

Your Ethical Dilemma

Sometimes a client files financial information you later discover to be false. What could you have done to prevent it and what should you do now?

By Linda Fidnick

Suppose that Dave has been represented during the preliminary stages of his divorce from his wife Karen by Attorney Smith. Dave is now in the process of buying himself a house and settling into his new single life. He is ready to proceed with the divorce.

Dave is self-employed and has told Attorney Smith that his business did not do well this past year, although it has been quite lucrative in other years. Attorney Smith has seen Dave's tax return, which is consistent with what Dave has told him about his reduced income.

Dave's wife Karen, based on her experience with Dave's business, is suspicious of his claim. Through her attorney, she makes a motion for Dave to pay additional support during the pending divorce. Attorney Smith is confident about the level of Dave's support payments; Dave's sworn financial statement and tax return, which have been submitted as evidence, make it obvious that Dave simply can't afford more support.

On the day of the hearing, Karen and her attorney present Dave's recent application for new home financing in support of their claim. Attorney Smith is shocked to find that the income reported by Dave to the bank is substantially higher than the income Dave stated to him, the IRS, and the court.

Now, Dave is in a dilemma. Isn't it natural that he would want to put his best foot forward for the bank and hide what he can from the IRS and his soon-to-be ex-wife? Attorney Smith is in a dilemma. His client has filed financial information with the court that now appears to have been false. What could he have done to prevent this and what should he do now?

The court is in a dilemma. It has a number of pieces of contradictory evidence to consider. One thing the court has learned, though: Dave is not a trustworthy witness, and Attorney Smith may be suspect as well.

The fair division of marital assets depends on full financial disclosure by both parties. However, some clients believe that hiding assets or income will earn them an advantage in the final division of the family's property. Such nondisclosure does a disservice to the court and can place both the client and attorney in jeopardy.

All states require some form of financial disclosure by divorcing spouses. Many also require the attorney to sign the client's financial statement certifying that he or she is unaware of any misstatements in the document. To avoid possible penalties of perjury and the almost certain loss of credibility that results from a client's failure to disclose income, both attorneys and clients must be aware of their obligations.

The lawyer's viewpoint

Under no circumstances can a lawyer offer evidence in court or to a third person that is known to be false. Under the American Bar Association Model Rules of Professional Conduct, not only is a lawyer prohibited from offering in court evidence known to be false, but if the lawyer later learns it was false the attorney must remedy the situation. This may include revealing the falsity to the court. (Rule 3.3 Candor Toward the Tribunal.)

Rule 4.1 (Truthfulness in Statements to Others) requires a lawyer to disclose to a third person any fact known to him when disclosure is necessary to avoid assisting a client in committing a fraudulent act, such as hiding income in a divorce. In many states, the standard under that state's version of the Model Rules of Professional Conduct is higher, extending the prohibition to evidence offered or statements of material fact that the lawyer reasonably believes to be false.

A "reasonable belief" is that which a reasonably prudent and competent lawyer in the same situation would believe. This requirement means that the attorney must use independent judgment to determine whether or not the client's financial disclosure is credible. In states in which the lawyer must also sign the financial disclosure form, the lawyer may be certifying to no actual knowledge of a misrepresentation or, depending on the jurisdiction, may be held to a standard of knowledge a reasonably prudent lawyer would have ascertained. This requires the attorney affirmatively to ask the questions necessary to ascertain accurate and complete information.

In addition, Rule 11 of the federal and state rules of civil procedure states that by signing a court document, a lawyer is certifying that she has good grounds to support the information contained in the document. Violating Rule 11 can subject an attorney to sanctions by the court and/or report to the state attorney-discipline board.

The lawyer's obligations

1. Inform the client of the full-disclosure requirement. Rarely does a client announce that she is lying about hidden income or directly ask the attorney to lie. The more common and more difficult problem arises when hidden income is truly undetectable, and the client is savvy enough not to tell the attorney about it directly. A client may tip his or her hand by describing cash management with a wink, mentioning that certain workers are paid "under the table."

It is the lawyer's ethical responsibility to inform clients that they have an obligation to report all income on the divorce financial disclosure statement, whether or not it is otherwise traceable. This can be a bitter pill for a client who has gone to the trouble of hiding income, whether recently in anticipation of the divorce or over many years of dodging taxes. However, given the serious consequences of perjury and/or failure to adhere to the rules of professional conduct, it is wise for the attorney to make it clear

from the very beginning of the representation that the client is required to make a full disclosure.

2. Seek supporting documentation. An attorney need not know that every single number on a client's financial disclosure form is perfectly accurate. There is, however, an obligation to inform the client that he or she is required to make an honest and complete declaration of all sources of income and assets. The lawyer also has an obligation to review the financial disclosure statement for accuracy and completeness and to question discrepancies between the form and any other statements made by the client. The attorney should seek and compare supporting documentary evidence, such as tax returns, corporate financial statements, and bank records.

3. Promptly correct false or misleading information. When a client has been called on hidden income, the next question usually is "but you are my lawyer and you can't tell anyone, right?" The answer to this question is complex. If the disclosure is in the early stages of the case and no representations have been made to the opposing side or to the court and the client agrees to tell the truth thereafter, the lawyer is under no obligation to report the nondisclosure.

The question becomes more difficult when a financial statement has been filed with the court. The lawyer is then under a duty to take remedial measures to correct the false statement. This means a new financial statement must be filed as soon as possible. If interrogatories were answered, new answers must be filed. Similarly, if meetings with the opposing side or letters contained an understatement of income, this misrepresentation must be corrected immediately.

Assuming that the client is cooperative and accepts his or her obligation to tell the truth, as a practical matter, no explanation for the correction is necessary. Any experienced lawyer has undoubtedly had a similar experience and, generally, the new information is accepted with no further ado, as long as no orders have been issued based on the false information.

If the tribunal has made a decision or otherwise relied on the understated income, if the lawyer is going to continue to represent the client, the lawyers must undo whatever has been done in reliance on the false statement. This is a very delicate process, as attorneys are obligated both to protect client confidences (Rule 1.6), and to avoid assisting a criminal or fraudulent act by a client (Rule 4.1). If a client refuses to allow the lawyer to disclose the information that will correct the falsehood on the statement, the lawyer must withdraw from representation, following the tenets of Rule 1.16 (Declining or Terminating Representation).

Disclosure of the fraud is generally not required in most states. In some jurisdictions, however, such as Massachusetts, New Jersey, and Wisconsin, not only must the lawyer withdraw, but he or she also must disclose even noncriminal fraud to the court. It is critical to know the bounds of advocacy in the jurisdiction in which the divorce action takes place.

Once the client has corrected the financial statement to reflect true income, other manifestations of the misrepresentation must be addressed. It is likely that the client also has underreported income on tax returns. If tax returns will be submitted as evidence of past income, they must be amended to reflect true income.

The client's obligation

1. Understand the obligation of full disclosure. Clients often believe that they do not have to make complete disclosure of income in the course of a divorce. This is particularly true for those who have been involved in business for a long time and who have not fully reported income on their tax returns. Such clients may believe that they don't need to report all of their income because they haven't yet been caught by the IRS, which they perceive to be a more formidable entity than the local family court. Unfortunately, there are many examples in business and professional communities of those who successfully avoid paying taxes.

In other cases, a client angered by the behavior of the other spouse can feel entitled to punish him by failing to disclose financial information. ("He doesn't deserve to get his hands on my 'under the table' pay after what he did!") For better or worse, the obligation to report honestly all forms of income does not rest on what the IRS believes or on the culpable spouse's behavior. The requirement is unwavering.

Why is accurate financial disclosure so important? The client must convince the court of the rightness of his or her position in the case. Particularly on financial issues, the two prerequisites for a favorable decision are that the judge has received sufficient accurate information and that the client is credible. The importance of credibility cannot be overstated. If a client's failure to disclose financial resources to the court is discovered, it is extremely difficult for that client ever to recover credibility in the eyes of the court. All testimony offered by that client thereafter, no matter how accurate, may be suspect. Perhaps the best argument is that without full disclosure of all income, the divorce judgment is always subject to being reopened. If false, misleading, or incomplete financial evidence is submitted and the court makes a judgment or the parties make an agreement based on that evidence, then the final divorce is always subject to being reopened and retried at great additional expense and at great disadvantage to the nondisclosing spouse.

2. Fill out financial forms accurately and completely. In an effort to make things easier, a client may believe that interpreting requests for financial information in the narrowest possible manner is best. The client will complete the financial disclosure form (mandated by all divorce courts in one form or another) accordingly; the forms have limited space and may not include a designated line for the exact type of income the client would rather not disclose. Thus, the form can be filled out by a determined client 'accurately' but incompletely. This is a trap; most financial statements include catchall language, requiring disclosure of all income not disclosed elsewhere on the form. More important, most judges lose patience immediately when confronted with a hypertechnical (and often absurd) exclusion of income, as when the self-employed litigant says: "Your honor, I didn't include the paycheck I wrote weekly to my six year old because I didn't really

benefit from that paycheck because I wrote a check out each week to my six-year-old son. Yes, I cashed it, but I put it in a bank account for him for college!”

If the financial structure of a client’s life is so complex that the court may not understand representations on the financial disclosure form, supplement the form with additional explanatory notes. The financial disclosure statement in a divorce proceeding is as serious as a tax return or a bank loan application, and the penalties for misrepresentation are severe.

For the client who has not reported income honestly on past tax returns, completing a financial statement presents a special dilemma with no easy solution. The financial statement must be accurate. It can be subpoenaed by the IRS in an audit. Filing a fraudulent financial statement in court exposes the client to prosecution for perjury. The divorce process may require past tax returns to be amended and taxes paid.

3. Understand the costs of failing to disclose income. Suppose that a client’s spouse has obtained evidence that the client’s financial statement understates income. The client’s credibility about anything will be eternally suspect.

This will mean that for the judge to be convinced of the client’s view of the case, the judge may require everything in dispute to be corroborated. An independent accountant may need to be hired to audit the business and then testify about the results of the audit. Years of records may need to be introduced and explained, increasing significantly the length and cost of the trial.

If the hidden income is discovered after the trial, the cost may include relitigation of the entire case, often with successful motions for payment of attorney’s fees by the errant spouse. This can more than double the cost of the original litigation. If the hidden-income problem results in a report to the IRS, expensive and time-consuming audits may be triggered, and years of unpaid taxes, plus penalties and interest will be imposed.

The judge’s viewpoint

During the trial, the judge is in the vortex of a swirl of information and advocacy. To render a sound judgment in a divorce case, the judge needs sufficient credible evidence to support his or her findings. All financial judgments must be supported by findings of fact. Accurate financial disclosure statements that are internally consistent with other extrinsic financial information are basic building blocks of those findings.

What is the practical reality for the court? The judge must make a decision based on extremely limited information. At best, a judge may hear a few hours of testimony from the litigants. Based on that brief, highly structured observation of a person being examined and cross-examined, the court must make a judgment about credibility. The court’s decision may involve not only monetary issues, but also custody of children. Although the judge will try not to allow a failure to disclose income to contaminate a person’s credibility, judges are human, and a cloud will hang over that litigant. What helps the court in assessing a witness’s credibility? Documentary collateral support for information in the financial statement, especially as to disclosures likely to be

challenged by the opposing party, will enhance the disclosure statement and reassure the court about the client's truthfulness. An opposing party's documentary evidence contradicting a financial disclosure statement will not only undermine the judge's confidence in the financial statement and in the credibility of the client in a more global way, but may give unwarranted credence to the opposing party's position.

Lastly, losing the case because a judge determines there was incomplete or inaccurate financial disclosure or because the client's credibility was destroyed may be just the beginning of problems arising from failure to report hidden income. Judges can and do refer such matters to the local prosecutor for perjury charges, to the Internal Revenue Service for tax scrutiny, and possibly even the lawyer to the state disciplinary board for engaging in conduct involving misrepresentation. An informal poll of Massachusetts family court judges indicated that most had at one time or another reported a litigant or a lawyer for tax fraud or fraudulent misrepresentations on financial disclosure forms.

Attempting to hide income is simply never worth it.

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Hot Tip

Bursting Bubbles

The client who has hidden income for years is usually extremely unhappy with the lawyer who bursts the bubble. Chances are good that the client will threaten to find another lawyer, one who will really represent his interests. Let that client go. Losing the business of a paying client may be difficult, but losing the business of a lying client is always in the attorney's professional and, therefore, economic best interests.

—Linda Fidnick

Hot Tip

Insist on interrogatories

Issue interrogatories regarding cash held, cash transactions, and transfers with or without consideration (gifts). Insist that answers be filed under oath. Make the wrongdoer commit perjury to hide cash. It is not unusual for the successful cash-hoarding spouse to brag about his or her success after the divorce has been finalized. Unless you insist on the filing of answers signed under oath, you are waiving your client's detrimental reliance argument if you discover fraudulent transfers.

—Miles Mason, Sr., Memphis, TN

Lawyer's Checklist

Walk the Talk

- Immediately, preferably at the first meeting, inform the client of his and your duty to provide truthful and complete financial information to the court and the opposing party.
- Direct the client to disclose fully income and assets on financial disclosure forms. Suggest that he or she use actual bank records, credit card statements, tax returns, and previously filed loan applications for accuracy and consistency. Give the client a checklist (see page 37) of the many types of income.
- Request that the client provide copies of supporting documentation, including documents on which he or she recently has disclosed financial information, such as mortgage or other credit applications.
- Review the client's financial form for discrepancies, such as an unexplained disparity between expenses and income.
- If there are discrepancies, review supporting financial documents (personal and business tax returns, mortgage loan applications, bank records, etc.) with the client.
- If discrepancies cannot be resolved and the client is unwilling to explain and correct either the financial form or tax returns, indicate your need to withdraw from representation and review your obligation to disclose the fraudulent information to the court, based on the rules of your jurisdiction and the status of the case.

—L.F.

Client Checklist

Income

Because line items on financial disclosure forms often are not all-encompassing, here is a list of often-overlooked items that must be disclosed. This list is not meant to be comprehensive, but rather to provide examples.

- Barter arrangements
- Canceled indebtedness
- Tax-loss carryforwards
- Savings matching programs
- Deferred compensation
- Expense account reimbursement
- Contributions to retirement or pension plans
- Accrued vacation pay
- Tuition refund plans
- Employee stock option plans
- Tax-free dividends

- Trust distributions
- Severance pay
- Commissions and bonuses
- Worker's compensation
- Disability income
- Lottery winnings
- Prizes and awards
- Earned income credit and other tax credits
- Spousal or child support from someone not a party to the present case
- Veterans' or military benefits
- Social Security or pension income
- Unemployment compensation
- Rental income
- Cash or under-the-table income

Overall, in thinking about what should be reported as income on a financial statement, think of any money directed to you or for your benefit, to or for the benefit of any member of your family (or friend), for services or goods you otherwise would pay for personally, or for some kind of benefit to you or a family member or friend

—L.F.