Law Firm Nightmare: Clients Using Lawyer Services for Ponzi Schemes

"'[The mastermind] was so charismatic and his Ponzi scheme so sophisticated that he duped everyone, including [the lawyers].'"

~*Norton v. Graham and Dunn, P.C.,*
2016 WL 1562541 at *11 (Wn. App. Apr. 18, 2016) (unpublished)

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THERE are few risk management problems that law firms confront that are potentially more catastrophic than the discovery that a seemingly "good" client has used the firm's services for a Ponzi scheme or similar fraud.[1] Although circumstances vary, a classic scenario is the one illustrated by the opening quotation: an outwardly successful and celebrated business person has duped hundreds of investors—and the law firm. Once unmasked, the master-mind and any compatriots are almost inevitably on their way to

[1]A "Ponzi scheme" is classically defined as "[a] fraudulent investment scheme in which money contributed by later investors generates artificially high dividends or returns for original investors, whose example attracts even larger investments." BLACK'S LAW DICTIONARY (10th ed. 2014). In practice, however, the term has been used broadly to describe a variety of frauds. *See generally In re* Rose, 425 B.R. 145, 152-153 (Bankr. M.D. Pa. 2010) (noting the breadth of the term in practice); United States v. Harder, 144 F. Supp.3d 1233, 1238 n.4 (D. Or. 2015) (same). This article uses the term in its broad practical sense.

jail, the business involved quickly spirals into bankruptcy, and angry litigants begin circling the professional firms that—presumably unknowingly—provided services to the business.

When a firm discovers that a client has used its services to further a fraud, three questions usually rush forward: (1) must or should the firm withdraw? (2) what can the firm disclose in its defense? and (3) what are the areas of potential exposure and what practical steps can a firm take in advance to better protect itself? This article surveys all three.

I. Withdrawal

Lawyers who knowingly participate in a fraud are usually on a short path to a new line of work and years of litigation.[2] In fact, ABA Model Rule 1.2(d)[3] expressly prohibits a lawyer from assisting a client "in conduct that the lawyer knows is criminal or fraudulent[.]" ABA Model Rule 8.4(c) similarly prohibits a lawyer from engaging in "conduct involving dishonesty, fraud, deceit or misrepresentation[.]" ABA Model Rule 1.16(a)(1), in turn, requires a lawyer to withdraw when "the representation will result in violation of the rules of professional conduct or other law[.]" Doing nothing once a client fraud is discovered is not an option.

The wrongdoer is occasionally a "lone wolf" in an otherwise upstanding company. In that circumstance, the law firm may be able to remain and assist the client in dealing with the fall-out. In most circumstances, however, four practical factors weigh against the law firm continuing to represent the client.

First, the "lawyer-witness rule"—ABA Model Rule 3.7—may effectively disqualify the firm because the question of whether the firm knew about—or at least

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[2] *See, e.g.,* Disciplinary Counsel v. Ulinski, 831 N.E.2d 425 (Ohio 2005) (lawyer involved in Ponzi scheme disbarred); *In re* Venture Mortgage Fund, L.P., 282 F.3d 185 (2d Cir. 2002) (litigation over Ponzi scheme involving lawyer). The lawyers in these two examples were also convicted or pled guilty to criminal charges. *Id*.

[3] The ABA Model Rules of Professional Conduct, which are referenced in this article as the ABA Model Rules as a shorthand, have been adopted in varying forms by 49 states and the District of Columbia. Individual state adoption and variation is surveyed on the ABA Center for Professional Responsibility's web site at: http://www.americanbar.org/groups/professional_responsibility.html. California is currently the only state with lawyer professional rules that are not based on the ABA Model Rules. It does, however, have a general parallel to ABA Model Rule 1.2(d) in the form of California Rule 3-210. California is currently considering a proposal that would move its rules into closer conformity with the ABA Model Rules. More information on the proposal and its status is available on the California State Bar's web site at: http://calbar.ca.gov. Federal district courts typically adopt the forum state's RPCs by local rule.

suspected—the wrongdoer's misconduct is often central to subsequent litigation. Under ABA Model Rule 3.7, a firm lawyer who will be a trial witness is personally disqualified from being an advocate at trial. That may not present a practical barrier to a firm continuing to represent the client if the lawyer who worked with the wrongdoer is a transactional attorney who would not be trying any resulting case anyway. But, if a firm lawyer's testimony will be averse to the firm's client, then ABA Model Rule 3.7 ripens into a rule of firm disqualification because the firm would have a non-waivable conflict.[4]

Second, the "crime-fraud" exception to the attorney-client privilege may put the firm's work on public display in subsequent litigation.[5] Although formulations vary, the exception is generally invoked when a client (or a client representative) consults with or uses a lawyer's advice in furthering a crime or fraud.[6] The lawyer consulted need not know of the client's purpose for the exception to apply.[7] Although framed as an exception to the attorney-client privilege, some courts have extended the logic to the work product and lawyer confidentiality generally.[8]

Third, the mastermind may contend that the law firm was representing him or her as an individual in addition to the corporate client involved in an effort to create a disqualifying conflict or to exclude evidence allegedly subject to a personal attorney-client privilege.[9] ABA Model Rule 1.13(g)

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[4] *See generally* United States v. Kiley, 2011 WL 6122287 (D. Minn. Nov. 10, 2011) (unpublished) (discussing disqualification under the lawyer-witness rule in the context of a Ponzi scheme); *see also* Scholes v. Tomlinson, 1991 WL 152062 (N.D. Ill. July 29, 1991) (unpublished) (same).

[5] *See generally* EDNA S. EPSTEIN, I THE ATTORNEY CLIENT PRIVILEGE AND THE WORK-PRODUCT DOCTRINE 670-744 (5th ed. 2007) (surveying the exception).

[6] *See generally* United States v. Zolin, 491 U.S. 554, 109 S. Ct. 2619, 105 L. Ed.2d 469 (1989) (discussing the exception); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 82 (2000) (stating the exception).

[7] *See In re* Bairnco Corp. Securities Litigation, 148 F.R.D. 91, 101 (S.D.N.Y. 1993) ("The intent, knowledge or culpability of counsel is not the dispositive factor; a communication of advice provided in good faith by counsel may yet lose its privileged status if its substance is misrepresented by the client with the intent to defraud.").

[8] *See, e.g., In re* Grand Jury, 705 F.3d 133, 153 (3d Cir. 2012) (work product); United States v. Cohn, 303 F. Supp.2d 672, 678 (D. Md. 2003) (lawyer confidentiality).

[9] *See, e.g.,* United States v. Aramony, 88 F.3d 1369, 1387-1392 (4th Cir. 1996) (CEO of organization argued that a personal attorney-client privilege attached to his

permits a lawyer representing an entity to also represent one of the entity's constituents—such as a director, officer or employee—subject to the conflict rules. Paragraph 17 of the Scope section of the ABA Model Rules leaves the question of whether an attorney-client relationship has been created to state law—with at least some states including the subjective belief of the putative client in the analytical mix.[10] Related questions of privilege, in turn, usually focus on whether the individual sought and received personal legal advice from corporate counsel.[11]

Fourth, as a practical matter, the law firm may simply be "too close" to the situation to give professionally objective advice. ABA Model Rule 1.7(a)(2) recognizes a conflict when "there is a significant risk that the representation of one or more clients will be materially limited by . . . a personal interest of the lawyer." Although conflicts under ABA Model Rule 1.7(a)(2) are waivable in some circumstances, any waiver under ABA Model Rule 1.7(b)(1) must be predicated on the lawyer's "reasonable belief" that the lawyer can provide competent representation notwithstanding the lawyer's interest.

In light of these factors, law firms in this uncomfortable situation are usually prudent to withdraw. ABA Model Rule 1.16(b)(3) specifically allows withdrawal when "the client has used the lawyer's services to perpetrate a crime or fraud[.]" Given the potential implications of having represented a client who used the firm's services to perpetrate a fraud on what is often a large scale, law firms in this situation are equally prudent to immediately secure outside counsel and notify their insurance carriers. Further, although jurisdictions vary in their approach to internal law firm privilege and corresponding exceptions, law firms are also prudent to limit their own initial internal investigation to firm general counsel (or similarly designated internal counsel) to maximize the probability that their own internal communications and analysis will remain privileged.[12]

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conversations with the organization's law firm).

[10] *See, e.g.,* Bohn v. Cody, 832 P.2d 71, 75 (Wash. 1992) (relying on the putative client's subjective belief if reasonable under the circumstances); *In re* Weidner, 801 P.2d 828, 837 (Or. 1990) (same).

[11] Many federal courts use a standard usually referred to as the "*Bevill* test" after Matter of Bevill, Bresler & Schulman Asset Management Corp., 805 F.2d 120, 123, 125 (3d Cir. 1986). *See generally* United States v. Graf, 610 F.3d 1148, 1159-1161 (9th Cir. 2010) (discussing the *Bevill* test).

[12] *See generally* Mark J. Fucile, *The Double-Edged Sword: Internal Law Firm Privilege and the "Fiduciary Exception*," 76 DEF. COUNS. J. 313 (2009) (discussing internal law firm privilege).

II. Revealing Information

In some situations, the fraud is revealed privately to the law firm by the wrongdoing client—either voluntarily or when pressed by a firm lawyer who has become suspicious. ABA Model Rule 1.6(b)(2) allows a lawyer to reveal otherwise confidential information "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[.]" Similarly, ABA Model Rule 1.6(b)(3) permits a lawyer to reveal otherwise confidential information "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[.]"[13] These exceptions to the confidentiality rule are discretionary, and, therefore, in theory, a firm could simply withdraw without revealing the fraud.[14]

In many situations, the fraud has been discovered through public events independent of the law firm, and the business involved is unravelling rapidly. The next volley is often a lawsuit by a receiver appointed to marshal the failed company's assets, defrauded investors, or both. The question at that point usually focuses on the extent to which the law firm can reveal confidential information to defend itself.

As noted earlier, a law firm's communications with a client that has used the firm's legal advice to further a crime or fraud will usually be subject to the crime-fraud exception and will likely be produced in the course of subsequent litigation. "'The crime-fraud exception strips the privilege from attorney-client communications that "relate to client communications in furtherance of contemplated or ongoing criminal

[13] ABA Model Rule 1.13(b) counsels that a lawyer who discovers substantial misconduct within a client organization must generally report to a higher level within the organization capable of taking appropriate action. ABA Model Rule 1.13(c), in turn, allows—but does not require—a lawyer to report misconduct to authorities outside the organization if the highest level of the organization refuses to address the misconduct.

[14] Another option is the so-called "noisy withdrawal": the firm withdraws without stating precisely why but also withdraws any representations it has made on the client's behalf. *See, e.g.,* United States v. Beckman, 787 F.3d 466, 481 n.7 (8th Cir. 2015) (describing a law firm's "noisy withdrawal" from a Ponzi scheme); *see generally* Dewar v. Smith, 342 P.3d 328, 337 (Wash. App. 2015) (discussing "noisy withdrawal" in the analogous context of accountants).

or fraudulent conduct.'"'"[15] Although the precise predicate standards for the crime-fraud exception vary by jurisdiction,[16] the very public undoing of a Ponzi scheme or similar fraud usually does not make its application in that setting particularly controversial.[17]

Beyond the crime-fraud exception, law firms may also generally use otherwise confidential materials in their own defense.[18] The "confidentiality rule"—ABA Model 1.6—includes a specific exception allowing a lawyer to disclose confidential materials in self-defense. Importantly, the exception—ABA Model Rule 1.6(b)(5)—applies in both the criminal and civil settings and in both litigation with a former client and third parties:

> "A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
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> . . .
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> "(5) to establish a . . . 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[.]"

III. Exposure and Practical Steps to Protect a Law Firm

When a Ponzi scheme involving a law firm client implodes, the claims that a law firm may face will vary with the particular facts and jurisdictional law.[19] The viability of state and federal securities claims, for example, usually turns on whether a firm lawyer participated

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[15] *In re* Enron Corp., 349 B.R. 115, 127 (Bankr. S.D.N.Y. 2006) (citations omitted).

[16] *See generally* EPSTEIN, *supra* note 5, at 670-744.

[17] *See, e.g., In re* Bonham, 1998 WL 460279 at *6 (Bankr. D. Alaska July 28, 1998) (unpublished) ("It is an easy call to say that . . . [mastermind] . . . may not claim either the attorney-client or the work product privilege due to the crime-fraud exception. Her promotion of the Ponzi scheme by offering unregistered securities, after hiding the scope of her operations from the Alaska Division of Banking and Securities, allows such a ruling.").

[18] *See, e.g.,* Grassmueck v. Ogden Murphy Wallace, P.L.L.C., 213 F.R.D. 567, 572-573 (D. Wash. 2003) (discussing the overlap between the crime-fraud exception to the attorney-client privilege and the "self-defense" exception to the lawyer confidentiality rule).

[19] As discussed in note 2 *supra*, lawyers who knowingly participate in a client fraud are at risk of both regulatory discipline and criminal prosecution. The comments in this section are directed to lawyers not falling into that category who instead face civil damage claims.

in the sale of securities.[20] Similarly, jurisdictional law typically controls the availability of legal malpractice and related breach of fiduciary duty claims by non-client investors[21] and whether a trustee or receiver stepping into the shoes of the client is subject to an *in pari delicto* defense to those claims.[22] Again depending on the facts, a law firm's fees collected from a Ponzi scheme may also be subject to disgorgement as a fraudulent conveyance.[23] A common allegation regardless of whether the claimant is an investor or a trustee is that the law firm aided and abetted the fraud.[24]

Aside from purely legal issues controlled by jurisdictional law such as the extent to which a non-client can sue a lawyer for malpractice, most theories advanced against law firms in this context are predicated on the assertion that the firm knew of the fraud. Although many of the theories require "actual knowledge," such knowledge is typically inferred from the circumstances. In other words, a firm cannot simply avert its eyes from the client's misconduct. As a New York court put it: "If the facts and circumstances herein do not support an inference of actual knowledge, then it is doubtful that any action for aiding-and-abetting fraud could be sustained against an attorney, who, like defendant attorneys, consciously chose to look the other way when their clients asked them to prepare the PPM (*i.e.,* private placement memorandum) for their next 'investment' vehicle."[25] Because knowledge is usually fact-specific, that often allows a case to move beyond the preliminary motion stage if the underlying legal theory is available in the jurisdiction concerned and properly pled.[26]

The focus on knowledge and related lawyer conduct in subsequent litigation suggests three risk management approaches that, if implemented systematically, will at least lessen risk.

First, be wary about allowing firm lawyers to participate in the

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[20] *Compare* Bell v. Kaplan, No. 3:14CV352, 2016 WL 815303 at *2-*4 (W.D.N.C. Feb. 29, 2016) (pointing to lawyer's participation in promoting scheme to investors) *with* Peterson v. Winston & Strawn LLP, 729 F.3d 750, 752 (7th Cir. 2013) (noting that law firm did not sign or warrant contents of offering circular to investors).

[21] *See, e.g.,* Goodman v. Merlino, 2014 WL 10537362 (N.J. Super. App. Div. Oct. 20, 2015) (unpublished). By contrast, claims by clients against law firms for, essentially, failing to protect them from investing in fraudulent enterprises usually turn instead on the scope of the firm's engagement and related causation issues. *See, e.g.,* Rothman v. McLaughlin & Stern, LLP, 8 N.Y.S.3d 113 (N.Y. App. Div. 2015).

[22] *See, e.g.,* Hays v. Pearlman, 2010 WL 4510956 (D. S.C. Nov. 2, 2010) (unpublished).

[23] *See, e.g., In re* Agape World, Inc., 467 B.R. 556, 569-572 (Bankr. E.D.N.Y. 2012).

[24] *See, e.g.,* Oster v. Kirschner, 905 N.Y.S.2d 69 (N.Y. App. Div. 2010).

[25] *Id*. at 73.

[26] *Id*.

promotion of the investment involved—either directly or implicitly. *Bell v. Kaplan*, illustrates the former: the lawyer appeared in "leadership calls" to promote the investment and made himself available to answer tax questions from interested investors.[27] *Hays v. Pearlman* is an example of the latter: the lawyer allowed the mastermind of a Ponzi scheme to identify him in a letter to prospective investors as tax counsel and "'the very best in the business[.]'"[28] Involvement in client marketing both increases the risk that a court will find later that the firm participated in the sale of securities and suggests a level of knowledge of the client's activities that may be enough to prevent disposition of subsequent litigation on motion—leaving the firm to explain itself to a jury.

Second, carefully define the scope of the firm's representation in a written engagement agreement. A law firm hired to handle a local office lease for what turns out to be a Ponzi scheme involving an investment product unrelated to the firm's work will have a much more viable defense than without that documentation. As the Seventh Circuit put it in affirming the dismissal of claims against a law firm that had represented what turned out to be a Ponzi scheme: "As for the Trustee's assertion that the law firm should have alerted the Fund's directors, the initial problem is that the law firm was not hired to blow the whistle on . . . [the mastermind]."[29]

Third, avoid making statements on the firm's own web site about being a client's "general counsel." Although there is a natural temptation to bask in the reflected glow of a seemingly successful client, that glow will fade quickly if the client turns out to have perpetrated a massive fraud. As in the examples noted above from *Bell* and *Hays*, being identified—or identifying yourself—as "the" lawyer for the client in either the firm's or the client's marketing suggests a level of knowledge about the client's internal affairs that may make it difficult to resolve any subsequent litigation on motion and may push the firm on to trial.

IV. Summing Up

As the opening quotation from a Washington case illustrated, law firms can be seduced by the same sales pitch from a seemingly successful client as the client's own investors. If an apparently stellar client is unexpectedly revealed as a fraud, the firm should in most instances withdraw and seek experienced counsel quickly. If the firm has been careful not to co-market its services with those of the client and has carefully defined its

[27] 2016 WL 815303.
[28] 2010 WL 4510956.
[29] *Peterson*, 729 F.3d at 752.

role in a written engagement agreement, then subsequent litigation may not be avoided, but the probability of an early and favorable disposition will be enhanced significantly.