Defending a Charles Ponzi or Bernie Madoff

State Bar Ethics Symposium
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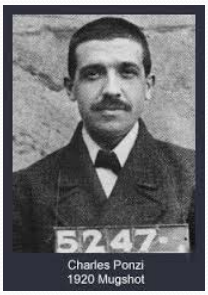
Ponzi Schemes and Other Financial Shenanigans



Charles Ponzi
1920 Mugshot

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Recent High Profile Financial Shenanigans

- Enron (Vinson & Elkins)
- Bernie Madoff
- Edward Okun (Silicon Valley Law Group)
- Allen Stanford (Chadbourne & Park)

A Plaintiff Lawyer's Dream?

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Ethical Duties of Lawyers Representing these "Bad Actors"

Overview

- Organizational Reporting
- Duty of Confidentiality
- Duty To Withdraw
- Conflicts of Interest
- Duty To Investigate Client?
- Duty of Competence (Supervision)

Hypothetical – Cool or Creepy?

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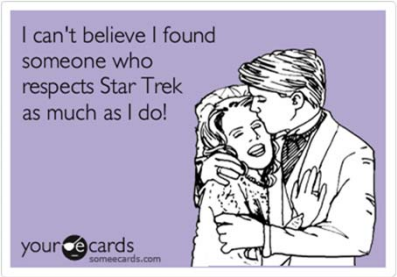
Hypothetical – Cool or Creepy?

Big Firm lands a big IPO for FlashPass, a dating website catering to the minimally committed. The website is starting to catch on, although people are having trouble deciding if it is really cool, or really creepy. There is a spirited debate in social media about whether the site allows shy people to meet outgoing people, or if it is a stalking tool.



Hypothetical – Cool or Creepy?

The attorneys learn the Chief Technology Officer, who developed the algorithm that makes FlashPass hum, was convicted twenty years prior for criminal sexual harassment. He was ordered to stay away from the victim and never try to contact her.

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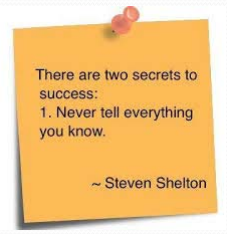
Hypothetical – Cool or Creepy?

Attorneys agonize over whether the conviction warrants mandatory disclosure in the offering materials. CTO, who helped the attorneys land the representation, assures attorneys the conviction was the result of a big misunderstanding, and has no bearing on his character, as evidenced by the last two decades. The conviction is old, and does not relate to either technology or finance. After extensive discussion with CTO, attorneys advise him disclosure would be in the company's best interest, but it is probably not mandatory. CTO promises he will personally discuss the matter with the other officers of the company, and let attorneys know their decision. Eventually CTO tells attorneys the officers decided not to make the disclosure.



Hypothetical – Cool or Creepy?

The IPO makes a splash, and investors commit approximately $30 million. One investor, a family trust, initially commits $5 million, but pulls back before funding. The officers of the company reward themselves with a big party, a private jet, and substantial bonuses for all officers. They also pay the law firm a "success fee."

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Hypothetical – Cool or Creepy?

After the close, and the publicity, the CTO's former victim appears on Ellen to tell her story. She reveals CTO has been cyber-stalking her for the last 20 years. After this, the dating public decides FlashPass is really creepy, not cool, and drop their subscriptions immediately. FlashPass becomes flash in the pan, the funds raised are now worth nothing, and the investors lose.

Hypothetical – Cool or Creepy?

The family trust that pulled back at the last minute turns out to be connected to Big Firm associate. Associate denies using inside information to warn his family away.

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Hypothetical – Cool or Creepy?

Investors sue the officers of the company and the law firm, alleging the CTO's history was deliberately held back despite its obvious relationship to how the public would perceive the product. Despite many inspired arguments that the attorneys did not owe a duty to the investors, the court overrules the law firm's demurrer to the complaint. Although she doesn't say so, the judge is especially troubled by the coincidence that associate's family trust pulled out before losing its investment, and the payment of the "success fee." The judge suggests not only insider trading, but that attorneys knew the revelation would tank the value of the company. The judge reasons it will all get sorted out at mediation, even if she is wrong about the duty of the law firm to the investors.

Hypothetical – Cool or Creepy?

The officers of the company assert advice of counsel. All officers but the CTO claim they did not know of the conviction, and were not given the opportunity to consider the company's options prior to the IPO.

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Organizational Reporting

Reporting within an organization

- Rule 3-600(B): (B) If a member acting on behalf of an organization knows that an actual or apparent agent of the organization acts or intends or refuses to act in a manner that is or may be a violation of law reasonably imputable to the organization, or in a manner which is likely to result in substantial injury to the organization, . . . the member may take such actions as appear to the member to be in the best lawful interest of the organization. Such actions may include among others:
  (1) Urging reconsideration of the matter while explaining its likely consequences to the organization; or
  (2) Referring the matter to the next higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest internal authority that can act on behalf of the organization.

Organizational Reporting

- Know who client is!
  - Company?
  - Individual officer(s)?

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Duty of Confidentiality and Attorney-Client Privilege

- Reporting up, but not reporting out.
  - Enron exception
  - Sarbanes Oxley

Public Statements

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Public Statements

- Duty of confidentiality versus attorney-client privilege
  - Must preserve client "secrets."
    - "Secrets" defined in State Bar Formal Opinion 1993-133: "any information obtained by the lawyer during the professional relationship, or relating to the representation, which the client has requested to be inviolate or the disclosure of which might be embarrassing or detrimental to the client."
  - "Attorney-Client Privilege" protects "information transmitted between a client and his or her lawyer in the course of that relationship and in confidence. . . ." Cal. Evid. Code § 952.

Internal Investigations

- Who is the client?
- *Ruehle* decision (*U.S. v. Ruehle*, 583 F.3d 600 (9th Cir. 2009))
- *Upjohn* warnings (*Upjohn Co. v. U.S.*, 449 U.S. 383 (1981))
- Rule 3-600(D): "In dealing with an organization's directors, officers, employees, members, shareholders, or other constituents, a member shall explain the identity of the client for whom the member acts, whenever it is or becomes apparent that the organization's interests are or may become adverse to those of the constituent(s) with whom the member is dealing. The member shall not mislead such a constituent into believing that the constituent may communicate confidential information to the member in a way that will not be used in the organization's interest if that is or becomes adverse to the constituent."

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When the Lawyer Becomes a Target or Defendant

- Duty of confidentiality
  - Waiver
    - Client sues lawyer
    - Third party (e.g., investors) sues lawyer

When the Lawyer Becomes a Target or Defendant

- Advice of counsel defense
- *In pari delicto*, or unclean hands, defense.
- Due process
  - *McDermott, Will & Emery v. Super. Ct.*, 83 Cal. App. 4th 378 (2000)
    - *But see Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970) (applying federal rule).
    - See also *Deitz v. Meisenheimer & Herron*, 177 Cal. App. 4th 771 (2009) (trial court required to consider competing interests and fashion ad hoc measures to permit an action to proceed).

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Responding to SEC (or other government agency) Subpoena

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- Can lawyer respond without client consent?
- Waiver of privilege?
  - Limited or unlimited waiver

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Responding to SEC (or other government agency) Subpoena

- Evidence Code section 912 (a): "[T]he right of any person to claim a privilege provided by Section 954 (lawyer-client privilege), . . . is waived with respect to a communication protected by the privilege if any holder of the privilege, without coercion, has disclosed a significant part of the communication or has consented to disclosure made by anyone."
- Evidence Code section 952: "[C]onfidential communication between client and lawyer" means information transmitted between a client and his or her lawyer in the course of that relationship and in confidence by a means which, so far as the client is aware, discloses the information to no third persons other than those who are present to further the interest of the client in the consultation or those to whom disclosure is reasonably necessary for the transmission of the information or the accomplishment of the purpose for which the lawyer is consulted, . . ."

Responding to SEC (or other government agency) Subpoena

- The law does not require that the holder of the privilege take "strenuous or Herculean efforts" to resist disclosure. *Regents of Univ. of Cal. V. Super. Ct.*, 165 Cal. App. 4th at 683 (finding no waiver from voluntary production to Department of Justice).
- A party's compliance with a governmental subpoena without asserting the privilege is a waiver. *In re Pacific Pictures Corp.*, 679 F.3d 1121 (9th Cir. 2012).
- *McKesson HBOC, Inc. v. Super. Ct.*, 115 Cal. App. 4th 1229 (2004) (finding waiver of attorney-client privilege and work product protection as a result of voluntary disclosure to government).

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Duty To Investigate?

Duty To Investigate?

- *FDIC v. O'Melveny & Myers*, 969 F.2d 744 (9th Cir. 1992)
  - Ninth Circuit found that the firm had no obligation to "ferret out fraud" but did have to make a "reasonable independent investigation."
  - "Attorneys, in rendering opinions relating to the securities laws, are not justified in assuming facts as represented to them by the client and in basing their opinion on the assumption that such facts are correct. Rather . . . the attorney must make a reasonable effort to independently verify the facts on which the opinion is based."

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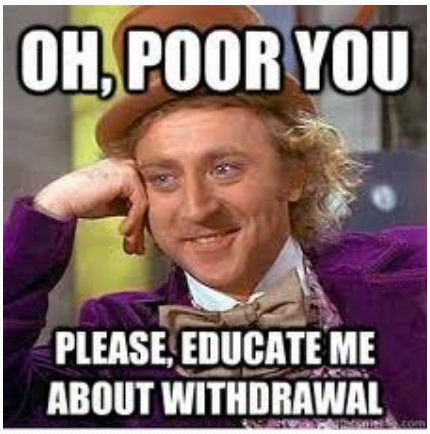
Duty To Withdraw



Duty To Withdraw

- Rule 3-600(C): "If, despite the member's actions in accordance with paragraph (B), the highest authority that can act on behalf of the organization insists upon action or a refusal to act that is a violation of law and is likely to result in substantial injury to the organization, the member's response is limited to the member's right, and, where appropriate, duty to resign in accordance with rule 3-700."

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Duty To Withdraw

Rule 3-700(B) Mandatory Withdrawal:

"A member representing a client before a tribunal shall withdraw from employment . . . if:

. . .

(2) The member knows or should know that continued employment will result in violation of these rules or of the State Bar Act . . . ."

Duty To Withdraw

Rule 3-700(C) Permissive Withdrawal.

If rule 3-700(B) is not applicable, a member may not request permission to withdraw in matters . . . unless such request or such withdrawal is because:

(1) The client

. . .

(b) seeks to pursue an illegal course of conduct, or

(c) insists that the member pursue a course of conduct that is illegal or that is prohibited under these rules or the State Bar Act, or

. . .

(e) insists, in a matter not pending before a tribunal, that the member engage in conduct that is contrary to the judgment and advice of the member but not prohibited under these rules or the State Bar Act, or

. . .

(2) The continued employment is likely to result in a violation of these rules or of the State Bar Act . . . .

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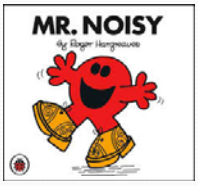
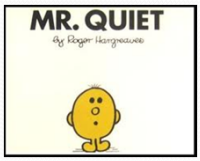
Duty To Withdraw

- "Noisy" vs. "Quiet" withdrawal





- Rule 3-700(A)(2): "A member shall not withdraw from employment until the member has taken reasonable steps to avoid reasonably foreseeable prejudice to the rights of the client. . . ."

Conflicts of Interest

Examples of common conflicts:

- When both lawyer and client are actual or potential defendants in civil litigation
- When SEC (or other government agency) investigates both lawyer and client
- When client states or hints that lawyer failed to properly advise

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Conflicts of Interest

- Insurance Issues

Conflicts of Interest

- In-House Counsel
  - *Yanez v. Plummer*, 221 Cal. App. 4th 180 (2013)
    - In-house counsel represented both company and employee/deponent.
    - In-house counsel found to have a conflict of interest because of divergent interests of both "clients."

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Duty of Competence

- **Rule 3-110 Failing to Act Competently**
  "(A) A member shall not intentionally, recklessly, or repeatedly fail to perform legal services with competence."

Discussion:

The duties set forth in rule 3-110 **include the duty to supervise the work of subordinate attorney** and non-attorney employees or agents. (*See, e.g.*, *Waysman v. State Bar* (1986) 41 Cal.3d 452; *Trousil v. State Bar* (1985) 38 Cal.3d 337, 342; *Palomo v. State Bar* (1984) 36 Cal.3d 785; *Crane v. State Bar* (1981) 30 Cal.3d 117, 122; *Black v. State Bar* (1972) 7 Cal.3d 676, 692; *Vaughn v. State Bar* (1972) 6 Cal.3d 847, 857-858; *Moore v. State Bar* (1964) 62 Cal.2d 74, 81.)

Takeaways

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