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Where Were the Lawyers?

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Where Were the Lawyers?

by Ed Hendricks and Mary Berkheiser

Last March, the Office of Thrift Supervision (OTS) sent shock waves through the legal community when it initiated a $275 million enforcement action against New York's Kaye, Scholer, Fierman, Hays & Handler and froze the firm's assets, all based on the firm's alleged misdeeds in representing the now-defunct Lincoln Savings & Loan. The OTS action, together with the recent spate of professional liability suits by the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC), raises questions with far-reaching consequences for the legal profession. Perhaps most disturbing, particularly in light of the OTS's unprecedented assault on Kaye, Scholer, is the question posed by U. S. District Court Judge Stanley Sporkin at the beginning of the *Lincoln Savings* case:

> Where were these professionals . . . when these clearly improper actions were being consummated? . . . Why didn't any of them speak up or disassociate themselves from the transaction? . . . What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.

Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990).

These words have provided powerful ammunition for government regulators. By late last year, the RTC and the FDIC had filed more than 50 lawsuits against lawyers and law firms in connection with their representation of failed savings and loans. *Professional Liability Law Suits Against Individual Attorneys/Law Firms* (Rev. Oct. 4, 1991) (FDIC Professional Liability Office). RTC officials suspect lawyer wrongdoing in nearly 50 percent of failed thrifts, and FDIC officials expect to file claims against lawyers and other professionals (including officers and directors) in 75 percent of 1990 and 1991 bank failures. *Bank and Thrift Failures: FDIC and RTC Could Do More to Pursue Professional Liability Claims, Testimony Before the Senate Comm. on Banking, Housing, and Urban Affairs,* 102nd Cong. 2nd Sess. 9-10 (June 2, 1992) (Statement of Harold A. Valentine, Assoc. Dir. Admin. of Just. Issues). To make matters worse, the FDIC, the RTC, and the OTS have asserted that each may be entitled to restitution emerging from *the same* alleged improper conduct. "A Serpent with Three Heads," *Legal Times,* Aug. 12, 1991, at 1. With the statute of limitations set to expire for many institutions in mid-1993, the pace of filings by the FDIC and RTC will continue to accelerate before it winds down, particularly if regulators obtain additional staffing and other resources they claim are needed. Valentine Testimony, at 14-17, 27-29.

In defense of its aggressive posture, the government maintains that it is bringing only the most egregious cases of lawyers' overreaching and abuse of the system. "Savings & Loan Lawyers: When the '80s Meet the '90s," A.B.A.J., May 1991, at 52, 56. But the stakes in these suits are so high and the legal defense so expensive that lawyers and their insurers are paying millions of dollars in settlement just to get out of court. E.g., Firm Fights, Rather Than Settle, S&L Allegations, Legal Times, Apr. 8, 1991, at 2. Only six days after the OTS froze its assets, Kaye, Scholer agreed to pay the government $41 million in fines. The firm had no choice because even a brief freeze would have devastated its access to vital lines of credit and its ability to continue day-to-day operations. Law Firm Agrees to Pay U.S. Regulators $41 Million, 24 Sec. Reg. & L. Rep. 335 (March 13, 1992).

The upshot is that important questions of liability and fault have gone unanswered, and the fact that lawyers are settling is being viewed by some as evidence that lawyers are primarily responsible for the downfall of the savings and loan industry. "Don't Blame the Lawyers," Nat. L.J., Nov. 26, 1990, at 13, 14. That is unfortunate, because although lawyers may bear some of the responsibility, laying the blame at their feet does not solve the problem. Rather, it presents a new set of problems exemplified by Judge Sporkin's misguided notion that lawyers must blow the whistle on their clients. If lawyers have that duty and can be sued and held liable for failing to perform it, aren't we saying that lawyers owe duties to someone other than their clients? And if so, who is the client, and what has become of the lawyer-client relationship?

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These questions do not seem to trouble the RTC and the FDIC. In case after case, they assert novel, undefined theories that are little more than thinly veiled attempts to prosecute lawyers for allegedly shoddy morals. "Maybe They Should Call It the Injustice Dept.," *Business Week,* June 10, 1991, at 16. They argue that "public policy" demands that lawyers for federally insured institutions be held to a higher standard of professionalism; then they push to extend that standard to lawyers who serve on an institution's board of directors, even when those lawyers do not also represent the institutions. "FDIC Brings New Theories to Federal Courts," *The FDIC Watch,* Sept. 13, 1991, at 3; "Cutting Their Losses: Insurers Seek to Limit Exposure," N.Y. L.J., June 27, 1991, at 5. This superstandard, coupled with the government's view that thrift lawyers' *advice alone* may constitute illegal conduct under FIRREA's "but for" test, dims the long-term prospects for targeted firms and their institutional clients. *Thrift News,* at 57. The RTC has even gone so far as to maintain that lawyers who represent an institution in one discrete transaction have a legal obligation (1) to investigate another totally unrelated transaction and (2) to prevent the institution from consummating the other transaction or, failing that, (3) to disclose the fraud underlying that transaction (even though the lawyers were unaware of it). *See Resolution Trust Corp. v. Charles H. Keating, Jr., et al.,* No. CV 89-1509 PHX-RMB (D. Ariz. 1989).

Exposure to such far-reaching liability is not a risk any lawyer or law firm could reasonably anticipate or long endure. In the end, the RTC's approach, if successful, will drive the best lawyers out of the practice and leave the savings and loans and other regulated industries unrepresented or underrepresented. This process of elimination has already begun for accountants, who were an earlier target than lawyers in the demise of the savings and loans. Jeffrey N. Leibell, "Accountants' Liability in the Savings and Loan Crisis: An Argument for Affirmative Defenses," 1991 Colum. Bus. L. Rev. 71, 80–81. The sheer magnitude of the liability a targeted law firm faces at the hand of the RTC threatens to wipe out many firms. At the same time, professional liability insurance rates for lawyers continue to rise, and some carriers are insisting on clauses that exclude coverage of claims by government regulators. "Cutting Their Losses," N.Y. L.J., June 27, 1991, at 5.

These developments are nothing short of shocking for the legal profession. For more than a century, the ironclad rule of privity barred *any* professional liability suits against lawyers by nonclients, and privity remains the letter of the law in many jurisdictions today. Ronald E. Mallen & Jeffrey M. Smith, *Legal Malpractice* § 7.10 at 376–78 (3d ed. 1989). Although the question of lawyers' duties to someone other than their clients was raised as early as 1879, the Supreme Court held tight to privity. *National Savings Bank v. Ward,* 100 U.S. 195 (1879). Attempts to hold accountants liable to third parties fared no better. In *Ultramares v. Touche,* 255 N.Y. 170, 174 N.E. 441 (1931), Justice Cardozo and his brethren held the ground against attempts to impose professional liability "in an indeterminate amount for an indeterminate time to an indeterminate class." *Id.* at 179–80, 174 N.E. at 444.

The first case to make an inroad into lawyer-client privity did not arise until 1961. In *Lucas v. Hamm,* 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821, *cert. denied,* 368 U.S. 987 (1962), the California Supreme Court considered whether extending a lawyer's duty to beneficiaries of a will the lawyer had drafted would impose an undue burden on the legal profession. The court concluded it would not and for the first time held a lawyer liable for negligent drafting of a will that cut off the nonclient beneficiaries. Using the same burden analysis, the California Supreme Court more recently refused to extend a lawyer's duty to nonclient purchasers of stock in a corporation the lawyer represented. *Goodman v. Kennedy,* 18 Cal. 3d 335, 556 P.2d 737, 134 Cal. Rptr. 375 (1976). The court cautioned against the profound burden such a duty would place on lawyers' dealings with their clients:

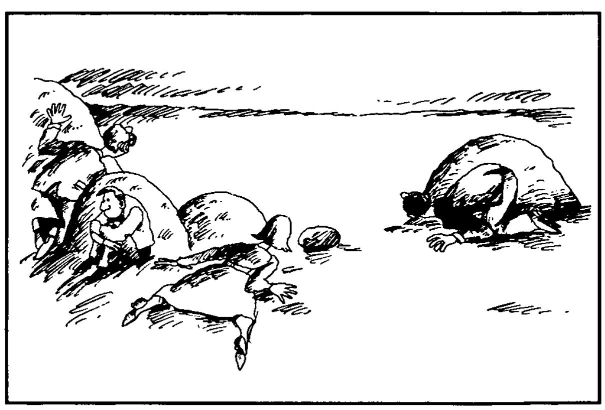
> *To make an attorney liable for negligent confidential advice* not only to the client who enters into a transaction in reliance upon the advice but also *to the other parties to the transaction with whom the client deals at arm's length would inject undesirable self-protective reservations into the attorney's counselling role, . . . and [result in] a diminution in the quality of the legal services received by the client.* [Emphasis added.]

Id. at 344, 556 P.2d at 743, 134 Cal. Rptr. at 381.

When, as in *Goodman,* implying a duty to a third party will drive a wedge between lawyer and client and burden the lawyer-client relationship with a high risk of divided loyalties, the policy considerations against the implied duty are compelling. Mallen & Smith, § 7.11 at 388. That burden can be no greater than when a plaintiff claims a lawyer should have blown the whistle on the client. Indeed, three federal circuit courts of appeal have faced this issue, all in the context of suits by disgruntled investors, and each has rejected the suggestion that lawyers should tattle on their clients. *Schatz v. Rosenberg,* 943 F.2d 485 (4th Cir.), *cert. denied,* 112 S. Ct. 1475 (1992); *Abell v. Potomac Ins. Co.,* 858 F.2d 1104 (5th Cir.), *cert. denied,* 492 U.S. 918 (1989); *Barker v. Henderson, Franklin, Starnes & Holt,* 797 F.2d 490 (7th Cir. 1986). The words of the Fourth Circuit in *Schatz* echo the concerns of the *Barker* and *Abell* courts:

> [P]ublic policy counsels against imposing such a duty. . . . Any other result may prevent a client from reposing complete trust in his lawyer for fear that he might reveal a fact which would trigger the lawyer's duty to the third party. . . . *The better rule—that attorneys have no duty to "blow the whistle" on their clients—allows clients to repose complete trust in their lawyers.* [Emphasis added.]

943 F.2d at 493.



So who is right—the courts in *Goodman, Schatz, Barker,* and *Abell,* or Judge Sporkin, the RTC, OTS, and FDIC? We believe the answer resides largely in the rules governing lawyers' ethical responsibilities.

The ethical rules were once invoked as the source of a whistle-blowing duty. For a brief period in the 1970s, the Securities and Exchange Commission (SEC) undertook a campaign to establish a whistle-blowing rule for securities lawyers. The rise and fall of the SEC's efforts is instructive in the present flurry of similar actions by the RTC, the OTS, and the FDIC.

A Whistle-blowing Duty

It all began in 1972, when the SEC filed its complaint in *SEC v. National Student Mktg. Corp.,* Fed. Sec. L. Rep. (CCH) ¶ 93,360 (D.D.C. 1972). This action was remarkable at the outset because it marked the first time the SEC had pursued members of prominent law firms for their actions in the ordinary course of representing their clients. Nicholas M. Wenner, "Determining Secondary Liability Under Securities Laws: Attorneys Beware!," 11 Hamline L. Rev. 61, 67 (1988). The SEC asserted that the lawyers should have advised their client that its proposed course of conduct violated the securities laws and that when the client refused to follow the advice, the lawyers had a duty to resign and blow the whistle to the SEC. Otherwise, the SEC argued, the lawyers themselves would be guilty of securities law violations. Fed. Sec. L. Rep. ¶ 93,360 at 91,913–18.

SEC Commissioner A. A. Sommer was most outspoken on the whistle-blowing duty asserted in *National Student Mktg.* He charged that lawyers could no longer function as mere advocates for their clients but also must act as independent auditors and guardians of the public trust. A. A. Sommer, Jr., "The Emerging Responsibilities of the Securities Lawyer," Fed. Sec. L. Rep. (CCH) ¶ 79,631 at 83,689–90 (Jan. 23, 1974). The debate within the SEC reached its zenith with what came to be known as the Georgetown whistle-blowing proposal, a petition by the Institute for Public Interest Representation at Georgetown University Law Center for an SEC rule defining a securities lawyer's responsibilities to include a broad whistle-blowing duty. *See generally* Kent Gross, "Attorneys and Their Corporate Clients: SEC Rule 2(e) and the Georgetown 'Whistle Blowing' Proposal," 3 Corp. L. Rev. 197, 198 (1980). Under the Georgetown proposal, if a client persisted in its unlawful course of action after the lawyer tried to rectify the violation within the corporate management and the board of directors, the lawyer would have a duty to disclose the violations not just to the SEC but to the public. *Id.* at 199, 208.

After receiving more than 300 comments, most of which opposed the Georgetown proposal, the SEC denied the petition. Exchange Act Release No. 16769, Fed. Sec. L. Rep. (CCH) ¶ 82,501 at 83,110 (Apr. 30, 1980). In a cryptic footnote to later proceedings, however, the commission suggested that although no SEC rule imposed a duty to blow the whistle, ABA Disciplinary Rule (DR) 7-102(B) might. *In re Carter and Johnson,* Fed. Sec. L. Rep. (CCH) ¶ 82,847 at 84,173 n.78 (Feb. 28, 1981), citing Model Code of Professional Responsibility DR 7-102(B)(1969).

The DR 7-102(B) mandatory disclosure rule to which the SEC alluded was in the 1969 Code of Professional Responsibility:

> A lawyer who receives information clearly establishing that: (1) His client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal.

This provision was one of the most controversial and confusing of all those found in the Code, largely because of problems arising when a lawyer's revelation would compromise client confidentiality. Charles W. Wolfram, *Modern Legal Ethics* § 12.6.4 at 669–70 (1986). The SEC's filing of the *National Student Mktg.* suit in 1972 did nothing to allay lawyers' misgivings about the apparently conflicting duties to their clients and the profession imposed by DR 7-102(B). The issue culminated in the ABA's 1974 amendment to DR 7-102(B)(1), which added the words "except when the information is protected as a privileged communication."

Any lingering uncertainty about a lawyer's duty to blow the whistle under DR 7-102(B) was put to rest nine years later by its successor, Model Rule 1.6. Under Rule 1.6, *non*disclosure is the rule and disclosure the rare exception, restricted exclusively to circumstances involving crimes likely to cause death or substantial bodily harm. The prohibition against disclosure in Rule 1.6 is very broad: "The confidentiality rule applies not merely to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source." Comment, Rule 1.6. Although a lawyer "is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation," the lawyer may not make even those disclosures if the client instructs otherwise or if "special circumstances limit that authority." *Id.*

Compromising Confidentiality

An earlier proposed draft of Rule 1.6 would have permitted disclosure also for crimes threatening substantial financial injury to another. This proposal generated a "firestorm of protest," many reading it as "a broad license and even direction to 'blow the whistle' at will." Geoffrey C. Hazard, Jr., & W. William Hodes, *The Law of Lawyering* § 1.6:302 at 166 (2d ed. 1990). Since the adoption of the Model Rules, the ABA House of Delegates has continued to resist efforts to make inroads on the restrictive disclosure permitted by Rule 1.6. "ABA Spurns Ancillary Business Activities, Refuses to Budge on Client Confidentiality," 60 U.S.L.W. 2121 (Aug. 20, 1991).

The controversy surrounding the drafting of Rule 1.6 highlighted the pivotal role confidentiality plays in the practice of law. It is a matter of intuition, if not empirical proof, that a lawyer bound not to disclose client confidences is better able to gain the client's trust than is a lawyer with no such obligation. Take away the trust, the common thinking goes, and clients will be less willing to "tell all" to their lawyers, and lawyers will be less able to represent their clients effectively. Some even suggest that, ultimately, our system of adversarial justice would disintegrate if the rule of lawyer-client confidentiality were abrogated. Fred C. Zacharias, "Rethinking Confidentiality," 74 Iowa L. Rev. 351, 358 (1989).

To be sure, the confidentiality principle has a solid moral base quite apart from the imprimatur placed on it by the rules of professional responsibility. It does far more than simply further the ends of the adversarial system. Professor Geoffrey Hazard, the reporter for the Model Rules, has observed that by creating a "zone of privacy" that cannot be breached by an overly inquisitive government, the confidentiality principle "enhances the autonomy and individual liberty of citizens." Hazard & Hodes, § 1.6:101 at 129. It assures that in some things—at least those they share with their lawyers—citizens can trust they will be left alone. The moral value of confidentiality is reinforced when lawyers protect their clients' confidences, even when faced with external pressures to speak out.

But that does not deny that confidentiality should yield to higher interests in some circumstances. Model Rule 3.3, Candor Toward the Tribunal, is perhaps the prime example. It is a potentially powerful directive. For example, it can have the effect of requiring a lawyer to reveal the client's perjury. Rule 3.3(a) provides that "[a] lawyer shall not knowingly . . . [o]ffer evidence that the lawyer knows to be false," and that a lawyer who "has offered material evidence and comes to know of its falsity" must "take reasonable remedial measures." It is generally agreed that the first of the "reasonable remedial measures" is to urge the client to make the situation right and to withdraw if the client does not. *Id.* § 3.3:219 at 610–11. Although Rule 3.3 applies only to judicial proceedings, Rule 3.9 extends the candor requirements of Rule 3.3 to proceedings before administrative and legislative tribunals. *Id.* § 3.9:101 at 704.

When withdrawal is not possible, the next step is more difficult. The drafters of the Model Rules rejected the suggestion that the lawyer should simply proceed as if nothing had happened, as well as the proposal that the client be allowed to present the client's story in narrative fashion, without assistance from the lawyer. *Id.* § 3.3:219 at 611. That leaves the lawyer with only one option—to reveal the perjury to the court. Then, if the court orders the lawyer to proceed, Rule 1.16(c) requires compliance and absolves the lawyer of any breach of Rule 3.3.

But reporting a client's perjury to the presiding judge in a judicial proceeding is a far cry from blowing the whistle to a regulatory body or group of investors. Nothing in Rule 3.3 or 3.9 can be stretched to imply such a general whistle-blowing obligation. And although two other ethical rules hint at a disclosure duty, in the end neither imposes one.

The first, Model Rule 1.2(d), provides that "[a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent." But this rule merely seeks to ensure that lawyers do not become their clients' accomplices in criminal or fraudulent activities. *Id.* § 1.2:103 at 24–25. It says nothing about whistle-blowing. To the contrary, under Rule 1.16 the lawyer who is presented with a Rule 1.2(d) situation should either refuse to participate or withdraw from the representation. *Id.* at 25.

The second rule that suggests a duty to disclose is Model Rule 4.1(b). Of all the ethical rules, Rule 4.1(b) looks the most like a whistle-blowing rule. It requires a lawyer to disclose material facts to a third person when "necessary to avoid assisting a criminal or fraudulent act by a client." But an exception for disclosures "prohibited by Rule 1.6" eviscerates most applications of Rule 4.1(b)'s disclosure requirement.

As all this makes clear, no one can look to the Model Rules of Professional Conduct for an affirmative duty to blow the whistle on a client. To the contrary, the Rules require protection of client confidences except in very limited circumstances. Moreover, the remedy for a Rules violation is not a private cause of action in any event. The Scope note for the Model Rules could not be clearer on this point. *Id.* § 1.1:201 at 10–11.

Although various plaintiffs have brought actions seeking to use the Model Rules or their predecessor, the Code of Professional Responsibility, as the basis for a civil cause of action, courts have consistently rejected the claims. *E.g., Schatz,* 943 F.2d at 492; *Williams v. Mordkofsky,* 901 F.2d 158, 163 (D.C. Cir. 1990). As the Model Rules themselves make clear, the remedy for an ethical violation is public disciplinary action, such as reprimand, suspension, or disbarment of the offending lawyer. Thus, even if the Model Rules established a duty to blow the whistle, they would afford no independent basis for a civil damages action.

To say that a lawyer has very limited duties of disclosure to the outside world is not to say, however, that the lawyer has no duty *to a client* who appears to be engaged in wrongdoing. Rule 1.13(b) imposes what might be called an internal whistle-blowing duty. It attaches only when (1) a lawyer discovers improper or questionable conduct by a constituent of a client organization (a director, officer, or member) and (2) the conduct is likely to harm the organization. Although this probably is not the sort of whistle-blowing the SEC or Judge Sporkin had in mind, it still warrants consideration here because it is central to an understanding of lawyers' responsibilities in institutional representation.

Rule 1.13(b)'s dictates are directed solely inward—to the entity itself; they are designed to protect only the entity, not third persons, the public, or the SEC. Under Rule 1.13(b), the strongest action a lawyer may take with respect to the outside world is to resign and perhaps to "give notice of the fact of withdrawal" to the outside world. Hazard & Hodes, § 1.13:111 at 402. Rule 1.13(c) leaves no doubt that a lawyer may *not* blow the whistle externally after resigning, though early drafts of the rule would have permitted a lawyer to reveal confidential information to an appropriate regulatory agency in an effort to prevent illegality. Model Rules, Rule 1.13(c), Discussion Draft, Jan. 30, 1980. But Rule 1.13(b) does not specifically answer the question of what a lawyer may or must do internally. Instead, it establishes the general process a lawyer should undertake when faced with constituent misconduct:

Nothing in Rule 3.3 or 3.9 can be stretched to imply such a general whistle-blowing obligation.

> [T]he lawyer shall proceed as is reasonably necessary *in the best interest of the organization.* . . . Any measures taken shall be designed to *minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization.* [Emphasis added.] Such measures may include among others:
>
> (1) asking reconsideration of the matter;
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> (2) advising that a second legal opinion on the matter be

sought for presentation to appropriate authority in the organization; and

(3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization.

Id. § 1.13:301 at 409; Model Rule 1.13(b).

A key internal limitation in Rule 1.13(b) is the requirement that the constituent misconduct be "in a matter related to the [lawyer's] representation." Thus, a lawyer is under *no* duty to invoke the "climbing the ladder" regimen of Rule 1.13(b) for matters on which the lawyer provided no representation. In addition, the internal whistle-blowing provisions of Rule 1.13(b) are triggered only when a lawyer *knows* that a constituent is engaging, or is planning to engage, in some illegality. Although no case law has developed the parameters of the knowledge requirement under Rule 1.13(b), in 1989 a state bar ethics committee considered a similar "knowledge" requirement under Rule 3.3. The committee concluded that a lawyer who had "more than a mere suspicion," but was not *certain* that the deposition testimony of the client was false, had "no duty to correct or rectify it." Mich. State Bar Comm. on Prof. and Jud. Ethics, Op. RI-13, reported in *ABA/BNA Lawyers' Manual on Professional Conduct: Ethics Opinions,* May 24, 1989, at 155 (*ABA/BNA Ethics Opinions*).

Assuming the lawyer *knows* of misconduct triggering the "climbing the ladder" duties of Rule 1.13(b), a Connecticut ethics opinion illustrates the proper procedure. Conn. Bar Ass'n Comm. on Prof. Ethics, Informal Op. 89-14, reported in *ABA/BNA Ethics Opinions,* June 21, 1989, at 186–87. There, an in-house litigation lawyer discovered an illegal and perhaps criminal agreement between outside counsel and an informant. The lawyer believed that another in-house lawyer had approved the agreement in advance. Before requesting guidance from the ethics committee, he had sought a separate legal opinion on the issue, had the matter reconsidered by the company's in-house legal department, and referred it to a higher authority within the company.

No Duty to Investigate

The committee approved these steps and added that the lawyer also could refer the matter to the board of directors, resign, or withdraw from representing the company in the litigation. Even though external disclosure was permissible under Connecticut's version of Rule 1.6 (for an impending criminal act likely to result in substantial financial injury to a third party), the committee opined that a lawyer who chose not to disclose had a duty to protect the company's confidences and not to report the wrongdoing to disciplinary authorities. The lawyer not only had no duty to blow the whistle under Rule 1.13 but was barred from doing so by the confidentiality prohibition of Rule 1.6.

If lawyers must "go up the ladder" only when they *know* of wrongdoing, the next question is what duty, if any, lawyers have to investigate so as to enhance their knowledge. Apart from the requirements of Rule 11, there is little authority for the proposition that a lawyer has *any* duty to investigate. Indeed, the lawyer's obligations to a client typically run counter to a duty to probe. For example, in *In re Grand Jury Subpoena (Legal Serv. Ctr.),* 615 F. Supp. 958, 969 (D.Mass. 1985), the court concluded that to require a lawyer to investigate the truth of a client's story would be fundamentally inconsistent with the lawyer's obligation to zealously represent the client within the bounds of the law and "would undoubtedly undermine [the] client's confidence in his attorney."

In this respect, lawyers' duties differ dramatically from those of auditors and accountants, who have duties to maintain independence from their clients and to detect errors and irregularities in their clients' financial statements. AICPA Professional Standards (CCH) AU §§ 150.02 at 81, 316.03 at 239–40 (1991). But even auditors and accountants have no duty to search for reasons to blow the whistle on their clients. As one commentator put it, "[A]n accountant is a watch-dog, but not a bloodhound." Zoe Holmes, *Accountant Liability to Third Parties,* 55 U.M.K.C. L. Rev. 608, 613 (1987). The Seventh Circuit emphasized this limitation on accountants' obligations in *DiLeo v. Ernst & Young:* "Although accountants must exercise care in giving opinions on the accuracy and adequacy of firms' financial statements, *they owe no broader duty to search and sing.*" [Emphasis added]. 901 F.2d 624, 629 (7th Cir.), *cert. denied,* 111 S. Ct. 347 (U.S. 1990).

A Blind Eye

Congress has even declined to impose a whistle-blowing duty on accountants. An attempted amendment to H.R. 5269 (passed as part of the Comprehensive Crime Control Act of 1990) would have imposed on accountants a duty to blow the whistle to the SEC. Under the amendment, if accountants discovered that managers had committed illegal acts and the board of directors refused to remedy them, the accountants would have been required to disclose them to the SEC. The amendment died in the House but not without generating vocal opposition by business interests, as well as trade associations representing internal auditors. "Financial Executives Institute Opposes Bill Expanding Auditor Role," *Accounting Today* (Oct. 22, 1990); "Auditors Slam Crime Control Bill," *Accounting Today* (Nov. 5, 1990).

On the other hand, a lawyer's decision to "turn a blind eye" to a client's activities may in certain circumstances be sufficient to establish knowledge. No one has said it better than the Second Circuit's Judge Henry Friendly in *SEC v. Frank:* "[A] lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand." 388 F.2d 486, 489 (2d Cir. 1968). In *Wyle v. R. J. Reynolds Indus., Inc.,* 709 F.2d 585, 590 (9th Cir. 1983), the Ninth Circuit heeded Judge Friendly's warning. There, a law firm had failed to investigate the substance of its client's assertions that it had not engaged in illegal rebating, even after the firm learned of the client's previous fine for rebating. For the Ninth Circuit, this "constituted the equivalent of knowledge of the truth" and could not save the firm or its client from dismissal of their antitrust action as a sanction for willful misconduct.

The ABA Ethics Committee addressed the same issue in a case in which a prospective client had sought a tax lawyer's advice about how to minimize tax liability on unreported funds received while employed by a U.S. company overseas. Although the client had not revealed enough facts for the lawyer to determine the legality of the payments, the lawyer suspected the payments might have been unlawful bribes or kickbacks. Under these circumstances, the committee decided: "At the least, the lawyer has a duty to inquire further into the circumstances surrounding the receipt of the funds in order to prepare properly and to avoid aiding the client in perpetrating fraudulent or criminal conduct." ABA Comm. on Ethics and Prof. Resp., Informal Op. 1470 (1981). But, like the duty acknowledged in *Wyle,* the tax lawyer's duty derived from a very narrow set of circumstances and arose out of improper conduct in the very matter for which the prospective client sought the lawyer's advice. Nothing in any of these cases suggests a broader application of the duty.

When lawyers act as more than lawyers *qua* lawyers, however, they assume broader duties and expose themselves to concomitant liabilities. Federal securities law provides ample examples, and Judge Friendly's opinion in *SEC v. Frank* is a case in point. The question in *Frank* was whether a lawyer was liable for securities fraud resulting from alleged misrepresentations in an offering circular he had prepared. The court remanded the case for an evidentiary hearing into facts concerning the lawyer's role in the offering, "*including the extent,* as the SEC claimed with respect to Frank, *to which his role went beyond a lawyer's normal one.*" [Emphasis added.] 388 F.2d at 489. In the same vein, the court in *Felts v. National Account Sys. Ass'n, Inc.,* 469 F. Supp. 54, 68 (N.D. Miss. 1978), found that a lawyer who obtained a securities registration exemption based blindly on information provided by his client owed a "special duty of diligent investigation and disclosure" because of the lawyer's pervasive involvement in the client's business.

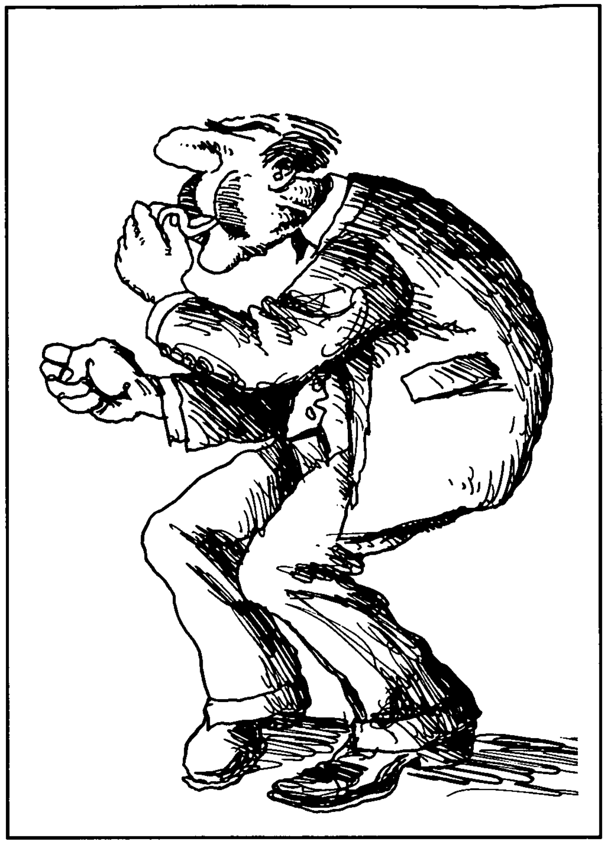
The ABA Ethics Committee has examined just how far this "special duty to investigate" can extend when a lawyer is rendering an opinion on whether certain sales of securities are exempt from registration. ABA Comm. on Ethics and Prof. Resp., Formal Op. 335 (1974). The committee concluded the lawyer should question the client about the relevant facts and probe more deeply if any of the facts "are incomplete in a material respect; or are suspect; or are inconsistent; or either on their face or on the basis of other known facts are open to question." But the committee opined that though a lawyer "should not accept as true that which he does not reasonably believe to be true, he does not have the responsibility to 'audit' the affairs of his client or to assume, without reasonable cause, that a client's statement of the facts cannot be relied upon."

Don't Question Everything

Thus, although circumstances may exist that impose on lawyers a heightened obligation to investigate apparent wrongdoing, lawyers need not question everything, or even most things, their clients tell them. Rather, as the court in *Escott v. Barchris Constr. Corp.,* 283 F. Supp. 643, 690 (S.D.N.Y. 1968), emphasized, "It is all a matter of degree. To require an audit would obviously be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable. Even honest clients can make mistakes."

In addition to the ethical barriers discussed in this article, a key to defeating any claim that lawyers should be blowing the whistle on their clients is proof of lack of duty. The first step in marshaling this defense must be a careful examination of the scope of representation in each case; that will define the scope of the duty owed. The cornerstone of this defense, not surprisingly, is one of the Model Rules.

Rule 1.2(a) provides: "A lawyer shall abide by a client's decisions concerning the objectives of representation, . . . and shall consult with the client as to the means by which they are to be pursued." The commentary to this provision notes that "[t]he objectives or scope of services provided by a lawyer may be limited by agreement with the client or by the terms under which the lawyer's services are made available to the client." In addition, Rule 1.2(c) states that "[a] lawyer may limit the objectives of the representation if the client consents after consultation."



Even government regulators recognize a distinction between the duties owed by general corporate counsel and by counsel retained for a particular, discrete purpose. Paul Grace, former associate general counsel and director of FSLIC litigation, has observed:

> Attorneys who are retained for a limited purpose, rather than as general counsel, usually will not be expected to protect the institution's legal interests in other matters. If a lawyer or a firm is acting as general counsel to an association, however, the FDIC and FSLIC expect that the lawyer or firm will oversee the institution's operations to the extent necessary to ensure compliance with relevant statutes and regulations.

John K. Villa & Thomas J. Murphy, "Emerging Theories of Liability for Lending Counsel, in Litigating for and Against the FDIC and RTC," 257, 309–10 (1990). Thus, in countering claims like those alleged by the FDIC, the OTS, and the RTC, it is critical to establish early the terms and scope of representation to which lawyer and client agreed and then to pursue aggressively motions to eliminate claims that fall outside the agreed representation. In the process, it is important to examine the law firm's billing statements and the

(please turn to page 65)

never get to use what I learned." Not a NITA program ends without a lawyer in the program saying to me, "This is great. Where can I go to actually use this stuff?" I then go into my public sector speech.

A final thought. In our profession we are in the midst of evaluating proposals for changes in civil practice rules to make litigation more efficient and cost-effective and to curb discovery and litigation abuse. I believe that a substantial part of discovery abuse results from the profession's breeding that new species, the litigator. Litigators know only what they *can* discover. Real trial lawyers know what they *need* to discover. The last time I looked, you could drive a truck through the difference.

So can trial lawyers be taught? No, if what we mean is producing the Clarence Darrows and Edward Bennett Williamses of the trial bar. At that level, trial lawyering is an art, not a science. Yes, if what we mean is trial lawyers who know the rules of procedure, the rules of evidence, and the psychology of persuasion and can put them all together to represent clients competently at trial.

We need not worry about the trial artists. They will always reveal themselves along the way. We must worry more about the others.

Where Were They

(continued from page 35)

lawyers' time records to ensure that they reflect the same scope of representation as the retainer or other agreement. Also consider the firm's promotional materials describing work done for institutional clients; they may provide the government with significant ammunition to fire at the firm.

Ironically, the legislative history of FIRREA itself may provide fertile ground for the defense of savings and loan lawyers. During deliberations on FIRREA, the House Banking, Finance and Urban Affairs Committee made it clear that if lawyers give advice that is in an unclear area of law and is in good faith, they should not be liable if that advice later results in a violation of law. The committee added:

> That such advice or services may conflict with the position of the federal banking agency and that a court may determine that position to be wrong would not usually or necessarily show bad faith.

H.R. Rep. No. 54(I), 101st Cong., First Sess. 307, *reprinted in* 1989 U.S. Code Cong. & Admin. News 86, 467. This "good faith" exception applies only to lawyers and compels the conclusion that, even under FIRREA, communications and advice regarding legal matters may deserve greater protection than, for example, communications with accountants relating primarily to tax or business issues. When the RTC places any legal advice or lawyer-client communication in issue, do not overlook good faith as a possible defense.

To the extent possible, also establish that the lawyer or law firm has no ties to the entity under investigation except the lawyer-client relationship. Case law demonstrates that the most significant ties to avoid are membership on the board of directors of the corporate or institutional client and significant investment in the corporation or institution. *FSLIC v. Mmahat,* 97 B.R. 293 (E.D. La. 1988), *aff'd,* 907 F.2d 546 (5th Cir. 1990), *cert. denied,* 111 S. Ct. 1387 (1991). The Kaye, Scholer experience has taught us that lawyers for clients responding to regulatory inquiries also should not interpose themselves between their clients and government regulators. In the OTS's view, Kaye, Scholer essentially stepped into Lincoln's shoes by instructing thrift examiners to address their inquiries to the firm and not the bank. Lawyers may be able to avoid the liability trap by making it clear that they are conveying, not adopting, the clients' information.

It also will be difficult for a law firm to avoid liability when its personal interests run counter to the interests of the institution it represents. In *Mmahat,* for example, the lawyer's negligent advice—that the client make numerous substantial loans in violation of LTOB regulations—itself generated large fees for the firm in connection with the documentation and closing of loans. An equally destructive conflict of interest can arise from a lawyer's dual representation of a lender and a borrower, particularly if the lawyer is compensated only if the loan closes.

Early on, consider potential expert testimony. For example, as a qualified expert, an experienced lending lawyer could substantiate that counsel retained to document loans *have a duty* to prepare documents that accurately reflect the terms of the loan approved and permit the lender to enforce the loan, *but do not have a duty* to discover secret side deals between senior officers and borrowers or collect, review, and analyze appraisals, financial statements, loan applications, and other underwriting documents.

Understanding Liability

An expert on professional responsibility and ethical issues can promote an understanding of the necessary limitations on lawyers' liability for acts in connection with their representation of clients. Some of the principal areas for such testimony include (1) the nature and formation of the lawyer-client relationship; (2) the client's identity and its meaning; (3) the criteria for determining a lawyer's ethical duties in institutional representation; and (4) the rules of professional responsibility, their development, and their application. The professional responsibility expert also can review the factual record of the defendant lawyer's conduct and provide opinion testimony concerning (1) the ethical obligations the lawyer had both generally and under the particular circumstances of the representation and (2) whether the lawyer behaved ethically.

As the saying goes, the best defense is a good offense. Thoroughly review current institutional representation to assess potential liabilities. Examine and reexamine. Assiduously ferret out patterns of unusual or suspicious behavior, such as multiple loans made by one officer who has a connection with a particular lawyer. Examine the firm's ownership of financial interests in any institution it represents, as well as board and committee seats that may influence the work flow from the institution to the firm. Substantiate in detail the scope of the firm's representation of institutional clients, in retention letters or elsewhere. Document lawyers' actual knowledge of an institution's regulatory and/or financial problems, if any.

These steps may not prevent a summons from being served, but they will go a long way toward minimizing the toll on the client and the firm.