Withering Leaves—Acting Ethically When You Fear Your Client Has Not

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I. Introduction

Most of us will never find ourselves in the situation where we learn information that leads us to conclude that our client is acting not only imprudently, but illegally. Should you find yourself in the unfortunate minority; the decisions made at the outset will have a significant impact on whether you lose your license to practice law, or potentially, your liberty.

In addition, as coverage attorneys, we face the additional dilemma regarding what to do when we learn that the policyholder is acting illegally. Not only may there be an impact on the duty to defend, but appointed defense counsel may be forced to make a "noisy withdrawal."

The purpose of this paper is to provide the coverage attorney with a starting point for making decisions that minimize the risk of ethical problems, as well as fulfill the attorney's ethical duties to the client insurer.

II. Illegal or Just Imprudent?

What is or is not criminal is beyond the scope of this paper. But it is important to note that in recent years, the federal government and various states have criminalized certain aspects of business behavior, or have chosen to apply statues of more general application to business behavior. Beyond the "honest services" statute, 18 U.S.C. §§371, 1346, discussed in the recent *Skilling v. United States* opinion, --- U.S. ---, 2010 WL 2518587 (2010) there have been prosecutions for wire fraud (18 U.S.C. §1343), mail fraud (18 U.S.C. §1341), securities fraud (18 U.S.C. §1348). In addition, the Sarbanes-Oxley Act, enacted in 2002 in the wake of the Enron and Worldcom incidents added additional criminal penalties. *See*, 18 U.S.C. §1519 (destruction or falsification of records); 18 U.S.C. §1513 (employment related retaliation against witness).

Thus, today, there is not only a risk of civil liability, but also a risk that the corporation, or some of its employees, may find themselves being prosecuted criminally. Outside lawyers are also at risk, as the case of Joseph Collins illustrates. Mr. Collins was a corporate partner at the Mayer Brown firm in Chicago. His principal client was Refco, a company that collapsed as a result of a fraud shortly after it went public. Mr. Collins was charged with numerous federal felonies and was eventually convicted at trial of multiple counts of conspiracy, wire fraud, mail fraud and securities fraud. He is currently serving a seven year sentence in federal prison while his conviction is being appealed. He and the Mayer Brown firm were also defendants in multiple civil actions.

III. Ethical Rules

A. The ABA Model Rules of Professional Conduct

Traditionally, an attorney owed a strict duty of confidentiality to the client, which could be breached only in the most egregious situations, such as where life and limb were at stake. That standard has been eroded in recent years, most significantly by the Sarbanes-Oxley Act (SOX).

Many states model their Rules of Professional Conduct on the ABA's Model Rules. Different states adhere to different versions of those Model Rules, often with local variations. A comprehensive summary of those state by state variations is beyond the scope of this paper, which will focus on the ABA Model Rules in

their current form. Attorneys need to be familiar with their state specific rules, however, because in some states the state rules are diametrically opposite the current ABA Model Rules on when and what an attorney may disclose to non-clients. *See e.g.*, Cal. Bus. & Prof. Code §6068, which imposes a more restrictive standard on disclosure.

The current ABA Model Rule 1.13 "Organization as a Client," a post Sarbanes-Oxley rule, is the single most important rule on this subject. It provides:

> (a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.
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> (b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.
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> (c) Except as provided in paragraph (d), if
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> > (1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and
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> > (2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.
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> (d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.
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> (e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.
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> (f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.
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> (g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

The most controversial provision in Rule 1.13 is subpart (c) that gives the lawyer permission to disclose facts outside the organization following an unsuccessful attempt to report and change the conduct internally. Note, however, that the institutional client is still intended to be the primary beneficiary of the rule. Disclosure is permitted only "to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization."

B. Sarbanes-Oxley Requirements

The Sarbanes-Oxley Act mandated disclosure by requiring that the Securities and Exchange Commission enact rules for attorneys who practice before it. 15 U.S.C. §7245 provides:

> Not later than 180 days after July 30, 2002, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule –
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> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
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> (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

The SEC's rule appears at 17 C.F.R. Part 205.

Now, you may say, "that rule applies only to attorneys practicing before the SEC." But, the SEC's rule defines "appearing" broadly:

> For purposes of this part, the following definitions apply:
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> (a) Appearing and practicing before the Commission:
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> (1) Means:
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> (i) Transacting any business with the Commission, including communications in any form;
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> (ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;
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> (iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or
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> (iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but
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> (2) Does not include an attorney who:

(i) Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii) Is a non-appearing foreign attorney.

17 C.F.R. §205.2.

Subsection (a)(1)(iii) should be of greatest interest to the attorney retained by the insurance industry to provide coverage or defense representation. Is the provision of information to a client's auditors, in the context of an annual audit letter inquiry within the scope of this section? The SEC's original version of this regulation drew criticism because it could be interpreted to include lawyers who simply respond to auditors inquires. The SEC's response was to narrow the definition, but only to a limited degree. It still applies to lawyers"

> [R]egarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document.

Attorney audit letter responses are not filed with the SEC in ordinary circumstances, but the information they provide is incorporated into SEC filings, if only by omission. So, the defense or coverage attorney may, in some circumstances, be deemed to be practicing before the SEC.

The next issue is how far must the attorney go? The standard in Sarbanes-Oxley is whether the person to whom the attorney reports the suspected wrongdoing "appropriately respond[s]." The SEC regulations contain the following definition:

(b) Appropriate response means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

(3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to Sec. 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative.

The problem it presents lies in its inherent ambiguity. Much as the "you know it when you see it" standard has been applied at times to pornography, what is an "appropriate" response by the corporate in general counsel or officer, short of complete agreement with outside counsel, such that outside counsel is relieved

of any obligation to report the violation or breach of fiduciary duty? What the SEC said in releasing the final rule was:

> The definition of "appropriate response" emphasizes that an attorney's evaluation of, and the appropriateness of an issuer's response to, evidence of material violations will be measured against a reasonableness standard. The Commission's intent is to permit attorneys to exercise their judgment as to whether a response to a report is appropriate, so long as their determination of what is an "appropriate response" is reasonable.

SEC Release 33-8185 (9/26/2003)

The SEC went on to explain:

> The standard set forth in the final version of Section 205.2(b) requires the attorney to "reasonably believe" either that there is no material violation or that the issuer has taken proper remedial steps. The term "reasonably believes" is defined in Section 205.2(m). In providing that the attorney's belief that a response was appropriate be reasonable, the Commission is allowing the attorney to take into account, and the Commission to weigh, all attendant circumstances. The circumstances a reporting attorney might weigh in assessing whether he or she could reasonably believe that an issuer's response was appropriate would include the amount and weight of the evidence of a material violation, the severity of the apparent material violation and the scope of the investigation into the report. While some commenters suggested that a reporting attorney should be able to rely completely on the assurance of an issuer's CLO that there was no material violation or that the issuer was undertaking an appropriate response, the Commission believes that this information, while certainly relevant to the determination whether an attorney could reasonably believe that a response was appropriate, cannot be dispositive of the issue. Otherwise, an issuer could simply have its CLO reply to the reporting attorney that "there is no material violation," without taking any steps to investigate and/or remedy material violations. Such a result would clearly be contrary to Congress' intent in enacting Section 307. On the other hand, it is anticipated that an attorney, in determining whether a response is appropriate, may rely on reasonable and appropriate factual representations and legal determinations of persons on whom a reasonable attorney would rely.

Id.

The definition of "reasonably believes" referred to is not particularly enlightening, given its circularity: "(m) Reasonably believes means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable." 17 C.F.R. §205.2(m).

Where does this leave the defense or coverage attorney? First, it is important to note that Sarbanes-Oxley only applies to breaches of securities laws, breaches of fiduciary duty by officers and directors and similar conduct. But, the scope of such conduct can be broad and the SEC has provided definitions:

> (d) Breach of fiduciary duty refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable Federal or State statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.
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> 17 C.F.R. §205.2(d).
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> (e) 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.

17 C.F.R. §205.2(e).

(i) Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.

17 C.F.R. §205.2(i).

Note that the definition of "material violation" is not limited to securities laws, but it also applies to any material breach of fiduciary duty under federal or state law or any similar material violation of federal or state law. Once again, the definition is circular.

There is an important exception, however. If the lawyer has been hired to investigate and counsel whether there is a material violation, the attorney is subject to different and less stringent rules. 17 C.F.R. 205.3(b)(6).

Where does this leave the coverage or appointed defense lawyer? If the client is a publicly traded company, and the information learned relates to a securities filing or something that will be in a securities filing, then the SEC's regulations may apply.

C. The Noisy Withdrawal Concept

One of the hallmarks of Sarbanes-Oxley is the concept of "noisy withdrawal." The ABA's Model Rules accommodate this by permitting the now former attorney to reveal confidential information "if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization." After initially proposing a "noisy withdrawal" requirement in its proposed regulations, the SEC backed down in the face of protests and omitted those requirements from 17 C.F.R. part 205. The SEC did, however, give the attorney the option of providing the SEC with confidential information:

(d) *Issuer confidences*. (1) Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.

(2) An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

The SEC has taken the position that its regulations preempt state ethics rules and statutes that impose less stringent standards on attorneys. SEC Release 33-8185 (9/26/2003)

D. Practical Strategies for Avoiding Misconduct or Discipline

Beyond the obvious, "Don't lie, cheat or steal," an attorney representing a business client today needs to understand what the government considers to be criminal conduct on the part of the business client. While activities that do not rise to the level of criminal conduct may still be fraught with peril for the attorney representing the business enterprise and can result in substantial civil liability, it is criminal conduct which presents the greatest peril. As noted at the outset, the parameters of white collar criminal law are well beyond the scope of this paper. But, some practical strategies for avoiding misconduct are not.

1. If It Sounds Slimy, It Probably Is

Does your client plan on lying to its customers, its competitors or the government? Of almost equal importance, is your client remaining silent in the face of a common law or statutory duty to speak? Particularly in the worlds of consumer product safety and environmental hazards, affirmative duties to speak and disclose information have been imposed on businesses. One example is 15 U.S.C. §2064(b) part of the Consumer Product Safety Act, which imposes affirmative reporting obligations to report certain defects and failures to comply with consumer product safety rules.

Thus, the first step for the attorney is to know not only what prohibitions exist, but what affirmative duties the client has in the particular circumstance. The attorney needs to know and to be able to counsel the client regarding its legal obligations.

2. Do Your Homework if You Are Going over Your Client Contact's Head

It may be self-evident, but if you feel that you are obligated to report potential wrongdoing and you have made no headway reporting it to your direct report at the client, before you go over that person's head, make sure you are correct. Research the issue. Have someone else look at it. Consider any factors that may justify the conduct. How severe is the problem? What will happen to the client organization if there is no change in conduct? Is the client just being stupid from your perspective, or is there an actual continuing statutory or regulatory violation? In short, do not go up the ladder until you are convinced that you are legally and ethically obligated to do so.

3. It Is Not about You

When reporting wrongdoing up the ladder, stick to the facts. Do not attempt to justify or explain your own conduct. Your credibility is diminished if you are perceived as disgruntled, glory seeking, officious, or otherwise more interested in yourself than your client.

4. Read the Ethical Rules in Your Jurisdiction, Again

Do not assume that ABA Rule 1.13 applies in your jurisdiction. The ABA does maintain a chart on its website which shows the state by state actions on ethics rules - http://www.abanet.org/cpr/pic/home.html. Whether or not the ABA version applies, re-read the applicable rule. For example, the core of ABA Rule 1.13 is in subsection (b):

> If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of

the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

Two main concepts are present in this rule: 1) the conduct is either a violation by an officer or employee of a legal obligation to the client organization or a violation that reasonably might be imputed to the organization; and 2) the conduct is likely to result in substantial injury to the client organization. Note also, that actual knowledge of the wrongdoing by the lawyer is required under the ABA Model Rule, while the SEC/Sarbanes-Oxley standard is a reasonable belief standard. Are those elements present?

Thus far, there are no published opinions discussing these aspects of ABA Model Rule 1.13. There are state by state ethics opinions or state comments on the proposed rules, some of which address these issues.

IV. Complications for Appointed Defense Counsel

Under the tripartite relationship, the policyholder is the defense attorney's client. In circumstances involving potential corporate wrongdoing, the appointed defense attorney may well learn information that implicates the "up the ladder" provisions of ABA Model Rule 1.13 or Sarbanes-Oxley. The defense attorney's duty of confidentiality, however, precludes the defense attorney from reporting this information to the client insurer without the policyholder's consent, preferably in writing.

Where the information is material to the defense and the liability insurer's evaluation of the claim, if consent to disclose it is not given, defense counsel may have no alternative but to withdraw, again not revealing to the insurer the particular information which has triggered the withdrawal.

V. Concluding Remarks

"The Truth shall set you free! Unless you killed somebody. In which case, tell the cops they were breathing when you left the room." *The Colbert Report*, April 24, 2008.

That is not good advice. If you discover corporate malfeasance, you owe it to your client, the organization, to report it to someone in a position to address and remedy that conduct. But, before you act precipitously and in a fashion that could destroy your relationship with the client, make sure that you are correct. Then, analyze the consequences to the client if the conduct continues, or if remedial action is not taken. If doing nothing is likely to result in serious harm to the client, your obligation is to report, in a non-defensive, factual manner, to the person or persons inside the organization who have the ability to address and remedy the conduct.