reasonableness is measured by the conduct of a reasonably prudent and competent lawyer. The ABA Task Force report recommends that lawyers should be held to the “reasonably should know” standard, which under the Model Rules means “that a lawyer of reasonable prudence and competence

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would ascertain the matter in question.”

It is not clear whether, in circumstances where a lawyer’s professional responsibilities are predicated upon actual knowledge of illegal or improper corporate conduct, the lawyer has an independent duty of inquiry to investigate facts or circumstances which appear to the lawyer to be inconsistent with statements or directions from his or her client. The ABA Task Force report concludes that “while lawyers should not be subject to discipline for simple negligence, they should not be permitted to ignore the obvious.” At least one federal court has reached a similar conclusion. In *FDIC v. O'Melveny & Myers,* the Federal Deposit Insurance Corporation, in its capacity as receiver of a failed financial institution, brought an action for professional negligence, negligent misrepresentation and breach of fiduciary duty against attorneys retained by the institution to prepare offering documents for two real estate syndications. In its complaint, the FDIC alleged that the law firm never communicated with the institution’s current or previous auditors or attorneys or its regulators regarding the institution’s financial condition. The Ninth Circuit Court of Appeals found that genuine issues of material fact existed with regard to whether the law firm fulfilled its professional duties to the client institution and reversed the lower court’s dismissal of the claims against it. The court stated that the law firm, as part of its professional duties to its client, was required to make a “reasonable, independent investigation to detect and correct false or misleading materials.”

**ABA Task Force on Corporate Responsibility**

In March 2002, the American Bar Association established a task force to examine corporate governance and responsibility issues raised by the collapse of Enron and similar situations. The Task Force was asked to “examine the framework of laws and regulations and ethical principles governing the roles of lawyers, executive officers, directors, and other key participants. The issues will be studied in the context of the system of checks and balances designed to enhance the public trust in corporate integrity and responsibility.”

The Task Force issued a preliminary report on July 16, 2002. In its report, the Task Force focused on two areas: first, recommendations for improving internal corporate governance systems and second, the proper role of corporate attorneys in promoting corporate responsibility. On the subject of lawyer responsibility and conduct, the Task Force proposed a series of revisions to the ABA Model Rules of Professional Conduct to “help lawyers comply with their duties to an organizational client in circumstances in which corporate officers engage in or countenance criminal, fraudulent or deceptive conduct likely to cause harm to the organization or its shareholders.” These proposals include:

- Amendments to Rule 1.13 to require a lawyer to pursue remedial measures for misconduct, whether the problem is related to the representation or learned through the representation, and to communicate with higher corporate authority where other efforts to prevent or rectify the problem fail.
- Amendments to Rule 1.6 to extend permissible third party disclosure to conduct that has resulted or is

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reasonably certain to result in substantial injury to the financial interests or property of another, and require disclosure under Rule 1.6 to prevent felonies or other serious crimes, including violations of the federal securities laws, where such misconduct is known to the lawyer. These amendments were previously recommended by the Ethics 2000 Commission and rejected by the ABA House of Delegates. The Task Force recommends that the House of Delegates reconsider the Ethics 2000 proposals.

Amendments to Rules 1.2(d), 1.13 and 4.1 to lessen the knowledge standard for lawyers to take action under these rules from actual knowledge to circumstances in which the lawyer reasonably should know of the crime or fraud.

The Task Force recommendations are expected to be presented to the ABA House of Delegates for its consideration later this year.

Sarbanes-Oxley Act

Section 307 of the Sarbanes-Oxley Act of 2002 directs the Securities and Exchange Commission to prescribe minimum standards of conduct for attorneys appearing and practicing before the Commission. The statute specifies that the standards must include a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company or any agent acting on its behalf to the chief legal officer or the chief executive officer. If the company has previously established a special legal compliance committee of independent directors to receive and investigate allegations of corporate misconduct (a “qualified legal compliance committee”), the attorney may instead report the evidence to the compliance committee. In this regard, the basic up-the-ladder reporting model in the new SEC rules is substantially similar to Model Rule 1.13(b) and the corresponding Kentucky ethics rule.

The SEC rules, which will become effective August 5, 2003, apply to attorneys “appearing and practicing” before the Commission. The Commission has chosen to adopt a very expansive definition which extends beyond securities lawyers and attorneys who specifically counsel clients on disclosure matters under the federal securities laws to include, among others, non-securities attorneys who participate in the preparation or review of any documents which the attorney knows will be filed with or submitted to the Commission.

For the most part, the rule covers only those attorneys who represent public companies before the SEC or in connection with U.S. securities laws. Attorneys advising non-public companies in connection with exempt securities offerings under the federal securities laws, for example, would be excluded from the rule. If the client company is a non-public subsidiary of a public company, however, the attorney would be subject to the rule if the legal services are provided to the subsidiary “on behalf of, or at the behest, or for the benefit of the [public company parent], regardless of whether the attorney is employed or retained by the [parent].” The rule also limits the internal reporting requirements to attorneys who provide “legal services to an issuer with whom the attorney has an attorney-client relationship.” Thus, attorneys representing parties in privity of contract with the issuer, such as banks and underwriters, and licensed attorneys employed by an organization in non-legal capacities, would be excluded.

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An attorney’s obligation to report under these new rules is triggered when the attorney becomes aware of “evidence of a material violation” by the company or by any director, officer, employee or agent of the company, of any federal or state securities law, a material breach of fiduciary duty or a similar material violation of any federal or state law. Evidence of a material violation means “credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur.” In the adopting release for the rule, the Commission states that, for a violation to be “reasonably likely,” it “must be more than a mere possibility, but it need not be ‘more likely than not’.” The Commission rejected suggestions from commenters that the up-the-ladder reporting obligations be triggered only
when an attorney knows that a material violation has occurred.

Following an attorney’s initial report to the chief legal officer or the chief executive officer, the corporate officer must investigate the evidence and respond to the attorney. The appropriateness of the officer’s response is to be measured both subjectively and objectively. The attorney will have no further reporting requirement if, as a result of the response to his or her report of a material violation, the attorney reasonably believes that (a) no material violation has occurred, is ongoing or is about to occur, (b) the issuer has adopted appropriate remedial measures, or (c) the issuer has retained an attorney to review the reported evidence and either has implemented the attorney’s remedial recommendations or has been advised that the attorney may assert colorable defenses on its behalf. Unless the attorney receives an appropriate response he or she is then obligated to report the matter to a higher authority within the organization, including the audit committee, another committee of non-employee directors or the full board of directors. If the attorney chose to report the evidence directly to a qualified legal compliance committee, the attorney would have no further obligations under the rules.

Importantly, the rules permit, but don’t require, an attorney appearing and practicing before the Commission to reveal to the Commission, without the company’s consent, confidential information related to the representation to the extent the attorney reasonably believes necessary to prevent substantial injury to the financial interests of investors. The SEC provision, then, directly conflicts with (and preempts) Kentucky Supreme Court Rule 3.130 (1.6), which allows disclosure of confidential client information only to prevent imminent death or substantial bodily harm. This preemption should provide grounds for an attorney to report evidence of improper corporate conduct to the SEC without risk of disciplinary action under the Kentucky rules of professional conduct.

The Commission’s initial rule proposal included provisions which would require attorneys appearing and practicing before the Commission to effect a “noisy withdrawal” from representation if a reporting attorney, after fully complying with the internal up-the-ladder reporting requirements of the rule, didn’t receive an appropriate response to his or her report of a material violation. Specifically, an attorney retained by the issuer who reasonably believes that a material violation likely to result in substantial injury to the financial interests of the issuer or its investors is ongoing or about to occur has fully reported evidence of that material violation up-the-ladder as required by the rule and not received an appropriate response would then be required to:

- Withdraw forthwith from representing the issuer, indicating that the withdrawal is based on professional considerations;
- Within one business day of withdrawing, give written notice to the Commission of the attorney’s withdrawal, indicating that the withdrawal is based on professional considerations; and
- Promptly disaffirm to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.

If, instead of referring evidence of the potential misconduct initially to the company’s chief legal officer or chief executive officer and then to a higher authority within the corporation, the attorney elected in the first instance to report the matter to a qualified legal compliance committee, the attorney would be relieved of the obligation to report his or her withdrawal outside the corporation.

This “noisy withdrawal” proposal attracted loud criticisms from commenters who feared that the new requirement would conflict with existing state ethics rules and interfere with attorney-client relationships. Commenters also questioned the Commission’s authority under Section 307 of Sarbanes-Oxley to require a “noisy withdrawal.” In response to these concerns, the Commission deferred action on its initial noisy withdrawal proposal and proposed an alternative requirement that issuers, rather than attorneys, report the fact of an attorney’s withdrawal to the Commission.13

Attorneys as Whistleblowers and the Duty to Speak: The Enron Case

The traditional common law rule is that attorneys owe their fiduciary duties only to their clients, not to non-client third parties. Thus, in the absence of an affirmative duty to speak, silence is generally not actionable and attorneys would not be liable for failing to blow the whistle on their cli-
Nevertheless, some courts have held lawyers accountable when an attorney voluntarily undertakes to communicate directly with non-clients in securities transactions who rely on misstatements or omissions by the attorney. In a 1998 opinion from the Sixth Circuit, the court held that "while an attorney representing the seller in a securities transaction may not always be under an independent duty to volunteer information about the financial condition of his client, he assumes a duty to provide complete and nonmisleading information with respect to subjects on which he undertakes to speak." The court further stated that an attorney who prepares a false or misleading document may be held liable as a primary violator of the federal securities laws even though direct negotiations with the securities purchasers were conducted by others.

The risk to an attorney or law firm of not speaking out about a client's misconduct is vividly illustrated by a recent memorandum opinion and order issued in Newby, et al. v. Enron Corporation, et al. A group of "secondary actors" including accountants, lawyers, banks and investment bankers for Enron were sued by investors for securities fraud under federal and state securities laws even though direct negotiations with the securities purchasers were conducted by others.

The defendants moved to dismiss the complaint on the grounds that, under the U.S. Supreme Court's ruling in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., they couldn't be held liable as aiders and abettors of Enron's primary securities law violations. In a controversial ruling, the court refused to dismiss the claims against one of Enron's principal outside law firms. After a lengthy review of the professional ethics rules and case law relevant to the duty of an attorney to disclose nonmisleading information about his or her client to nonclients and third parties, the court concluded that "professionals, including lawyers . . . , when they take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client's financial condition, do have a duty to third parties not in privity not to knowingly or with severe recklessness issue materially misleading statements on which they intend or have reason to expect that those third parties will rely." The opinion contains a lengthy and detailed account of the allegations in the complaint regarding the law firm's extensive participation in the preparation and review of Enron's filings with the SEC, press releases and shareholder reports and the structuring and documentation of numerous financial transactions on behalf of Enron. The complaint alleges that these financing transactions were not legitimate arms-length commercial transactions but rather manipulative arrangements which Enron's attorneys knew were designed to disguise the company's true financial condition. The court found that the law firm was "not merely a drafter, but essentially a co-author of the documents it created for public consumption concealing its own and other participants' actions."

For this reason and because it directed the alleged fraudulent misrepresentations publicly to potential investors, credit rating agencies and banks to maintain Enron's financial condition, it had a duty to be accurate and truthful. In contrast, the court dismissed claims against a second law firm on the grounds that its work product on behalf of Enron never reached the public and that traditional rules of attorney-client privilege and privity protected it against investors' claims.

Conclusion

In the post-Enron reform era, legislators, regulators and the courts will be looking closely at the role of attorneys in the corporate governance system. Greater accountability will be expected from lawyers whose services and professional advice contribute materially to a client's financial fraud or crime. At some point, traditional ethics principles of non-disclosure, privity and attorney-client privilege must be subordinated to the interests of investors and shareholders who suffer substantial financial losses as a result of corporate fraud. Efforts like the ABA Task Force on Corporate Responsibility are a meaningful and commendable step in the process of rethinking professional ethics rules to achieve an appropriate balancing of these interests.

Endnotes appear on page 61

C. Craig Bradley, Jr. is a member in the Louisville office of Stites & Harbison, PLLC, where his practice focuses on securities law and corporate finance. He received his J.D. from the University of Kentucky College of Law and his undergraduate degree from the University of Virginia. Mr. Bradley served as a member of the drafting committee for the revised Kentucky Business Corporation Act and co-chaired the special legislative committee of the Business Law Section of the Kentucky Bar Association which drafted the 2002 amendments to the Business Corporation Act. He also served as a member of the Kentucky legislative advisory committee which assisted the Kentucky Department of Financial Institutions in developing a comprehensive reform of state securities laws. He is a past chair of the Business Law Section of the Kentucky Bar Association.