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CLIENT FRAUD AND THE SECURITIES LAWYER'S DUTY OF CONFIDENTIALITY

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I. INTRODUCTION

Under the current Model Rules of Professional Conduct and state codes of professional responsibility, there exists a conflict between the lawyers' duty of confidentiality to their clients and the lawyers' duty to disclose an ongoing fraud or other crime. That conflict raises a number of critical ethical issues for the securities practitioner as well as the bar in general. Under what circumstances does a lawyer have the obligation, or at least the discretion, to disregard the attorney-client privilege and the duty of confidentiality owed to a client when the lawyer knows that the client is engaged in the commission of a fraud? May the lawyer continue the engagement on behalf of the client or must he or she resign? If the lawyer resigns, must he or she remain silent and observe the continuing commission of a crime, or does the lawyer have a duty, or at least the right, to warn the intended victim and to assist in preventing or rectifying the injury?

These questions have been hotly debated within the legal profession in general and within the securities bar in particular for a number of years. They have been raised in enforcement actions instituted by the Securities and Exchange Commission (SEC),[1] as well as in private actions under the federal securities laws.[2] They are now being raised again in no uncertain terms by the Office of Thrift Supervision which has arisen from the ashes of the savings and loan debacle with the mission of recouping as much of

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1. *See* SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978); Marc I. Steinberg, *Attorney Liability for Client Fraud*, 1 COLUM. BUS. L. REV. 1, 1 (1991).

2. Wachovia Bank & Trust Co. v. National Student Mktg. Corp., 650 F.2d 342 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981).

the losses from failed institutions as possible.[3] This agency has sought to fulfill its mission by making claims against the legal and accounting firms that served the insolvent institutions—claims that often are predicated on novel concepts of a lawyer's duty.[4]

II. ABA Model Rule 1.6 and Financial Frauds

Lawyers frequently find themselves struggling with the conflict between their duty to keep client confidences and their duty to avoid participation in a fraud. For the securities lawyer that conflict may become particularly severe when the lawyer learns that the disclosures disseminated by a publicly held client are materially false and misleading. For example, suppose that in a merger of a publicly held company the lawyers for the company that is being acquired learn prior to closing that the shareholders have approved the merger on the basis of financial statements showing substantial earnings when in fact the company had substantial losses. Under what circumstances can the firm continue to represent the client in connection with the merger? Does the firm have any obligation to disclose the facts to the acquiring company and its shareholders who approved the merger on the basis of materially false and misleading financial statements?

A threshold issue may well be what law of professional responsibility applies. This question, like all choice-of-law issues, may be complicated by the complexity of many modern legal transactions. The deal may have been negotiated in West Virginia with the closing scheduled to take place in Virginia. The parties may be incorporated under the laws of Maryland and Delaware and have their principal places of business in New York and New Jersey. The law firm may be a District of Columbia firm with offices in five jurisdictions, and the individual lawyers may be members of the bar in various jurisdictions.

Under these circumstances, the quickest way to get a handle on the issue might well be with the ABA Model Rules of Professional Conduct (Model Rules). These rules have been adopted in some form or another by 38 jurisdictions, albeit with substantial variations among them.[5]

Rule 1.6 of the Model Rules governs the confidentiality of client information.[6] The rule states that a lawyer shall not reveal information relating to the representation of a client without the client's authorization, except when a lawyer reasonably believes that it is necessary to prevent a client from committing a criminal action likely to result in death or substantial bodily harm, or to establish a claim or defense in a suit involving the lawyer which arises out of the representation.[7] Although the comment

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3. *See generally* Harris Weinstein, Remarks at the Administrative Conference of the United States' Colloquy on Ethical Obligations of Attorneys Representing Depository Institutions (Mar. 21, 1991).

4. *Id.*

5. Laws. Man. on Prof. Conduct (ABA/BNA) § 1 at 3-4 (Dec. 19, 1990).

6. Model Rules of Professional Conduct Rule 1.6 (1990).

7. *Id.*

to Rule 1.6 indicates that the lawyer must withdraw from the representation if his or her services will be used to materially further the fraud,[8] Rule 1.6 clearly states that no disclosure is authorized.

III. One View Expressed by the Case Law: No Duty to Disclose

An issue which Model Rule 1.6 does not answer is the question of whether the law firm would be liable under the antifraud provisions of the federal securities laws if it were simply to terminate representation, knowing that the client will consummate the transaction anyhow and perpetrate a fraud on the client. One answer to that question has been furnished by the recent decision of the Fourth Circuit in *Schatz v. Rosenberg*.[9] *Schatz* involved a law firm which was a defendant in a private action under Rule 10b-5 of the Securities Exchange Act of 1934 as well as other statutes.[10] The action was brought by the seller of a company who claimed that the buyer's financial statements on which he relied were fraudulent and that the lawyers who prepared the documentation and attended the closing knew of the fraud but failed to disclose it to him, the intended victim.[11]

The District Court granted the buyer's motion to dismiss on the ground that because the complaint did not allege that the defendant law firm made affirmative misstatements, the law firm owed no duty of disclosure except to its client.[12] Therefore, the court held that the law firm could not be liable for a fraud against the seller, even though it continued to represent the buyer with knowledge of the fraud. The Fourth Circuit affirmed, holding that even if the law firm's conduct violated an ethical rule of the Maryland state bar, such a violation did not create a legal duty of disclosure.[13]

According to the Court of Appeals, the law firm simply "papered the deal" and acted as a mere "scrivener" in putting into writing the terms to which the parties agreed in preparing the closing documents.[14] When there is no duty running from the alleged aider and abettor to the plaintiff, the Court of Appeals held that in order to incur liability for aiding and abetting a violation of the securities laws, the defendant must possess a "high conscious intent" and a "conscious and specific motivation to aid the

8. "If the lawyer's services will be used by the client in materially furthering a course of criminal or fraudulent conduct, the lawyer must withdraw. . . ." Model Rules of Professional Conduct Rule 1.6 cmt. (1990). The comment further states: "After withdrawal the lawyer is required to refrain from making disclosure of the clients' confidences, except as otherwise provided in Rule 1.6." *Id.*

9. 943 F.2d 485 (4th Cir. 1991), *cert. denied*, 112 S. Ct. 1475 (1992).

10. Defendants were also charged with aiding and abetting liability under the securities laws and with common-law misrepresentation. Schatz v. Rosenberg, 943 F.2d 485, 488 (4th Cir. 1991), *cert. denied*, 112 S. Ct. 1475 (1992).

11. *Id.* at 489.

12. *Id.*

13. *Id.* at 492 (stating that "[a]n ethical duty of disclosure does not create a corresponding legal duty under the federal securities laws").

14. *Id.* at 495.

fraud."[15] Therefore, despite the lawyers' actual knowledge of the fraud, they could remain silent and participate in the closing of the transaction without liability under either the federal securities laws or Maryland State law.

The Fourth Circuit's characterization of the securities lawyer in a merger transaction as a mere scrivener is generally not shared by other courts. Most courts recognize that in complex financial frauds, the lawyer, however innocent he or she may be, is an essential actor in the scheme. Thus, lawyers have often been referred to as possessing the "passkey" to the securities markets and their legal opinion as the "red or green light to consummation of the transaction."[16] As Judge Friendly stated in a Second Circuit opinion: "In our complex society . . . the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar."[17]

Nevertheless, although the facts as alleged in *Schatz v. Rosenberg* are rather extreme, the Fourth Circuit's decision exonerating the lawyer is not entirely unique. A number of courts have exhibited great deference to the duty of confidentiality by holding that lawyers have no duty to disclose their clients' frauds or crimes committed in connection with the representation.[18] Thus, one could conclude from these decisions that the law is clear: a lawyer has no right to disclose client fraud or crime unless it involves serious bodily injury, and lawyers are not liable for fraud under the federal securities laws, or otherwise, if they fail to disclose their knowledge of a client's fraud.

IV. Another View: The "Quit and Rat" Doctrine

There is, however, another approach that imposes a duty of disclosure which has been colorfully labeled as the "Quit and Rat Doctrine." This doctrine was first articulated by the SEC in an enforcement action filed against a company in *SEC v. National Student Marketing*.[19] Other defendants included the law firm that represented Student Marketing in connection with the merger transaction.[20] The SEC alleged that Student Marketing, a stock market high flyer of the 1970s, committed a fraud in consummating a merger with another company on the basis of materially inaccurate financial statements.[21] According to the SEC, the law firm partner in charge

15. *Id.* at 496; *see also* Marc I. Steinberg, *Attorney Liability Under the Securities Laws*, 45 Sw. L.J. 711, 728 (1991).

16. Steinberg, *supra* note 1, at 1.

17. *Id.* (citing United States v. Benjamin, 328 F.2d 854, 863 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964)).

18. *See* Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496-97 (7th Cir. 1986) (holding that absent fiduciary relationship with third party, law firm had no duty to disclose its client's financial stability).

19. 457 F. Supp. 682 (D.D.C. 1978).

20. SEC v. National Student Mktg. Corp., 457 F. Supp. 682, 686 (D.D.C. 1978).

21. *Id.* at 687.

of the transaction for the acquiring company, as well as the lawyers for the company being acquired, were advised prior to the closing of a clearly material change in the financial statements.[22] The SEC contended that this change required that shareholder approval of the transaction be resolicited.[23] Notwithstanding this knowledge, the SEC maintained, the lawyers proceeded with the transaction and in so doing, committed a fraud on the shareholders of the acquired company.[24]

According to the SEC's complaint, the lawyers had a duty to advise their clients not to proceed with the closing and, failing to persuade them, to resign from the representation and advise the SEC so that the public investors could be protected[25]—in other words, to quit and rat. However, the Quit and Rat Doctrine was never tested in *National Student Marketing.* Prior to trial, the law firm consented to an injunction without admitting or denying the violation, and the court never had an opportunity to rule upon the firm's obligations.[26]

Since *National Student Marketing*, the SEC has not taken the position that a lawyer who knows the client is committing a fraud affecting public investors must disclose the fraud to the SEC. Most recently, however, the Chief Counsel of the Office of Thrift Supervision has suggested that lawyers for federally insured thrift institutions may have a duty to disclose to the insuring agency an impending violation of law which endangers the solvency of such an insured institution. The Chief Counsel also suggests that if these lawyers fail to do so, they may be responsible for any losses in the event that the institution becomes insolvent.[27]

V. The Need for Changes To Professional Responsibility Rules

Notwithstanding the black letter finality of ABA Model Rule 1.6 and its support by court decisions such as *Schatz v. Rosenberg*, there is continuing debate within the legal profession over the disclosure duty of lawyers when confronted with a client fraud involving the use of a lawyer's services. This debate is particularly acute among members of the securities bar. Many members of the Bar believe that the obligation of silence imposed by Model Rule 1.6 undermines public confidence in the integrity of the legal profession. They argue that the public simply has difficulty understanding how, in the name of legal ethics, a lawyer can remain silent, knowing that his or her services are being used to harm innocent third parties.

Indeed, of the 38 jurisdictions that have adopted the Model Rules, 29 have modified Rule 1.6 to permit disclosure of client confidences in a

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22. *Id.* at 691-92.
23. *Id.* at 700.
24. *Id.* at 712.
25. *Id.* at 700-01.
26. *Id.* at 687 n.2.
27. *See* Weinstein, *supra* note 3 (stating that lawyer should first "press the matter to the institution's highest internal authority").

broader set of circumstances than permitted by the Model Rule.[28] For example, the Virginia Code of Professional Responsibility permits a lawyer to disregard the duty of confidentiality if it is "clearly established that the client is using the lawyer to perpetuate a fraud or other crime."[29] Moreover, in August, 1991, the Business Law Section of the ABA, in cooperation with other ABA components, attempted to amend Rule 1.6 to permit disclosure of client fraud where the lawyer's services have been used to perpetuate the fraud and the lawyer believes it is necessary to rectify the consequences of the fraud.[30]

The proposed amendment was limited in scope. It gave a lawyer the discretion, but not the obligation to disclose, and then only if the lawyer's services were used in the fraud.[31] Its proponents argued vigorously that the proposed amendment was necessary to protect both the legal profession and the public.[32] They recognized the importance of encouraging free communications between lawyers and their clients by assuring clients that their confidences will be preserved.[33] They pointed out, however, that under the proposed amendment, disclosure would be permitted only when the client has misused the lawyer's services by not telling him everything, thereby involving the innocent lawyer in a crime. To protect confidentiality under these circumstances, the proponents urged, would not encourage clients to tell the lawyer everything, but instead would have the opposite effect of rewarding misleading statements.[34]

The proponents also pointed out that the present rule has a double standard. It permits the lawyer to disclose client confidences when the lawyer is suing for a fee or when he or she is being sued for alleged misconduct in connection with the representation.[35] It therefore permits disclosure of client confidences to prevent harm to the lawyer, but prohibits disclosure to prevent harm to third parties arising from the use of the

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28. Among those states whose confidentiality provisions differ substantially from the Model Rules are: New Jersey, Arizona, Minnesota, Washington, North Carolina, Arkansas, New Hampshire, Nevada, Connecticut, New Mexico, Florida, Idaho, Indiana, Wyoming, Mississippi, Wisconsin, North Dakota, Utah, Pennsylvania, South Dakota, Kansas, Oklahoma, Michigan, West Virginia, Texas, and South Carolina. LAWS. MAN. ON PROF. CONDUCT, *supra* note 5, at 11-41.

29. VIRGINIA CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101(c)(1) (1992). The Virginia Code of Professional Responsibility also states that "A lawyer may reveal . . . [i]nformation which clearly establishes that his client has, in the course of the representation, perpetrated upon a third party a fraud related to the subject matter of the representation." *Id.*

30. Letter from American Bar Association, Section of Business Law, Section Delegates, to the Council and Officers of the Section of Business Law (July 25, 1991), *reprinted in* Officers' Meeting Agenda Book, Annual Meeting, American Bar Association, Section of Business Law, Atlanta, Ga. (Aug. 1-14, 1991).

31. Annual Meeting, American Bar Association, Section of Business Law, Atlanta, Ga. (Aug. 1-14, 1991).

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

lawyer's services. The inability to prevent or quickly rectify the harm from client abuse of the lawyer's services both undermines confidence in the integrity of the legal profession and unnecessarily exposes lawyers to civil and criminal litigation on alleged complicity in the client's fraud.

Despite the strength of these arguments, the proposed amendment was rejected in the House of Delegates.[36] The opponents of the amendment refused to distinguish between street crimes and financial frauds. The perpetuation of street crimes does not require the services of lawyers. In contrast, the use of a lawyer's services to perpetuate a financial fraud is often essential. In such situations, the lawyer is not a "mere scrivener," but brings to the transaction essential expertise in intricate matters of corporate, securities and commercial law, as well as a professional reputation often relied upon by the parties. For these reasons, there is a need to distinguish between the ethical responsibility of the lawyers in dealing with street crimes and financial frauds.

Indeed, securities and other business lawyers may well need a special code of ethics that is tailored to their role in the consummation of financial transactions. That need was recently recognized by Judge Stanley Sporkin, the former chief enforcement officer of the SEC and now a federal district judge in Washington, D.C. Judge Sporkin argues that securities lawyers have a responsibility to prevent fraud and other crimes that goes beyond their duty to clients, and that they should be governed by a set of ethical principles that recognizes their dual responsibility to both their clients and to the public.[37] Judge Sporkin's suggestion is beginning to receive very serious discussion, both by the Securities Law Committee of the Federal Bar Association and by the Section of Business Law of the ABA.[38]

There is a broad consensus among securities and other business lawyers for an ethical rule that permits a lawyer whose services have been used in the commission of a fraud or crime to disclose client confidences to the extent necessary to prevent or rectify the consequences of the misconduct. Indeed, notwithstanding the existing provisions of Model Rule 1.6, many lawyers will not tolerate a client who uses their legal services to inflict illegal harm on third parties and will take whatever action necessary to prevent or rectify the harm. It is their position that the lawyer's obligation of confidentiality should not be used to require silence in the face of such abuse of the lawyer's services. If the client objects, he or she may use another law firm or press disciplinary charges from his jail cell.

The more difficult question is whether disclosure to victims of a client fraud or crime should be an obligation or simply a right of the lawyer, and whether the lawyer who violates that obligation should be liable as an aider

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36. *Id.*

37. *See* Harris Weinstein, Remarks before Southern Methodist University (September 13, 1990); Steinberg, *supra* note 1, at 26.

38. *See* Annual Meeting, American Bar Association, *supra* notes 31-36 and accompanying text.

or abettor under the securities laws and other applicable statutes. There is no doubt that any attempt to impose such liability on the legal profession would be met with great opposition from most segments of the Bar.

The concern of the Bar over the creation of such an obligation with intended liability for breach of the obligation is two-fold. First, even under the present state of the law, lawyers increasingly are being sued for complicity in a client's fraud or criminal conduct.[39] The charges usually are not based on actual knowledge, but rather on allegations that the lawyer should have known or was reckless in not knowing that its services were being used in a client fraud.[40] Prosecutors, judges and juries in such cases often make their judgments on the basis of 20-20 hindsight and frequently assess damages against the lawyer and other professionals simply because they represent the only deep pocket available from which to compensate the victims.

The second concern arises from the doctrine of joint and several liability. Under this doctrine, lawyers and other professionals who are not the primary participants in the fraud but who are charged with a violation of a duty of care and are clearly secondary offenders are nevertheless jointly liable with the primary wrongdoers for the full amount of the damage caused by the fraud.[41] The primary wrongdoers, however, are frequently in jail and, in any event, are judgment proof; the lawyers and other professionals are the deep pockets and frequently bear the full brunt of liability without regard to relative fault.

Unless liability were limited by concepts of comparative fault and based on actual knowledge of the fraud, the imposition of a legal obligation to disclose client fraud and other crimes to third parties would too often result in professional liability based on hindsight judgments of professional dereliction that were wholly disproportionate to the gravity of the conduct involved. For this reason, one can expect that the legal profession would strongly resist an ethical rule that imposed an obligation to disclose client fraud or other crimes if such obligation carried with it liability under the securities laws and other statutes.

The lack of consensus, however, on the issue of liability should not obscure the need for revision of Model Rule 1.6 and state codes of professional responsibility which inhibit the lawyer's right to take action to disclose client fraud involving the use of legal services. In such instances, the lawyer should be authorized to take appropriate action to prevent or rectify the harm to third parties. It is time to bring ethical rules into line with common sense, as well as with common standards of decency. It is neither common sense nor decent to require that the lawyer remain silent

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39. *See* Steinberg, *supra* note 15, at 728.

40. *Id.*

41. *See* SEC v. National Student Mktg. Corp., 457 F. Supp. 682, 700 (D.D.C. 1978) (stating that SEC typically makes little effort to distinguish between principals and aiders and abettors).

while a client abuses his or her services to commit a fraud or other crime upon innocent third parties.