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The 'Corporate Watch Dogs' That Can't Bark: How the New ABA Ethical Rules Protect Corporate Fraud

Monroe H. Freedman
Maurice A. Deane School of Law at Hofstra University

THE "CORPORATE WATCH DOGS" THAT CAN'T BARK: HOW THE NEW ABA ETHICAL RULES PROTECT CORPORATE FRAUD[1]

Monroe H. Freedman*

INTRODUCTION

Attorney Lucy Lawton finds that her client, Curtis Cline, has devised a billing scheme that appears to be defrauding Cline's customers. Lawton is especially concerned because her services are being used in carrying out the scheme. She confronts Cline and insists that he stop, but Cline refuses. Lawton is not certain, but she reasonably believes that the scheme is both criminal and fraudulent, and that she is the only one who has caught on or is likely to do so.

What is Lawton to do? The answer is: It depends entirely on who Cline is. If Cline is an individual businessman (not a corporate officer), Lawton can ethically blow the whistle on Cline's fraud and offer to help the defrauded customers get their money back; indeed, she might even be required to do so. But if Cline is the officer of a corporation, Lawton is forbidden under the ABA's new ethical rules to blow the whistle.[2]

The reason for this anomalous result is that the ABA's Corporate Task Force has carried out a drafting and public-relations scam that has persuaded the public and commentators that corporate lawyers are now permitted to report their clients' fraud. In the words of one commentator, the ABA's new ethical rules have turned corporate lawyers into "corporate watchdogs."[3] As we will see, however, these corporate watchdogs are forbidden to bark.

Here's how it works.

I. THE AMENDMENTS TO MODEL RULE 1.6

Until 2003, MR 1.6 forbade a lawyer to reveal to anyone that her client was defrauding others. Two of ABA's amendments to MR 1.6[4] have changed that.

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* Professor of Law, Hofstra University Law School.

1 This article is adapted from MONROE H. FREEDMAN & ABBE SMITH, UNDERSTANDING LAWYERS' ETHICS (3d ed. 2004).

2 In her excellent article in this issue of the UDC/DCSL L. REV., Professor Laurie Morin makes an insightful and powerful case for different ethical rules for maintaining confidentiality for individual clients as against corporate clients. Laurie A. Morin, *Broken Trust and Divided Loyalties: The Paradox of Confidentiality in Corporate Representation.* Ironically, there *are* different ethical rules for individuals and corporations, but the difference favors the corporations over the individuals.

3 *See, e.g.*, James Podgers, *Corporate Watchdogs: ABA House Oks Rule That Would Allow Lawyers to Report Financial Wrongdoing*, 2 A.B.A. J. EREPORT 32 (Aug. 15, 2003).

4 MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(2) (2004), *at* http://www.abanet.org/cpr/mrpc/rule_1_6.html, Confidentiality of Information, (incorporating the 2003 amendments) states:

The first of these amendments, which added MR 1.6(b)(2), is not unreasonable. It permits the lawyer to reveal client confidences "to the extent the lawyer reasonably believes necessary" 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." This allows a lawyer to avoid being the unwilling instrument of a *fraud in progress*. In such a case, for example, the lawyer could tell the party who is being defrauded that he should not rely on representations made by the lawyer that the lawyer has since learned are false.

Moreover, the addition of MR 1.6(b)(2) gives life to MR 4.1(b).[5] The latter rule requires the lawyer to disclose information necessary to prevent assisting a client in any fraudulent or criminal act. However, prior to the amendment to MR 1.6(b)(2), MR 4.1(b) had no practical effect on client fraud, because MR 4.1(b) includes an exception: "unless disclosure is prohibited by Rule 1.6." Thus, as long as MR 1.6 had no fraud exception, MR 4.1(b) could never have any effect. With the amendment to MR 1.6(b)(2), however, the lawyer would be required to reveal client information when (a) the lawyer reasonably believes divulgence to be necessary to prevent a fraud by the client; (b) the fraud is reasonably certain to

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

The 2003 amendments added (2), (3), (4) and (6) in paragraph (b) above as additional circumstances permitting revelation of client information.

5 MODEL RULES OF PROF'L CONDUCT R. 4.1(b) (2004), *at* http://www.abanet.org/cpr/mrpc/rule_4_1.html, Truthfulness in Statements to Others, (which has not been amended) states:

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 prohibited by Rule 1.6.

result in substantial injury to the financial interests of another; and (c) the client has used or is using the lawyer's services in furtherance of the fraud.

The second amendment to MR 1.6, the addition of MR 1.6(b)(3), is far broader. It permits the lawyer to "mitigate or rectify" substantial injury to the financial or property interests of another when the injury already "has resulted." This is an extreme form of blowing the whistle on a client. Even though the fraud has been completed, the lawyer is allowed to go to the third party, volunteer information about the client's fraud, and offer to mitigate or rectify the fraud by testifying in a legal action on behalf of the third party against the lawyer's own client.

Such testimony by the lawyer would be permitted under the law of *evidence* by the traditional crime/fraud exception to the lawyer-client evidentiary privilege. But *ethical rules* permitting a lawyer to *volunteer* client information, even regarding a crime, have traditionally been limited to the information necessary to *prevent* the crime, not to "mitigate or rectify" it. Under the ABA's 1969 Model Code of Professional Responsibility, for example, the lawyer was permitted to reveal "[t]he intention of his client to commit a crime and the information necessary to prevent the crime."[6] There was no exception relating to a completed crime.

Similarly, MR 1.6(b)(1) of the current ethical rules permits a lawyer to reveal client confidences to *prevent* death or substantial bodily harm, but does not permit the lawyer to reveal client confidences about a death or physical harm that has already occurred. Ironically, therefore, under amended MR 1.6, the ABA has provided greater protection to someone who has lost money to the client through fraud than to a person who has been intentionally maimed by the client, or to someone whose spouse has been murdered by the client.

II. The Amendments to Model Rule 1.13

The amendments to Model Rule 1.6 are a major victory for those who have long lobbied for a fraud exception to confidentiality. How much of a victory would it have been, however, if the exception were subject to the following condition: "provided that the lawyer shall not act to prevent, mitigate, or rectify a client's fraud unless it is in the interests of *the client* to do so, *and unless the fraud is reasonably certain to be revealed anyway.*"

That proviso expresses what the ABA Corporate Task Force has achieved in its new amendment to MR 1.13. That is, the lawyer for a corporation (referred to in the rule as an "organization") is permitted to reveal the fraud only if: (a) the board of directors' failure to take appropriate remedial action is "clearly" criminal;[7] (b) the board's failure to take appropriate remedial action is "reasonably

6 Model Code of Prof'l Responsibility DR 4-101(C)(3) (1969).

7 Model Rules of Prof'l Conduct R. 1.13(c)(1) (2004).

certain" to cause "substantial injury *to the organization*";[8] and (c) reporting out is "necessary" to prevent "substantial injury *to the organization.*"[9] All three of those criteria must be met. In Lucy Lawton's billing-fraud case, none of them is met, so Lawton would be forbidden to blow the whistle on Cline's fraud.

Consider, in contrast to MR 1.13, the language and purpose of the amendments to MR 1.6. Repeatedly, the expressed concern of MR 1.6(b)(2) and (3) is with substantial injury to the financial or property interests of "another"—*not* with the best interests of the client. Indeed, the whole point of the amendments to MR 1.6 is to make the interests of third parties paramount to those of the client in cases of client fraud.

In sharp contrast to MR 1.6, the language in MR 1.13—which determines how corporate lawyers should deal with fraud by corporate clients—makes no reference whatsoever to the interests of anyone other than the corporation. On the contrary, the paramount responsibility of the lawyer under MR 1.13 is solely, and repeatedly, for preventing "substantial injury to the organization" itself.[10] Moreover, whenever a lawyer might consider revealing corporate fraud, she is expressly restricted by an overriding obligation to protect the best interest of the corporate client.[11]

This was not simply an oversight in drafting, and it is not a new issue. Since the early 1980s, similar preferential treatment for corporate clients in the original, unamended version of MR 1.13 has been pointed out, but ignored.[12] The short of it is that MR 1.13 was designed from the outset by the corporate bar to give special protection to corporate clients, and this preferential treatment was accepted by the Kutak Commission in order to get the endorsement of the Model Rules from the ABA's powerful Corporate Section.[13]

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8 MODEL RULES OF PROF'L CONDUCT R. 1.13(c)(2) (2004) (emphasis added).

9 *Id.* (emphasis added).

10 MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2004) (one reference); MODEL RULES OF PROF'L CONDUCT R. 1.13(c)(2) (2004) (two references).

11 MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2004) (two references).

12 *See, e.g.*, Monroe Freedman, *Lawyer-Client Confidences: The Model Rules' Radical Assault on Confidentiality*, 68 A.B.A. J. 428, 432 (1982):

> The proponents of whistle-blowing . . . insist that the whistle-blowing requirement should be imposed only on lawyers for corporations, as distinguished from lawyers representing individuals.
>
> Ironically, the Kutak commission has turned that notion upside-down. While lawyers representing individuals are required to make disclosures in many instances and permitted to make them in many more, lawyers representing business organizations are absolutely forbidden under Rule 1.13(b) and (c), in virtually all circumstances, to reveal even ongoing and future crimes.

See also Ted Schneyer, *Professionalism as Bar Politics: The Making of the Model Rules of Professional Conduct*, 14 LAW & SOC. INQUIRY 677 (1989); MONROE FREEDMAN, UNDERSTANDING LAWYERS' ETHICS, (1st ed. 1990) (Ch. 10 "Corporate Lawyers and Their Clients: Some Special Ethical Rules"); Monroe Freedman, *The Corporate Bar Protects Its Own*, LEGAL TIMES, June 15, 1992.

13 *See* sources *supra* note 12.

A. *Reporting Up: Going "Up the Corporate Ladder"*

There is language in MR 1.13 which, when read out of context, appears to require the corporate lawyer to report corporate fraud to the highest authority in the corporation. The language is: "the lawyer shall refer the matter . . . to the highest authority that is authorized to act on behalf of the organization. . . ."[14] Because of this misleading language, there is a misconception that amended MR 1.13 requires the lawyer to report "up the ladder" to the highest authority in the corporation (ultimately to the board of directors) to forestall corporate fraud.[15] This is incorrect for a number of reasons.

First, references to going up the ladder to higher authority in the corporation has been in MR 1.13 all along.[16] Thus, that much-acclaimed amendment in 2003 is not a significant amendment at all.[17]

More important, the lawyer is not *required* by MR 1.13 to go up the ladder. Indeed, she is not even *permitted* to refer the matter to higher authority unless the fraud is "likely to result in substantial injury to the organization."[18] In our hypothetical case, the fraud is not likely to be detected, so there is not likely to be substantial injury to the corporation if the lawyer remains silent. Accordingly, the lawyer is *forbidden* to go up the ladder.

Furthermore, the lawyer is expressly directed to act "in the best interest of the organization,"[19] and she is further told *not* to go up the ladder if she reasonably believes that doing so is not "necessary in the best interest of the organization."[20] (Note again that there is not a word here about the best interests—or any interest—of those who are being defrauded.) Since the CEO's fraud is not likely to be detected, the lawyer could reasonably believe it to be in the best interest of the corporation not to report it to the board, on the grounds that the fewer people who know about the fraud, the better for the corporation. (This would be of particular concern whenever there are independent directors on the board.) In

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14 MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2004).

15 *See, e.g.*, STEVEN GILLERS & ROY D. SIMON, REGULATION OF LAWYERS: STATUTES AND STANDARDS 143 (2004) (concluding that the amendment to MR 1.13 "create[d] a "presumptive 'reporting up' requirement in certain circumstances").

16 The ABA's ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT 203 (4th ed. 1999) refers to this reporting-up provision in the original MR 1.13 as "loyal disclosure" (within the corporation) as distinguished from the "more common . . . adverse disclosure" (to someone other than the client), *citing* George C. Harris, *Taking the Entity Seriously: Lawyer Liability for Failure to Prevent Harm to Organizational Clients through Disclosure of Constituent Wrongdoing*, 11 GEO. J. LEGAL ETHICS 597 (1998).

17 Nor, of course, does the corporate lawyer need permission from MR 1.13 to inform the board of directors of information that is material to the representation. The lawyer has always been *required* to "keep the client reasonably informed about the status of the matter." MODEL RULES OF PROF'L CONDUCT R. 1.4(a)(3) (2004).

18 MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2004) (first sentence).

19 *Id.*

20 *Id.* (second sentence).

that event, it would not be "necessary in the best interest of the organization" to go up the ladder to the board of directors, and the lawyer would be forbidden to do so.

B. *Reporting Out: Blowing the Whistle Outside of the Corporation*

Going up the ladder refers only to revealing the CEO's fraud *within* the organization by going to the "highest authority that can act on behalf of the organization."[21] As we have seen, even reporting the corporate officer's wrongdoing within the corporation is severely restricted under MR 1.13(b).

Reporting out—blowing the whistle outside the corporation—is dealt with in MR 1.13(c), which sets out what the lawyer should do, or not do, if the board of directors fails to put a stop to the CEO's fraud. Here again, there is serious misunderstanding on the part of commentators regarding what the rule actually says.[22] MR 1.13(c)(2) does indeed use the words, "the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure." But the lawyer must squeeze through several needle-eyes before reaching that point.

First, the board's failure to act appropriately regarding the fraud must itself be "clearly" a violation of law (that is, not just condoning fraud, but criminal).[23] In addition, the lawyer must reasonably believe that this unlawful act by the board is "reasonably certain" to result in substantial injury to the organization.[24] That quoted language is actually a *more restrictive* condition on the lawyer than that in the original, unamended version of MR 1.13, which required only that the board's criminal act be "likely" (not, as now, "reasonably certain") to result in substantial injury to the organization. (Note again, the exclusive emphasis on injury to the organization, not to the defrauded customers.) Thus, if the lawyer reasonably believes that the board's failure to take remedial action is not "reasonably certain" to injure the company substantially, the lawyer is forbidden to blow the whistle.

After those limitations comes the language, quoted above, that appears to permit reporting out—but in a stringently restrictive context:

> . . . 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.*[25]

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21 MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2004).

22 *See, e.g.*, "[T]his 'reporting out' authority is a further exception to client confidentiality, beyond the exceptions in Rule 1.6." GILLERS & SIMON, *supra* note 13, at 143.

23 MODEL RULES OF PROF'L CONDUCT R. 1.13(c)(1) (2004).

24 MODEL RULES OF PROF'L CONDUCT R. 1.13(c)(2) (2004).

25 *Id.* (emphasis added).

As suggested earlier, imagine if the fraud exception to MR 1.6 contained that express proviso: "but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the client." Would there be any doubt that this "but only if" clause had nullified the fraud exception? As long as the corporation's fraud is not likely to be exposed otherwise, it cannot be "necessary" for the lawyer to reveal it "to prevent substantial injury to the client."[26] On the contrary, for the lawyer to blow the whistle would lead directly to "injury to the client" through prosecution and/or civil suits.

Here, then, is the position of the lawyer in our hypothetical case. She reasonably believes that (a) the CEO's fraud is not likely to be found out; (b) the board's failure to act is not clearly criminal; (c) the board's inaction is not reasonably certain to result in substantial injury to the company; (d) revealing the fraud outside the company is likely to cause substantial injury to the company (*i.e.*, prosecution and/or civil suits); and (e) reporting out is not necessary to prevent substantial injury to the company. If the lawyer reasonably believes any one of those things, she is forbidden under MR 1.13 to take any action, directly or indirectly, to reveal the company's fraud outside the company.[27]

III. SUMMARY OF THE EFFECTS OF THE 2003 AMENDMENTS

In short, amended MR 1.6 permits, and might require, a lawyer to blow the whistle on an individual (non-corporate) client's fraud, but MR 1.13 forbids it when the client is a corporation. This is accomplished by making injury to the interests of third parties the paramount concern of MR 1.6, and making the interests of the corporation the overriding concern of MR 1.13.

In a case in which it is likely that an individual (non-corporate) client will continue to get away with defrauding third parties unless the lawyer reveals it, under MR 1.6 the lawyer may reveal the client's fraud, because doing so is reasonably necessary to protect the paramount interests of the defrauded third parties. But under MR 1.13, on the same facts, the lawyer is forbidden to reveal a corporate client's fraud, because revealing the fraud is contrary to protecting the overriding interest of the corporation. Put another way, the lawyer for the corpo-

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26 Of course, if the corporation's fraud *is* likely to be exposed otherwise than through the lawyer, then permitting the lawyer to report out at that point becomes inconsequential (although it might enable the lawyer to appear to be distancing herself, if belatedly, from the fraud).

27 Comment [6] to MR 1.13 does not change this result. Indeed, if it did, the text of the rule would control. "The Comments are intended as guides to interpretation, but the text of each rule is authoritative." MODEL RULES OF PROF'L CONDUCT, Preamble and Scope, paragraph [21] (2004). Moreover, Comment [6] reiterates the restrictive language of the rule itself:

> Under Paragraph (c) the lawyer may reveal such information *only when* the organization's highest authority insists upon or fails to address threatened or ongoing action that is *clearly* a violation of law, *and then only* to the extent the lawyer reasonably believes necessary to prevent *reasonably certain* substantial injury *to the organization*. [Emphasis added.]

ration is expressly forbidden to reveal the client's fraud outside the company unless the fraud is reasonably certain to come out anyway.[28]

Thus, the ABA continues to give the interests of corporate clients far greater protection than those of individual clients, while persuading the public and commentators that it has taken serious measures to deal with corporate fraud.

28 A majority of states already permit or, in some cases, require a lawyer to reveal client confidences to prevent a client's fraud. Morin, *supra* note 2, citing authorities. However, all of these states also have versions of MR 1.13 that effectively restrict the lawyer for a corporation from blowing the whistle.