SPECIAL REPORT: SHOULD TAX LAWYERS BE PERMITTED (REQUIRED?) TO DISCLOSE CLIENT MISCONDUCT?

by James P. Holden, Washington, DC

INTRODUCTION: In this Special Report, James P. Holden raises and analyzes an issue that pits two of a lawyer's primary ethical duties against one another: whether there are circumstances when lawyers should be permitted, or indeed required, to tell the government of their client's misconduct. The issue is one that could crop up in anyone's practice, and the Special Report provides a guided tour through the maze of often conflicting ethical rules.

As a service to its members, the Section, the Center for Professional Responsibility, and the Center for CLE, in cooperation with LexisNexis™, are sponsoring a teleconference that will present a panel discussion of the issues raised in this Special Report. The Section gratefully acknowledges LexisNexis™ for its contribution in support of this program. The panel will be moderated by Jim Holden and feature Professor Linda Galler, Hempstead, NY, and Michael I. Saltzman, New York, NY. The teleconference format will provide members with an opportunity to be part of the live discussion of this important question—all anybody needs is a telephone. The teleconference will take place on WEDNESDAY, DECEMBER 12, 2001, 2:00-3:00 p.m. Eastern Time. There is no charge for Section members, and registration is easy. For details on registering and obtaining CLE credit, please see the box immediately following this Report.

It could be your worst nightmare. Your client, facing a substantial income tax deficiency, accompanied you to a conference in Appeals; the client made representations of importance to the Appeals Officer; and the Appeals Officer announced that, on the basis of those representations, the tax dispute would be resolved in favor of your client. A nice day's work; you and your client are delighted. While you and the client later bask in the glow of this shared accomplishment, the client informs you that the representations made to the Appeals Officer were false. You recoil in horror because you thought the representations were accurate. You tell the client that this conduct is unacceptable and constitutes a criminal offense. You strongly advise the client immediately to return with you to the Appeals Office in order to correct the record. The client says, "Hey, you're supposed to be on my side. No one is ever going to know that the facts were other than as I stated them, and I am not going to penalize myself financially by disclosing something that will never be known." What courses of action are available to you?

If we assume that your conduct is governed by the ABA Model Rules of Professional Conduct, your options are quite limited. Under current Model Rule 1.6, a lawyer is required to maintain in confidence information relating to a representation, and the exceptions to this obligation are narrow indeed. Information may, of course, be disclosed with client consent, but that option is unavailable on these facts. Rule 1.6 also permits disclosure of information to prevent a client from engaging in a criminal act that you believe is likely to result in imminent death or substantial bodily harm, facts not present here. Finally, Rule 1.6 permits disclosure of client information in the course of a legal controversy between you and your client, an element likewise not present here.

In search of guidance, you examine other Model Rules. You learn that Rule 3.3 requires disclosure of client misconduct that will result in a fraud on a "tribunal." Moreover, this disclosure obligation expressly overrides the confidentiality obligation of Rule 1.6. This has promise. If the IRS Appeals Officer were a "tribunal," you would not only be permitted, but required, to disclose your client's misconduct. However, you research the ethics opinions and learn that ABA Formal Opinion 314, issued in 1965, concludes that the IRS is not a tribunal within the meaning of Rule 3.3. Another dead end. Finally, you read Model Rule 4.1, which states forthrightly that a lawyer shall not 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. However, it adds the emasculating qualification, "unless disclosure is prohibited by Rule 1.6." Yet another dead end. Your tentative conclusion that you may not ethically disclose your client's misconduct is confirmed when you read ABA Formal Opinion 93-375, holding that a lawyer whose client has made material misrepresentations to bank examiners may not disclose the fraud.

Model Rule 1.2(d) commands that you shall not assist a client in conduct that you know to be criminal or fraudulent. If the client is likely to

have further contact with the IRS on the matter involving the misrepresented facts, it may be difficult for you to avoid violating Rule 1.2(d) if you are in any way involved. At this point, you naturally consider whether you may (must?) separate yourself from this undesirable client by withdrawing. May you do that? Like so many ethical questions, the answer is not entirely clear.

Model Rule 1.16 *directs* a lawyer to withdraw from a representation that will result in a violation of the "rules of professional conduct or other law." Continued representation of this client, though repugnant, may not in itself result in such a violation *unless* there remain actions to be taken that are necessary to perfect the now completed fraudulent misrepresentation and the lawyer will participate in those actions. If those facts exist, continued representation could violate Rule 1.2(d).

Rule 1.16 *permits* a lawyer to withdraw if the client:

- persists in a criminal or fraudulent course of action *involving the lawyer's services*;
- *has used the lawyer's services* to perpetrate a crime or fraud, or
- insists on pursuing a course of action that the lawyer considers repugnant or imprudent.

It seems likely that you can find justification here for permissive withdrawal, but there is yet another hurdle to consider. ABA Formal Opinion 314 states that a lawyer who believes that the IRS "relies on him as corroborating statements of his client which he knows to be false" is under a duty to withdraw "unless it is obvious that the very act of disassociation would have the effect of violating" the confidentiality obligation of Rule 1.6. Thus, if withdrawal would effectively amount to disclosure, even that option may not be available.

However, in ABA Formal Opinion 93-375, involving the bank examination case, there is a footnote stating that "withdrawal may be required even if it has the collateral effect of inferentially revealing client confidences." As authority for this proposition (which seems at variance with Formal Opinion 314, addressing specifically the IRS) Formal Opinion 93-375 cites Formal Opinion 92-366. In the latter opinion, the ABA Standing Committee struggled with the language of the Model Rules ("tortured" in the words of the dissent) to develop a procedure that has come to be known as the "noisy withdrawal." In Formal Opinion 92-366 a lawyer learns that her client, in obtaining a bank loan in a prior year, furnished the bank with fraudulent financial statements. In connection with the loan, the lawyer furnished a favorable opinion concerning legal matters. The client has confessed the fraud to the lawyer but has decided not to notify the bank. The loan is still outstanding, and the client intends to continue to deal with the bank, although it proposes to use a different law firm in future dealings with the bank. The Formal Opinion holds that the lawyer must withdraw from the representation and must (notwithstanding Rule 1.6) disavow the outstanding legal opinion. The rationale of the Formal Opinion is that there is a continuing fraud that will be advanced by the lawyer's outstanding work product. Thus, the lawyer must disavow that work product in order not to violate Rule 1.2(d) by assisting in that ongoing fraud.

The problem with Formal Opinion 92-366 is that it has no satisfactory foundation in the Model Rules. It is effectively a rationalization designed to deal with client misconduct in the face of an unsatisfactory framework of ethical rules. Beyond that, it is clear that the noisy withdrawal procedure is available only where there is a continuing fraud that will be assisted by the lawyer's outstanding work product. You are perplexed because it is not at all clear that those circumstances exist in your situation. In short, you find no definitive solution to your problem.

The ABA Commission on Evaluation of the Rules of Professional Conduct (the "Ethics 2000 Commission") has recommended various changes to the Model Rules and those changes are currently under consideration by the ABA House of Delegates. Among these recommendations is a proposal to permit (not require) a lawyer to disclose client crime or fraud where necessary to prevent "substantial injury to the financial interests or property" of another or to rectify the consequences of such crime or fraud. However, at its August 2001 meeting in Chicago, the ABA House of Delegates soundly rejected this liberalized disclosure provision. The House of Delegates has not yet completed its work on the recommendations of the Commission, and it is quite possible that this issue will be revisited, probably at the February 2002 meeting in Philadelphia.

Proponents of liberalized disclosure argue that lawyers should be vested with the right to disclose client fraud for several reasons. First, they argue that third parties should not suffer economic damage as a result of client misconduct. Second, they argue that the existence of the right to disclose, whether or not ever exercised by the lawyer, furnishes the lawyer with a tool that can be used to convince the client to take remedial action. Third, they argue that it is in the lawyer's economic interest that disclosure occurs because, if the fraud is not uncovered and third parties suffer, the lawyer may face claims for damage. Finally, proponents note that the professional rules adopted in forty-one states depart from the ABA Model Rules or Code by allowing lawyers, subject to various conditions, to disclose client fraud. Thus, they contend that the proposed change to the ABA Model Rules will simply bring them into conformity with the rules in a majority of states.

Opponents of the proposed change argue that a disclosure option is antithetical to the fundamental lawyer/client relationship. For example, a monograph prepared by the American College of Trial Lawyers states, "The Model Rules and the Code of Professional Responsibility foster trust between client and attorney by placing no duty on the attorney to discover and prevent illegal conduct and by prohibiting disclosure of a client's secrets in all but the most extreme and carefully limited instances." The American College also criticizes the role that the proposed rule would impose on the lawyer. It states, "In many respects, the attorney's role under the proposed Rule would resemble a combination of prosecutor, judge and jury; he would gather information about possible fraud, render a decision, and then exact a punishment—disclosure—as he saw fit in a context in which the client no longer has a legal representative or advocate." Further, opponents argue that the ethical obligation of confidentiality is rooted in the principle that full disclosures by clients to their lawyers is facilitated by the rule requiring strict confidentiality. Relaxing that rule, they argue, will militate against full disclosure.

In the fact situation considered above, there probably would be near universal agreement that the fraud should be corrected. However, whether the lawyer should be authorized under the ethical rules to effect that correction by making disclosure without client consent is less clear. Are lawyers always able to determine whether fraud has occurred? In our hypothetical situation, the fraudulent nature of the conduct is clear, but if the alledgedly fraudulent conduct was the client's participation in a transaction that is viewed by some as fraudulent but by others as only aggressive, how is the lawyer to judge? Is tax fraud the kind of fraud that will result in substantial injury to the financial interests of another? What makes it "substantial?" If the lawyer does elect to make disclosure, and if the allegedly fraudulent transaction is later sustained as valid under substantive law, is the lawyer at risk of damages to the now-offended former client? Should a lawyer always be permitted to withdraw from a representation that may involve client misconduct? Should a "noisy" withdrawal be permitted or required?

These are important questions that are now being debated within the ABA. Lawyers who have views on this subject should convey them to members of the ABA House of Delegates. ■

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