**December 2016-January 2017 WSBA *NWLawyer Ethics & the Law* Column**

## The Problem of "Bad" Clients

**By Mark J. Fucile**
**Fucile & Reising LLP**

One of the most searing problems a law firm can face is the discovery that a seemingly "good" client has used the firm's services in perpetrating a fraud. Circumstances vary, but a common theme in this unhappy genre is that an apparently successful businessperson is running a Ponzi scheme that has defrauded hundreds of investors. In many instances, the law firm is among the duped. As a King County trial court put it in one recent case, *Norton v. Graham and Dunn, P.C.*, 2016 WL 1562541 at *11 (Wn. App. Apr. 18, 2016) (unpublished): "'[The "bad" client] was so charismatic and his Ponzi scheme so sophisticated that he duped everyone, including the . . . [law firm].'"

Although there are certainly regulatory duties that quickly come into play in this context, liability concerns also loom large. Unless the perpetrator is truly a "lone wolf" operating on the fringes of an otherwise solid business, the discovery of the fraud usually sends the business into bankruptcy. The mastermind, in turn, is often on the way to jail. And, if it is a classic Ponzi scheme, there is no "money in the bank" to pay off expectant investors and other creditors. In that toxic mix, law firms can soon become targets for both defrauded investors and bankruptcy trustees seeking to salvage any remaining assets. In hindsight, the plaintiffs in the resulting litigation will ask pointed questions about why the law firm did not have the foresight to warn them.

When a firm learns that a client is engaging in a continuing fraud, three questions usually rush forward. First, does the firm have to withdraw? Second, must the firm reveal the fraud? Third, what exposure does the firm face? In this column, we'll look at all three.

***Withdrawal***

If the miscreant was an outlier in an otherwise upstanding company that was equally shocked by the conduct, fired the offender and immediately went to the authorities, the firm might remain to assist a corporate client in cleaning up the mess. Even in this situation, however, developments might trigger the firm's withdrawal later, such as a lawyer-witness or other conflict and the firm would need to carefully monitor potential conflicts moving forward. In *Grassmueck v. Ogden Murphy Wallace, P.L.L.C.*, 213 F.R.D. 567 (W.D. Wash. 2003), for example, a law firm that had represented a business group and its principal was put in the middle of a fight over its confidential files between a court-appointed receiver for the business group and the former principal after the business collapsed and the principal was indicted on securities fraud charges. Difficult issues of privilege—including the "crime-fraud" exception followed. Although the law firm had withdrawn, *Grassmueck* provides an excellent illustration of how conflicts can quickly make remaining untenable.

In many circumstances, however, the master of the scheme is effectively "the company" and may try to continue the fraud. In that scenario, the firm should withdraw. RPC 8.4(c) includes "conduct involving dishonesty, fraud, deceit or misrepresentation" within the definition of "professional misconduct." Similarly, RPC 1.2(d) prohibits a lawyer from knowingly assisting a client in criminal or fraudulent conduct and RPC 4.1(b) prohibits a lawyer from failing "to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client[.]" Finally, RPC 1.16(a)(1) counsels that a lawyer must withdraw when continuing in a representation "will result in violation of the Rules of Professional Conduct or other law[.]" Again as *Grassmueck* illustrates, the practical need for the firm to defend itself once a business client at the center of the scheme collapses will almost always create acute conflicts dictating withdrawal.

***Revealing Client Fraud***

In the situation where the perpetrator is the "lone wolf" in an otherwise honest company, RCP 1.13(b) counsels that a lawyer's principal duty upon discovery of fraud (or other illegal conduct) by an entity constituent that "is likely to result in substantial injury to the organization" is to report the findings to management so that the organization can take action appropriate to the circumstances. In the vernacular of RPC 1.13, this is often called "reporting up."

If, however, the perpetrator is "the company," then both the confidentiality rule (RPC 1.6) and the entity client rule (RPC 1.13) permit what is often called "reporting out." RPC 1.6(b)(2) permits a lawyer to reveal otherwise confidential information to prevent a continuing course of criminal conduct by a client and RPC 1.6(b)(3) permits a lawyer to reveal confidential client 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[.]" RPC 1.13(c), in turn, also permits a lawyer to reveal similar information if management of the business involved does not take action. The exceptions in both RPC 1.6 and 1.13 are discretionary through the use of the word "may" rather than "shall." As the Court of Appeals noted in *Dewar v. Smith*, 185 Wn. App. 544, 563, 342 P.3d 328 (2015), which dealt with the analogous area of accountant confidentiality, another option is a so-called "noisy withdrawal" in which the firm on withdrawing disavows any representations it has made to third parties. In many instances, however, the firm will not need to parse these fine distinctions because the fraud has become public through a dramatic failure of the business rather than the perpetrator confessing in private to a lawyer.

***Exposure***

A lawyer who knowingly participates in a client's fraud is likely looking at a new line of work. In *In re Smith*, 170 Wn.2d 721, 246 P.3d 1224 (2011), for example, the Supreme Court disbarred a lawyer following the lawyer's federal conviction for conspiracy to commit securities and wire fraud. Litigation following the collapse of Ponzi schemes and other large scale frauds that used legal services, however, usually involve both more nuanced facts and a focus on civil claims rather than regulatory discipline.

The potential claims asserted against a law firm will turn on the facts of the particular case involved. Securities claims against law firms, for example, often depend on whether the law firm participated in the sale of securities to the investors (*see generally Hines v. Data Line Systems, Inc.*, 114 Wn.2d 127, 147-51, 787 P.2d 8 (1990)). "Aiding and abetting" claims are more common and were discussed extensively in the Ponzi scheme context (albeit as it related to a bank, not a law firm) in *In re Consolidated Meridian Funds*, 485 B.R. 604 (Bankr. W.D. Wash. 2013). Ironically, traditional legal malpractice claims—at least by defrauded investors—have less traction because, under *Hizey v. Carpenter*, 119

Wn.2d 251, 260-61, 830 P.2d 646 (1992), generally a plaintiff must have been the client of the lawyer to have the requisite standing. In the *Norton* case noted earlier, for example, summary judgment was entered on a legal malpractice claim because the defrauded investors where not clients of the law firm.

When a law firm has represented a client who turned out to be the mastermind of a Ponzi scheme, there is probably no practical way to avoid the fallout entirely. Firms can, however, take three proactive steps that will lessen their risk.

First, define the client at the outset in a written engagement agreement. A relatively common scenario after a Ponzi scheme unravels is for the mastermind of a corporate client to argue that he or she was also an individual client of the firm to disqualify the firm from assisting the corporation or to assert privilege over conversations with firm lawyers. Both state (*Bohn v. Cody*, 119 Wn.2d 357, 363, 832 P.2d 71 (1992)) and federal (*United States v. Graf*, 610 F.3d 1148, 1159-61 (9th Cir. 2010)) law will give great weight to written engagement agreements in determining whether an attorney-client relationship exists.

Second, define the scope of the representation in a written engagement agreement. If, for example, you have been hired to handle a very discrete matter, make that plain in your engagement agreement. Assuming you acted consistent with that agreement, it will be more difficult for a third party—like a defrauded investor—to argue later that you were privy to the client's inner workings in other areas.

Third, be wary about making statements on your web site about being a client's "general counsel." As the *Consolidated Meridian Funds* case explains, theories of "aiding and abetting" fraud or breaches of fiduciary duty are predicated on knowledge of the fraud or breach. Firms that openly advertise that they are a client's "general counsel" will have a much more difficult time explaining why their lawyers weren't aware of incendiary facts.

**ABOUT THE AUTHOR**

Mark J. Fucile of Fucile & Reising LLP handles professional responsibility, regulatory and attorney-client privilege issues for lawyers, law firms and corporate and governmental legal departments throughout the Northwest. Mark has chaired both the WSBA Committee on Professional Ethics and its predecessor, the WSBA Rules of Professional Conduct Committee. Mark is also a former member of the Oregon State Bar Legal Ethics Committee and is a current member of the Idaho State Bar Section on Professionalism & Ethics. Mark writes the monthly Ethics Focus column for the Multnomah (Portland) Bar's *Multnomah Lawyer*, the quarterly Ethics & the Law column for the WSBA *NWLawyer* and is a regular contributor on legal ethics to the WSBA *NWSidebar* blog. Mark is a contributing author/editor for the current editions of the OSB Ethical Oregon Lawyer, the WSBA *Legal Ethics Deskbook* and the WSBA *Law of Lawyering in Washington*. Before co-founding Fucile & Reising LLP in 2005, Mark was a partner and in-house ethics counsel for a large Northwest regional firm. He also teaches legal ethics as an adjunct for the University of Oregon School of Law at its Portland campus. Mark is admitted in Oregon, Washington, Idaho, Alaska and the District of Columbia. He is a graduate of the UCLA School of Law. Mark's telephone and email are 503.224.4895 and Mark@frllp.com.