AMERICAN BANKRUPTCY INSTITUTE

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Ethics: Fraudulent Transfers, Pre-Bankruptcy Planning Workshop

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PLENARY SESSION

2017

Ethics: Fraudulent Transfers, Pre-Bankruptcy Planning Workshop

Avoiding being sued along with or in lieu of your client
Avoiding ethical violations and malpractice

I. Liability for alleged "in-concert" claims

A. Attorney Liability for "Aiding and Abetting" a Client's Transaction

1. Many jurisdictions have recognized liability for aiding and abetting tortious activity, including fraud, fraudulent transfers and breaches of fiduciary duty. This has been applied to professionals, including bankers and attorneys.

2. Aiding and abetting should be contrasted from conspiracy claims. The primary difference is that conspiracy involves an agreement to participate in wrongful activity, while aiding and abetting focuses on whether a party gave substantial assistance to someone who engaged in wrongful conduct, not on whether a party agreed to join in the wrongful conduct. *See Aetna Cas. & Sur. Co. v. Leahey Const. Co.*, 219 F.3d 519, 534 (6th Cir. 2000).

3. Additionally, aiding and abetting is not typically a standalone cause of action. Rather, it is a theory used to hold a party liable for the tort of another. It is similar to piercing the corporate veil, which is a theory used to hold one person or entity liable for the conduct or debts of another, nominally distinct entity. But there is no standalone claim for "piercing the corporate veil."

4. Like civil conspiracy (discussed below), aiding and abetting requires the commission of an underlying tort – such as fraud or breach of fiduciary duty.

5. For instance, under the theory/cause of action aiding and abetting, if a trustee breached his/her fiduciary duties to the beneficiaries, a beneficiary could bring a claim against that trustee attorney as if the attorney had committed the breach him/herself for having advised the trustee or documented a transaction (e.g. taking a personal loan from the trust).

6. Generally, to hold someone liable as an aider and abettor, a plaintiff must show the person knowingly and substantially assisted in the wrongful conduct of another. **Knowledge is key.**

7. Slight differences do exist across the jurisdictions in which the cause of action of aider/abettor liability is recognized.

Illinois

- In Illinois, to state a claim for aiding and abetting, one must allege that (1) the party whom the defendant aids performed a wrongful act causing an injury, (2) the defendant was aware of his role when he provided the assistance, and (3) the defendant knowingly and substantially assisted the violation. *Hefferman v. Bass*, 467 F.3d 596, 601 (7th Cir. 2006)

- In *Bass*, the 7th Circuit, applying Illinois law, reversed the dismissal of an aiding and abetting claim against an attorney who allegedly participated in fraudulently misrepresenting the terms of a release to another party.

- Also, in *Thornwood, Inc. v. Jenner & Block*, the Illinois Appellate Court reversed the dismissal of a claim against an attorney for aiding and abetting a breach of fiduciary duty. That case concerned a partnership formed to develop a golf course and the partners unsuccessfully attempted to get the PGA involved.

  When one partner expressed dissatisfaction in the partnership, the other partner hired Jenner & Block to help in buying out the other partner's interest in the partnership. Unbeknownst to the other partner, Jenner was continuing to negotiate with the PGA as it was assisting its client in buying out his partner. The partner then brought a claim for breach of fiduciary duty against Jenner for *not* informing him of the ongoing negotiations with the PGA under an aiding and abetting theory. The court allowed the claim to go forward.

  This Illinois case is heavily cited by courts in other states as supporting the existence of a cause of action for aiding and betting.

- In *Stoller*, the plaintiff brought a claim for aiding and abetting fraud and perjury against attorneys based on the filing of allegedly false affidavits in an underlying suit for defamation. The plaintiff alleged that the defendant-attorneys aided and abetted by preparing and filing affidavits with awareness of "their role as part of the overall tortious activity." The court cited the *Thornwood* case and Section 876(b) of the Restatement of Torts to supply the elements of aiding and abetting.

  Ultimately, the court affirmed dismissal of the claim because plaintiff failed to plead any specific facts to support the elements of the cause of action, and did not plead any cognizable harm as a result of the filing of the allegedly false affidavits. The case was not dismissed because such a cause of action was not viable. *See* Stoller v. Johnson, 2017 IL App (1st) 161613-U, ¶¶ 25-29.

Michigan

- In Michigan, although we found no state court case that definitively recognized the existence of civil aiding and abetting liability, several federal courts sitting in Michigan have applied the theory citing to Michigan law.

- In *El Camino Res., Ltd. v. Huntington Nat. Bank*, 2009 WL 427278, at *3 (W.D. Mich. Feb. 20, 2009), the court looked to the Restatement and stated the elements: (1) the existence of an underlying fraud; (2) knowledge of this fraud on the part of the aider and abettor, and; (3) substantial assistance by the aider and abettor in perpetration of the fraud. *Id.*

- Although it did not involve claims against attorneys, the *El Camino* court allowed a claim against a bank for aiding and abetting fraud where the bank acted as the main fraudster's principal financial institution and depository and loaned them the funds necessary to perpetrate the fraud.

- Michigan courts, like Illinois courts, have emphasized that a plaintiff must show *actual* knowledge of the underlying fraud/tortious conduct to hold a party liable for aiding and abetting.

- However, "[e]ven the supplying of routine services can constitute substantial assistance if done with knowledge that such services are assisting the primary actor's tortious conduct." *Ivie v. Diversified Lending Grp., Inc*., 2011 WL 996112, at *7 (W.D. Mich. Mar. 17, 2011). In *Ivie*, the court allowed an aiding and abetting claim against an insurance company to proceed on allegations that the insurance company continued to issue annuity contracts to the fraudster after the company was aware that the fraudster was misrepresenting the nature of the annuities as full reinsurance.

- In *Rivet v. State Farm,* 316 Fed. Appx. 440 (6th Cir. 2009) an attorney was held liable for aiding and abetting fraud-of his client who made material misrepresentations in resolving an insurance claim of which the lawyer had knowledge. The underlying tort was fraud and breach of fiduciary duty of the claims agent. The Court's reasoning was that an attorney "may not use fraud to obtain a verdict or look the other way when he knows a client has testified falsely. *See Nix v. Whiteside,* 475 U.S. 157, 166, 106 S.Ct. 988, 89 L.Ed.2d 123 (1986) ("[C]ounsel's duty of loyalty and his overarching duty to advocate the defendant's cause ... [are] limited to legitimate, lawful conduct compatible with the very nature of a trial as a search for truth. . . . .counsel is precluded from taking steps or in any way assisting the client in presenting false evidence or otherwise violating the law.")

Minnesota

- Like Illinois and Michigan, Minnesota does recognize civil aiding and abetting claims where: : (1) a primary tort-feasor committed a tort against plaintiff; (2) the defendant knew that the primary tort-feasor's conduct was a breach of duty; and (3) the defendant substantially assisted or encouraged the primary tort-feasor in committing the tort. *In re Senior Cottages of Am., LLC*, 482 F.3d 997, 1007 (8th Cir. 2007).

- In *Senior Cottages*, the court allowed an aiding and abetting claim to proceed against the tortfeasor's law firm for assisting in and advising a transaction that stripped a company of its assets without reasonably equivalent value.

Ohio and Indiana

- In contrast, Ohio and Indiana appear to not recognize civil aiding and abetting claims.

- In *DeVries Dairy, L .L.C. v. White Eagle Coop. Ass'n, Inc*., 974 N.E.2d 1194 (Ohio 2012), the Ohio Supreme Court answered a certified question from an Ohio federal court, and without issuing an opinion, declined to recognize civil aiding and abetting claims. Courts applying Ohio law have continued to rely on *DeVries* in dismissing such claims. *See Omega Riggers & Erectors, Inc. v. Koverman*, 65 N.E.3d 210, 232 (Ohio Ct. App. 2016).

- The state of the law is a little less clear in Indiana. In *Crystal Valley Sales, Inc. v. Anderson*, 22 N.E.3d 646, 656 (Ind. Ct. App. 2014), the court dismissed an aiding and abetting claim and reasoned "[w]e believe that the decision to adopt a new cause of action for aiding and abetting in the breach of fiduciary duty is a decision better left to the legislature or our supreme court."

- Although earlier cases decided by federal courts sitting in Indiana have implicitly recognized such claims, the trend is to reject aiding and abetting claims until the Indiana Supreme Court weighs in on the issue. *See Washington Frontier League Baseball, LLC v. Zimmerman,* 2015 WL 7300555, at *9 (S.D. Ind. Nov. 18, 2015) (rejecting aiding and abetting claim where no allegations that defendant had actual knowledge of tortious conduct "even if Indiana does recognize such a claim").

B. Attorney Liability for "Civil Conspiracy" for participating in a Client's Transaction

1. Four elements of civil conspiracy

a combination of two or more persons;

a real agreement or confederation with a common design;

the existence of an unlawful purpose, or of a lawful purpose to be achieved by unlawful means; and

Proof of special damages.

See *Morganroth & Morganroth v. Norris, McLaughlin & Marcus, P.C.*, 331 F.3d 406, 414 (3rd Cir. 2003). *Accord, March v. Statman,* 2016 Ohio App. LEXIS 1734 (May 6, 2016)*; Mich. AFSCME Council 25 v. Livingston County Road Comm'n,* 2007 Mich. App. LEXIS 2544 (November 13, 2007)*; Pye v. Estate of Fox*, 369 S.C. 555 (2006); *Banco Popular North America v. Gandi*, 184 N.J. 161 (2005); *Edelman v. Hinshaw & Culbertson*, 788 N.E.2d 740 (Ill. Ct. App. 2003); *Lane v. Sharp Packaging Systems, Inc.*, 635 N.W.2d 896 (Wisc. Ct. App. 2001); *Macke Laundry Service LP v. Jetz Service Co.*, 931 S.W.2d 166 (Mo. Ct. App. 1996); *Celano v. Frederick*, 203 N.E.2d 774 (Ill. Ct. App. 1964) (cases addressing civil conspiracy claims against attorneys, among other issues).

2. Civil conspiracy is not itself actionable. Rather, some wrongful act must be committed by one or more of the alleged conspirators in furtherance of the agreement.

   See e.g., Morganroth, 331 F.3d at 414-415 ("Mere agreement to do a wrongful act can never alone amount to a tort, whether or not it may be a crime."); *Banco Popular*, 184 N.J. at 177-178; *Macke Laundry Service*, 931 S.W.2d at 175. Without an underlying actionable wrongful act, there can be no actionable conspiracy claim. *See March v. Statman*, 2016 Ohio App. LEXIS 1734 at *12. Moreover, the plaintiff must allege that the wrongful act underlying the conspiracy resulted in damages caused by the defendants. *Mich. AFSCME Council 25 v. Livingston County Road Comm'n,* 2007 Mich. App. LEXIS 2544 at *17. *See, Pyle v. Estate of Fox*, 369 S.C. at 567 ("The 'essential consideration' in civil conspiracy 'is not whether lawful or unlawful acts or means are employed to further the conspiracy, but whether the primary purpose or object of the combination is to injure the plaintiff.'")(internal citation omitted).

3. The fact of the conspiracy bears on the liability of the various defendants/co-conspirators as joint tortfeasors. *Id*. Proof of conspiracy makes the conspirators jointly liable for the wrong and resulting damages. *Morganroth*, 331 F.3d at 414; *Banco Popular*, 184 N.J. at 179.

4. While a wrongful act in furtherance of the conspiracy is required, not every conspirator must commit an overt act. *Morganroth*, 331 F.3d. at 415; *Lane*, 635 N.W.2d at 902. Rather, "[I]t is enough [for liability] if you understand the general objectives of the scheme, accept them, and agree, either explicitly or implicitly, to do your part to further them." *Banco Popular*, 184 N.J. at 177, *quoting Jones v. City of Chicago*, 856 F.2d 985,992 (7th Cir. 1988). *Contra*, *Essex Crane Rental Corp. v. Carter*, 371 S.W.3d 366, 378 (Tex. Ct. App. 2012) ("to negate summary judgment on a conspiracy claim in a fraudulent transfer case, there must be some evidence of the movant's participation in a conspiracy to commit a fraudulent transfer.")

5. Moreover, the fact that a conspirator may not have personally benefitted from the conspiracy or the underlying wrongful act does not exonerate it from potential

liability. *Dalton v. Meister*, 239 N.W.2d 9, 18 (Wisc. 1976). The law "does not confer immunity to a conspirator because the conspirator did not receive a benefit from the wrongful act or because another conspirator may have played a more dominant or active role in the conspiracy." *Lane v. Sharp Packaging Systems*, 635 N.W.2d at 902.

6. Specific Issues In Civil Conspiracy Claims Against Attorneys:

a. As a *very* general rule, "a lawyer is authorized to practice his profession, to advise his clients, and to interpose any defense of supposed defense, without making himself liable for damages. *Likover v. Sunflower Terrace II, Ltd.*, 696 S.W.2d 468, 472 (Tex. Ct. App. 1985); *Essex Crane Rental v. Carter*, 371 S.W.3d at 378 (an attorney for an opposing party may not be held liable for breach of fiduciary duty or fraud (and, therefore, not liable for civil conspiracy) merely for making representations to the opposing party in litigation that furthers the interests of his or her own clients".) *See Blatt v. Green, Rose, Kahn & Piotrkowski*, 456 So.2d 949, 951 (Fla. Ct. App. 1984) ("Extreme caution should be exercised when an attempt is made to hold an attorney liable for a wrong committed by his client by way of a civil conspiracy cause of action.") In California, this caution is mandated by statute; a plaintiff must obtain a prior court order before filing an action against an attorney that includes a claim for civil conspiracy with a client arising from any attempt to contest or settle a claim while representing the client. *Cal. Civil Code* § 1714.10.

b. Some courts base their analyses on the fact that the attorney-client relationship is one of agency. *See e.g., Wiles v. Capital Indemnity Corp.*, 75 F. Supp. 2d 1003 (E.D. Mo. 1999); *Macke Laundry Service*, 931 S.W.2d at 176; *Edelman v. Hinshaw & Culbertson*, 788 N.E.2d at 751; *Mich. AFSCME Council 25*, 2007 Mich. App. LEXIS 2544 at *18. Under agency principles, a principal cannot conspire with its own agent because it is legally impossible to have a "meeting of the minds" between two entities which are not legally distinct. *Wiles*, 75 F. Supp. 2d at 1005. *Macke Laundry Service*, 931 S.W.2d at 176. Other courts reject this view, holding that an attorney and client are distinct legal entities. *Lane v. Sharp Packaging Systems*, 635 N.W.2d at 901-902.

c. Notwithstanding the applicability of agency principles, all courts appear to agree that an attorney can be liable if:

1. he/she knowingly commits fraudulent acts that injures a third person or knowingly enters into a conspiracy to defraud a third person. *Wiles v. Capital Indemnity Corp.*, 75 F. Supp. 2d 1003 (E.D. Mo. 1999); *Likover v. Sunflower Terrace II, Ltd.*, 696 S.W.2d 468 (Tex. Ct. App. 1985);

2. knowingly participates in client's unlawful conduct to hinder, delay or defraud creditors. *Essex Crane Rental Corp. v. Carter*, 371 S.W.3d 366 (Tex. Ct. App. 2012); *Banco Popular North America v. Gandi*, 876 A.2d 253 (N.J. 2005);

3. knowingly participates in a fraudulent obstruct enforcement of judgment or order of a court. *Morganroth & Morganroth v. Norris, McLaughlin & Marcus*, 331 F.3d 406 (3rd Cir. 2003); *Celano v. Frederick*, 203 N.E.2d 774 (Ill. Ct. App. 1964); or

4. acts outside of the scope of the attorney-client relationship and has an independent personal stake in achieving the object of the conspiracy. *Macke Laundry Service, Ltd. v. Jetz Service Co.*, 931 S.W.2d 166 (Mo. Ct. App. 1996).

d. As is the case in proving an actual intent to hinder, delay or defraud creditors, it is difficult to obtain direct evidence of a 'meeting of the minds' to commit an actual fraudulent transfer. Like cases involving actual fraudulent transfers, courts will rely on the traditional "badges of fraud," in an effort to discern whether the attorney's involvement evidenced a meeting of the minds. *Essex Crane*, 371 S.W.2d at 378-381. In *Essex Crane*, for example, the court held that the attorneys' active participation in the preparation of the legal documents, among other acts, necessary to effectuate the fraudulent transfer raised a question of fact precluding summary judgment. *See Banco Popular North America*, 184 N.J. at 177-178 (holding that, while an unwitting party may not be liable under a conspiracy theory, "'[I]t is enough [for liability] if you understand the general objectives of the scheme, accept them, and agree, either explicitly or implicitly, to do your part to further them.'") (internal citation omitted).

e. In whether an attorney acted outside of the scope of the attorney-client relationship or had an independent personal stake in achieving the object of the conspiracy, some courts hold that the fact that the attorney has been or will be paid legal fees is insufficient. *Wiles v. Capital Indemnity*, 75 F. Supp. 2d at 1006. At least one court has held to the contrary. *Essex Crane Rental v. Carter*, 371 S.W.3d at 381 (finding a fact issue as to whether the attorneys "promoted the scheme to earn a fee for themselves that they would not have earned had they not assisted" in a fraudulent transfer to shield assets from creditors.)

f. As the above-cases indicate, civil conspiracy claims based upon fraudulent transfers are fraught with issues of fact making it difficult to succeed on a motion to dismiss. Moreover, even in those cases where summary judgment was granted to the defendant-attorneys, more often than not, it was as a result of the plaintiff's inability to meet its burden on the

underlying wrongful or tortious act. *See, e.g., March v. Statman*, 2016 Ohio. App. LEXIS 1734 (May 6, 2016).

II. Ethical Consideration and Malpractice

A. Relevant Rules of Ethics:

1. *Rule 1.2* - Scope Of Representation And Allocation Of Authority Between Client And Lawyer:

> (a) Subject to paragraphs (c) and (d), a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation.
>
> (d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

2. *Rule 1.4* – Communications

> (b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

3. *Rule 1.6* – Confidentiality of Communications

> (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
>
> (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
>
> > (1) to prevent reasonably certain death or substantial bodily harm;
> >
> > (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;[1]

[1] Pursuant to THE PROFESSIONAL ETHICS COMMITTEE FOR THE STATE OF TEXAS OPINION 603, "Fraud" or "Fraudulent" denotes conduct having a purpose to deceive and not merely negligent misrepresentations or failure to apprise another of relevant information

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

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

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

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

(7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.[2]

4. *Rule 1.13* – Organization as Client

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(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.

[2] Note that Rule 1.6(c) is mandatory, while Rule 1.6(b) is permissive.

5. *Rule 3.3* – Candor Towards the Tribunal

(a) A lawyer shall not knowingly:

(i) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;[3]

(ii) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or

(iii) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client, or a witness called by the lawyer, has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, which the lawyer reasonably believes is false.

(b) A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal.

(c) The duties stated in paragraphs (a) and (b) continue to the conclusion of the proceeding, and apply even if compliance requires disclosure of information otherwise protected by Rule 1.6.

(d) In an ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer that will enable the tribunal to make an informed decision, whether or not the facts are adverse.[4]

7. *Rule 4.1* – Truthfulness in Statements to Others

In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is

[3] Comment 2 to Rule 3.3 notes that there may be circumstances where failure to make a disclosure is the equivalent of an affirmative misrepresentation.

[4] Note that Rule 3.3 trumps Rule 1.6.

prohibited by Rule 1.6.[5]

8. *Rule 8.4* – Misconduct
It is professional misconduct for a lawyer to:
(c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation;

a. D.C. BAR ETHICAL OPINION 336: Virtually any conduct by attorney that relies on or otherwise uses information the attorney knows to be false would constitute dishonesty, deceit, or misrepresentation, even if the conduct is not legally fraudulent.

B, **Applying Ethics Rule -- Rules 1.2 & 1.4**

1. Failure to Advise: The attorney-client relationship presumes that there can be effective communication between client and lawyer, and that the client, after consultation with the lawyer, can make considered decisions about the objectives of the representation and the means of achieving those objectives.[6] The question, thus, arises whether an attorney's representation falls below the ordinary and reasonable skill and knowledge commonly possessed by members of the legal profession when the attorney fails to advise his/her client the possible consequences of an action, e.g., that a leverage buy-out could be viewed as a fraudulent conveyance in violation of applicable law. Stated another way, does a professional commit malpractice by failing to alert his/her client as to possible problems with a transaction.[7]

a. STATE BAR OF CALIFORNIA – OPINION NO. 2008-175: This opinion stated that an attorney should explain the applicable legal and ethical principles, as well as the policies underlying those principles, and the potential adverse ramifications to the client of pursuing the proposed course of conduct.

b. Nichols v. Keller, 19 Cal.Rptr.2d 601 (1993): "One of an attorney's basic functions is [give] advice. Not only should an attorney furnish advice when requested, but he or she should also volunteer opinions when necessary to further the client's objective. The attorney need not advise and caution of every possible alternative, but only of those that may result in adverse consequences if not considered."

c. In re JTS Corp., 305 B.R. 529 (Bankr.N.D.Cal.2003): Corporation sells real estate to a shareholder, with a repurchase option, for $5 to $6 million

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[5] According to the STATE BAR ASSOCIATION OF NORTH DAKOTA ETHICS COMMITTEE OPINION NO. 10-01, Rule 4.1 prohibits a lawyer from making a statement to a third person of fact or law that the lawyer knows to be false. However, Rule 4.1 is inapplicable where the lawyer made no statement of fact or law to others *after* the attorney discovered the client's false statement.

[6] ABA FORMAL OPINION 96-404 (1996).

[7] *Camarda v. Danziger, Bangser & Weiss*, 561 N.Y.S.2d 233 (1990) (Attorney failed to advise plaintiff that a heavily leveraged buy-out could be a fraudulent conveyance.

less than fair market value. The attorney is accused of breaching her fiduciary duties because she failed to advise the board of directors that corporate property was being sold for less than fair market value, a fact that could have adverse legal consequences to the company. Attorney argues that she had no duty to provide "business advice."

(i) Scope of Attorney's Duty: The court noted that the scope of attorney's duty will turn on the parameters of the agreed representation. Nevertheless, an attorney may still have a duty to alert clients to legal problems that are "reasonably" apparent, even when they fall outside the scope of the retention.[8]

(ii) Logic: Skilled attorneys are substantially more qualified to recognize potential legal problems than the typical client would be. As a result, attorneys should be prepared to volunteer legal opinions when necessary to further a client's objectives and should provide advice regarding alternatives where the failure to consider them could result in adverse consequences.[9]

d. In re Greater Southeast Community Hosp. Corp., 353 B.R. 324 (Bankr.Dist.Col.2006): In this case, the question is raised as to whether an attorney was negligent in failing to advise the debtors of the consequence for their deepening insolvency?

Business Advice: "Lawyers are not responsible for the business decisions of their clients." Citing to *Kon Public Employees Ret. Sys. v. Kutak Rock*, 44 P.3d 407, 416-18 (2002), court notes that attorneys "may have a duty to inform corporate clients of any fiduciary breaches committed by the company's officers and directors, but they are neither obligated nor expected to second-guess the business judgments made by those fiduciaries, and . . . deepening insolvency itself does not constitute a tort.

e. Peterson v. Katten Muchin Rosenman LLP, 792 F.3d 789 (7th Cir.2015): The complaint filed in this case alleged that attorneys violated their duty to their clients by not telling them that the financing arrangement they assisted in setting up posed a risk that Tom Petters was not running a real business. Attorneys had been engaged to structure transactions, the plaintiff asserted, and part of that duty should have entailed telling their client what contractual devices are appropriate to the situation.

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[8] The issue came before the court on motions for summary judgment, which the court denied, finding that fact issue existed as to whether attorneys provided directors of corporation with appreciation of dangers of the floorless convertible financing involved or its potential impact on company, and whether a lock-up provision should have been part of written agreement.

[9] Citing *Nicholas v. Keller*, 19 Cal.Rptr.2d 60 (1993).

(i) Analysis: "[Attorneys] had to alert [their] client to the risk of allowing repayments to be routed through Petters, drafting and negotiating any additional contracts necessary to contain that risk. As the complaint depicts matters, the client did not appreciate the difference between funds coming from retailer and funds from Petters. A competent transactions lawyer should have appreciated that the former arrangement offers much better security than the latter and alerted its client. If a client rejects that advice, the lawyer does not need to badger the client; but the complaint alleges that the advice was not offered, leaving the client in the dark about the degree of the risk it was taking."

(ii) Business v. Legal Advice: The appellate court noted that the trial court decision failed to identify any principle of Illinois law "that sharply distinguishes between business advice and legal advice." Further, it was hard to see how any such bright line could exist, since one function of a transactions lawyer is to counsel the client how different legal structures carry different levels of risk, and then to draft and negotiate contracts that protect the client's interests. The court noted that a client can make a business decision about how much risk to take and the lawyer must accept and implement that decision.

But it is in the realm of legal advice to tell a client that the best security in a transaction such as this one is direct verification with retailer plus direct deposits to a lockbox; the second-best is direct deposits to a lockbox; and worst is relying wholly on papers over which Petters had complete control, for they may be shams with forged signatures by the retailer who have never heard of Petters. Knowing degrees of risk presented by different legal structures, a client *then* can make a business decision; but it takes a competent lawyer, who understands how the law of secured transactions works ,. . . to ensure that the client knows which legal devices are available and how they affect risks.[10]

C. Applying Ethics Rule -- Rules 1.6, 3.3, 4.1 & 8.44

1. THE RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §68 (2000) – Identifies 4 elements for determining what is confidential information.

--A communication,

[10] *Peterson* cited to *Conklin v. Hannoch Weisman, P.C.*, 678 A.2d 1060 (1996) which held that "[m]alpractice in furnishing legal advice is a function of the specific situation and the known predilections of the client. An attorney in a counselling situation must advise a client of the risks of the transaction in terms sufficiently clear to enable the client to assess the client's risks. The care must be commensurate with the risks of the undertaking and tailored to the needs and sophistication of the client.

--Made between privileged persons,
--In confidence,
--For the purpose of obtaining or providing legal assistance to client

2. Example of General Proposition of Confidentiality – LOS ANGELES COUNTY BAR ASSOCIATION OPINION NO. 417:

a. Facts: The inquiring attorney defended a client who was a debtor in an involuntary bankruptcy case. During the involuntary case the client replaced the attorney, leaving a substantial unpaid bill. The new attorney has since been replaced by the client acting in propria persona. An order for relief was entered in the bankruptcy case, and it proceeded under Chapter 7 of the Bankruptcy Code.

Through conversations with and representation of the former client, the attorney acquired substantial knowledge of the former client's complex business affairs. The attorney claims that the information is not unique, but that it amounts to a general overview of the complex business affairs of the client that could be of great assistance to a creditor or the trustee. Because of the complexity of these business affairs, the attorney's knowledge could save the bankruptcy trustee considerable time in locating assets, and make it more likely that assets will be located. It is likely that nobody else has comparable knowledge of the former client's affairs. The attorney has filed a claim for his fees in the Chapter 7 case. The attorney's assistance could include, for example. assisting the trustee in locating valuable assets and in examining the debtor. It may also include objecting to the debtor's discharge, or prosecuting a proceeding to have the attorney's debt declared nondischargeable.

b. Questions:

(i) Would he violate any fiduciary relationship, privilege, or ethical standard by exercising the rights of a creditor in the bankruptcy case?

(ii) If he possesses confidential information, may he use non-confidential information in the exercise of the rights of a creditor?

(iii) May he use the confidential information to pursue the rights of a creditor?

(iv) In exercising the rights of a creditor, would the attorney expose himself to a malpractice action by the former client, who may claim that the attorney was employed to protect the client's assets?

c. Committee's Analysis:

The policy against disclosure of confidences and secrets is strictly enforced, and exceptions are narrowly construed. Further, the obligation to protect a client's confidences and secrets continues, notwithstanding the termination of the attorney-client relationship. And any of the information that is not confidential information, still qualifies as a client secret, because the attorney himself proposes to use it to the detriment of the former client.[11] Thus unless the former client authorizes disclosure, the information may not be disclosed, unless it falls within an exception.

In collecting a fee or defending against a malpractice action an attorney may disclose both confidential information and client secrets, but only to the extent necessary to the action. Filing a claim in a bankruptcy case to collect a fee is covered by this exception. Thus an attorney may file his or her claim and may use confidences and secrets to litigate it if the claim is contested. However, the attorney should seek appropriate protective orders to prevent disclosure of confidences or secrets beyond what is necessary to litigate the claim.

However, in the opinion of the Committee, actions to collect debts generally from a former client do not fall within the scope of this (or any other) exception. It is, therefore, improper for a former attorney to disclose any confidential or secret information concerning a client in the collective collection effort in the client's bankruptcy case. This includes information obtained both during the representation of the former client and outside this

D. Applying Ethics Rule -- Rules 1.6(b)(3)

1. If an attorney believes that his/her services were used in the client's criminal or fraudulent act, then under Rule 1.6(b)(3), the attorney has the option to reveal the minimum amount of confidential information necessary to prevent, mitigate or rectify the consequences of that conduct. However, with respect to corporate clients, any action which the attorney chooses to take under Rule 1.6 must be done only after disclosure is made to the Board of Directors and after an evaluation of what the Board chooses to do or not do in response to the communication.

2. PENNSYLVANIA BAR ASSOCIATION INQUIRY NO. 2010-035.

   a. Facts: Attorney represented an individual in filing a chapter 7 bankruptcy case and prepared the required schedules and statement of affairs based upon information given to the attorney by the client. The attorney also represented the client at the first meeting of creditors at which time the

[11] Per LOS ANGELES COUNTY BAR ASSOCIATION OPINION NO. 436 (non-confidential information obtained during attorney-client relationship protected under the rules of ethics.)

client answered questions and completed a written work sheet. The client was discharged and the case was closed.

Subsequently, the attorney learned from a third party that the client may have committed fraud in the bankruptcy case, specifically that the client had not listed on his schedules or disclosed to the trustee at the 341 meeting that he had fraudulently transferred a motorcycle and had failed to list or disclose a condemnation claim about which he may have had knowledge at the time of his bankruptcy filing. The debtor received $50,000 for this condemnation claim although it is unclear whether he received the monies during or after the bankruptcy case was concluded.

b. Issues: Whether the attorney has a duty to tell the bankruptcy court or the former trustee about the former client's fraud.

c. Answers:

(i) Tribunal: The Committee stated that although the question was not free from doubt, it assumed that the trustee at a 341 meeting was a "tribunal", defined in Rule 1.0 as "a court, arbitrator in a binding arbitration proceeding or a legislative body, administrative agency or other body acting in an adjudicative capacity. A legislative body, administrative agency or other body acts in an adjudicative capacity when a neutral official, after the presentation of evidence or legal argument by a party or parties, will render a binding legal judgment directly affecting a party's interests in a particular matter." The Committee stated that its conclusion was "fortified by Comment [1] to Rule 3.3, which states: 'It [the definition of 'tribunal'] also applies when the lawyer is representing a client in an ancillary proceeding conducted pursuant to the tribunal's adjudicative authority, such as a deposition."

(ii) Obligation to Disclose: The Committee, however, went on to state that because the bankruptcy case had closed before the attorney learned of the false testimony, his obligation to correct it ceased pursuant to Rule 3.3(c). However, if the attorney wished to do so, Rule 1.6(c)(3) would permit, but not require, the attorney to disclose the false testimony since his services were used in preparing the Statement of Financial Affairs and the attorney represented the debtor at the Section 341 meeting.

E. Applying Ethics Rule – Rule 3.3 - Candor Towards Tribunal

1. Continuing Criminal or Fraudulent Acts: The lawyer has a duty to disclose to the court any facts necessary to avoid assisting a client who is committing an ongoing continuing criminal or fraudulent act.

2. Timing of Events: As noted in PENNSYLVANIA BAR ASSOCIATION INQUIRY NO. 2010-035, referenced briefly above, where the misconduct is not ongoing, the lawyer may not disclose the prior misconduct to the court pursuant to Rule 1.6. As a result, in situations where assets have been misappropriated, the lawyer's only recourse is to seek to persuade the client to either replace any misappropriated funds or to voluntarily disclose to the court the client's misconduct.

3. PENNSYLVANIA BAR ASSOCIATION INQUIRY NO. 2009-024.

   a. Facts: An attorney represent a husband and wife as chapter 7 debtors. On their behalf, the attorney filed an answer to a complaint to determine dischargeability. The husband subsequently informed the attorney that he concealed assets from the bankruptcy trustee and thereby committed bankruptcy fraud.

   b. Issues:

      (i) *How can the attorney continue to represent the clients when they do not want the information as to asset concealment disclosed? Does the attorney have a duty of candor with the tribunal?*

      (ii) *Must the attorney withdraw from the representation? What should he do with respect to the answer which he filed which he now knows was materially false?*

      (iii) If the attorney seeks to withdraw, what disclosures must he make to the court?

   c. Answers:

      (i) *If the attorney continues to represent either or both of his clients, he cannot make a false statement of material fact to the tribunal, fail to correct a false statement of material fact previously made to the tribunal, or offer evidence that he knows to be false.*

      (ii) *If the client intends to go forward without revealing what they did, then the Committee suggested that the attorney follow the suggestions found in Comment 6 to Rule 3.3.*

      (iii) Comment 6:

      If a lawyer knows that the client intends to testify falsely or wants the lawyer to introduce false evidence, the lawyer should seek to persuade the client that the evidence should not be offered. If the persuasion is ineffective and the lawyer continues to represent the

client, the lawyer must refuse to offer the false evidence. If only a portion of a witness's testimony will be false, the lawyer may call the witness to testify but may not elicit or otherwise permit the witness to present the testimony that the lawyer knows is false.

The Committee was not clear whether an answer to a complaint constituted a statement to a tribunal. However, it suggested that the "prudent course of action is to file an amended answer which does not misstate facts.

The Committee stated that the attorney had grounds to withdraw. If he filed a motion for leave to withdraw, the Committee suggested that he reference Rule 1.116 of the Rules of Professional Conduct without specifying issues between him and his clients so as not to prejudice them.[12]

F. Applying Ethics Rule 1.13

1. Sole Duty: Rule 1.13(a) makes it clear that the inquirer's sole duty is to the organization, not its members. The organization is governed by a Board of Directors and, therefore, the inquirer's duties as counsel flow directly to that Board.

2. MICHIGAN BAR ASSOCIATION – R1345:

Factors on Action Taken: The particular steps required of the lawyer will depend on such factors as the governance structure of the organization, the degree of independence of the board and the CEO's relationship with higher authority.

a. Step 1: – Attempt to dissuade the CEO from the threatened course of conduct.

b. Step 2: – Recommend a second opinion be obtained regarding the implications of the threatened conduct.

c. Step 3: – Refer the matter to higher authority in the corporation if the CEO does not recant, e.g., the board of directors. If CEO is a member of the board, make sure any independent directors are informed.

[12] In the PHILADELPHIA BAR ASSOCIATION PROFESSIONAL GUIDANCE COMMITTEE OPINION 2009-09, the Committee instructs attorneys how to withdraw from cases for ethical issues. The Committee stated that first, the attorney should advise the client to retain substitute counsel in order to avoid having to file a motion with the court. The Committee stated that the Rules of Professional Conduct impose no duty on attorneys to advise the new attorney of his concerns about the client's veracity and possible culpability. If substitute counsel cannot be obtained, the motion to withdraw should not reveal confidential information. Rather, the motion should simply state that the attorney reasonably believes that continued representation will result in violation of the Rules of Professional Conduct.

d. Step 4: – Withdraw from representing the corporation.

3. The Professional Ethics Committee for the state of Texas Opinion 603

a. Facts: Lawyer represents an insolvent corporation controlled and managed by an individual who is the corporation's sole shareholder, sole director and sole officer. The corporation representative is engaged in conduct that, although not criminal, constitutes a breach of the corporate representatives fiduciary duty to the corporation and will result in substantial harm to the corporation's creditors. The attorney advises the officer to stop his activity. The officer continues his conduct.

G. Applying Ethics Rule 1.6

1. Rule 1.6 – Confidential Information: Preservation of a client's confidential information is one of the fundamental obligations of a lawyer. This includes conclusions reached by a lawyer regarding conduct of a corporate client's representative and the resulting advise that the lawyer gives to the corporation.

2. Exception to the Rule: Disclosure however, is permissible in order to prevent the client from committing a criminal or fraudulent act.[13]

3. If Fraudulent: If the corporate representative's breach of fiduciary duty results in fraudulent conduct by the corporation, the lawyer is permitted to reveal his conclusions and advise to the extent necessary to prevent the fraudulent conduct to the Board of Directors. If it is necessary, the attorney may be entitled to reveal the confidential information to the corporation's creditors.

However: If the lawyer believes that revealing confidential information to the corporation's creditors would not prevent the fraud, then the lawyer is not permitted to reveal confidential information to the creditors even if the corporation's conduct constituted fraud.

Minimize Disclosure: Minimize the extent of the disclosures and the adverse effect of the disclosure upon the corporate client while also accomplishing the goal of preventing the client from committing fraud.

4. If Not Fraudulent: If the corporate representative's breach of fiduciary duty does not result in corporate conduct constituting fraud, then nothing in the Disciplinary Rules would authorize the lawyer to reveal the lawyer's conclusions and advise the corporation's creditors.

[13] The Opinion notes that not all breaches of fiduciary duty are fraudulent.

H. Issue/Malpractice Actions as Property of the Estate

Question: Does a legal malpractice cause of action is property belonging to the client as an individual or is property of his bankruptcy estate.

1. Section 541: The phrase "all legal and equitable interests of the debtor in property in §541(a) embraces rights only as they exist under non-bankruptcy law and subject to limitations non-bankruptcy law imposes on such rights, including state law affirmative defenses to the assertion of such rights.[14]

2. Generally: Malpractice actions are property of the bankruptcy estate, with the only question is whether the malpractice claim constituted a legal and equitable interest of the debtor in property as of commencement of the case.[15]

   Existence and Accrual: A malpractice action accrues when the client discovers or should have discovered, using a reasonable person standard, that the injury he suffered related to the attorney's action or non-action or when the attorney-client relationship is terminated[16]

3. In Pari Delicto:

   a. Scholes v. Lehmann: The court stated that the wrong doer must not be allowed to profit from his wrong by recovering property that he had parted with in order to thwart his creditors. However, the appointment of the receiver removed the wrongdoer from the scene. As a result, "[t]he corporations were no more the agent evil zombies. Freed from his spell, they became entitled to the return of the moneys – for the benefit not of the agent but of innocent investors – that the agent had made the corporations divert to unauthorized purposes. Put differently, the defense of in pari delicto loses its sting when the person who is in pari delicto is eliminated."

   b. "Innocent Successor" Exception: Has been rejected as contrary to §541(a)(2), which rests on the premise that the representative of the estate holds all interests of the debtor as of the commencement of the case. As a result, the estate representative has no greater rights than those held by the debtor pre-petition.

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[14] *Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 4.3d 1145, 1150-52 (11th Cir 2006).

[15] *In re Alvarez*, 224 F.3d 1273 (11th Cir. 2000); and *In re: RCK Modular Homes System, Inc.*, 363 B.R. 29 (Bankr.D.N.H.2007) (The trustee is the successor to the Debtor and, as such, is the proper party to bring the malpractice claims since there must be an attorney-client relationship under New Hampshire law. Citing to *Bezanson v. Thomas (In re: R&R Assocs. Of Hampton)*, 402 F.3d 257, 264-65 (1st Cir.2005); In re: Almasri, 378 B.R. 550 (Bankr.N.D.Ohio 2007) (The malpractice claim is property of the Debtor's estate pursuant to §541 and it is the Trustee's duty to "reduce to money the property of the estate." 11 USC §704(a)(1)).

[16] *In re: Tomaiolo*, 205 B.R. 10 (Bankr.D.Mass.1997).

c. Collateral Estoppel:
Harline v. Barker, 912 P.2d 433 (Utah 1996): this court held that where a bankruptcy court denies a discharge based on the debtor's intent to hinder, delay or defraud his creditors, the debtor is collaterally estopped from attributing the denial of discharge to his bankruptcy attorney's conduct in a subsequent legal malpractice action.

Logic: The court noted that because of the plaintiff's alleged good faith reliance on his bankruptcy attorney's advice, and the attorney's preparation of the debtor's statements and schedules, gave rise to a plausible defense in the bankruptcy discharge hearing, and the plaintiff did in fact raise the good faith defense, he could not relitigate those issues in a subsequent malpractice action. In other words, a malpractice plaintiff cannot have a jury reconsider a bankruptcy court's decision whether the plaintiff acted with fraudulent intent or innocently relied on incompetent attorneys. Therefore, collateral estoppel may represent a defense in an actual fraud situation, where the judgment finally and conclusively established that the plaintiff knew all of the defects in the transaction at the time and therefore cannot recover against his lawyers.