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AVOIDING LAWYER LIABILITY IN THE WAKE OF KAYE, SCHOLER

BRIAN W. SMITH* & M. LINDSAY CHILDRESS**

For better or worse, the Kaye, Scholer case heralded a new era in the management of the relationship between law firms and financial institution clients. The Office of Thrift Supervision ("OTS") brought an administrative action against Kaye, Scholer, Fierman, Hays & Handler ("Kaye, Scholer") and three partners of the firm individually, alleging that the law firm committed malpractice while representing the now infamous Lincoln Savings and Loan Association ("Lincoln Savings") from 1984 to 1989.1 Kaye, Scholer had also represented American Continental Corporation ("ACC"), the parent of Lincoln Savings, since 1977.2

In just six days, the specter of an asset freeze,3 and the pressure exerted by the firm’s clients and by the banks holding the firm’s lines of credit,4 made the total disintegration of a large New York law firm seem imminent and caused the firm to settle with the OTS for a then record-breaking $41 million.5 The settlement also barred two of the firm’s partners from any further representation of federally insured depository institutions and restricted certain

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2 Id.
3 See 12 U.S.C. § 1818(i)(4) (Supp. 1994) (grants power to employ an asset freeze or “asset protection” as it is referred to by the OTS). This section has since been amended to apply Rule 65 of the Federal Rules of Civil Procedure in an attempt to grant due process protection to the attachment of assets. See Pub. L. No. 204, 107 Stat. 2408 (1993).
4 See, e.g., Susan Beck & Michael Orey, They Got What They Deserved, AMER. LAW., May 1992, at 68, 69; Michael Orey, The Lessons of Kaye, Scholer: Am I My Partner’s Keeper/Am I My Client’s Keeper?, AMER. LAW., May 1992, at 3, 81; Amy Stevens & Paulette Thomas, Legal Crisis: How a Big Firm Was Brought to its Knees by Zealous Regulators, WALL ST. J., Mar. 13, 1992, at A1, A6; Kenneth H. Bacon, Kaye, Scholer Settles Charges in Lincoln Case, WALL ST. J., Mar. 9, 1992, at A3, A7. It is interesting to note that the asset freeze order was not, in the estimation of some, the sole cause of the swift settlement. Rather, it heightened the sense of terror caused by the astronomical $275 million suit. While the freeze order was carefully written to allow the law firm to continue to function and to utilize its lines of credit with the banks, the banks viewed a law firm facing such a large suit as being doomed. In effect, Kaye, Scholer had its financial feet taken out from under it.
activities of a third partner. The Attorney's Liability Assurance Society ("ALAS"), an insurer of large law firms, stated that this was the first instance within their knowledge where law firm partners were required to pay a portion of the settlement because it exceeded insurance coverage.\(^6\)

Kaye, Scholer also entered into a consent cease and desist order which articulated the OTS's theories concerning appropriate attorney action during the bank examination process under certain circumstances.\(^7\) The order requires Kaye, Scholer's banking practice group to supervise all future matters concerning financial institutions. A banking partner with ten years or more banking experience must act as the partner in charge whenever Kaye, Scholer provides significant representation of an insured depository institution. The order also requires Kaye, Scholer "not to knowingly make any misrepresentations of fact or omit any material information in communications to federal regulators on behalf of any clients covered by federal banking laws, or to engage in any conflicts of interest in representing such clients."\(^8\)

It is questionable whether any law firm could stand up to the intense pressure of administrative action backed by the threat of an asset freeze. This is especially true in light of the fact that most law firms lack liquid assets and utilize debt to fund day-to-day operations, and rely heavily on reputation to attract business.\(^9\) Whether one believes that Kaye, Scholer was railroaded or acted inappropriately and unethically, the fact remains that the case\(^10\) signaled an end to the false sense of security most lawyers had that the actions and activities of clients could not affect the


\(^7\) The argument has been made that the OTS's position with regard to Kaye, Scholer was unique because the consent order was designed to address specific wrongdoing and should not be considered definitive. See, e.g., Comments of the Office of Thrift Supervision on the Report and Recommendations of the ABA Working Group on Lawyers' Representation of Regulated Clients, 2 Bank Law. Liab. Rep. (Bureau) G-1, G-18 (Aug. 20, 1993) [hereinafter OTS Statement to ABA]; Lawrence G. Baxter, Overview of Federal Regulatory Attempts at Guidance or Control of Attorney Conduct, 534 ALI-ABA 265, 267, 270 (Dec. 10, 1993); Arthur W. Leibold, Jr., Zealous Representation of Thrift Clients; Can It Exist?, 534 ALI-ABI 189, 191, 193 (Dec. 10, 1993); Steve France, Unhappy Pioneers: For S&L Lawyers, Liability Has Displaced Ethics, 534 ALI-ABI 517, 530 & n.10 (Dec. 10, 1993).


\(^10\) For an interesting, albeit highly critical, discussion concerning the actions of the Kaye, Scholer attorneys and the internal memoranda which proved so damaging, see Beck & Orey, supra note 4, at 69.
law firm.

This Article intends to set forth the prevailing perceptions in the legal profession concerning the impact of the Kaye, Scholer case on a law firm's bank regulatory practice and to identify areas where a firm might establish policies to provide some protection against allegations of misconduct.

I. THEORIES OF LAWYER LIABILITY

The power which the OTS exerted over Kaye, Scholer stemmed, in part, from the new relationship between professionals and financial institutions forged out of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"). This statute was spawned in a political climate furious over the egregious abuses of certain individuals who took over thrift institutions and used them to further their own fraudulent and highly speculative schemes.

Section 204(f)(5) of FIRREA created a new term "institution-affiliated party" and defined it to include independent contractors. Attorneys are expressly included if they "knowingly or recklessly participate in (A) any violation of any law or regulation; (B) any breach of fiduciary duty; or (C) any unsafe or unsound practice, which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution." In addition, at least one commentator has pointed out that this "independent contractor" category is expanded by the FIRREA definition of "violation" which "includes any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding and abetting a violation." The First Interim Report of the American Bar Association Task Force on the Liability of Counsel Representing Depository Institutions, ("ABA Task Force Exposure Draft"), outlines the theories

of attorney liability articulated by the then Chief Counsel to the OTS, Harris Weinstein. These theories have caused an increasing level of uncertainty among both attorneys and their financial institution clients concerning the proper role of attorneys when representing financial institutions and the continued reliability of codes of conduct and the opinions of the courts, the state bars and the ABA concerning the ethical conduct of attorneys.\(^\text{15}\)

The most striking of these theories is that attorneys representing financial institutions owe a fiduciary duty to the government based on one of several alternative arguments:

The government holds a "negative equity" interest in the financial institution because it is the holder of "potentially unlimited equity risk" in the institution.\(^\text{16}\)

The government in situations of imminent insolvency, should be considered comparable to a creditor under bankruptcy law because it is the largest single potential creditor of an institution.\(^\text{17}\)

The government is the insurer and is therefore subrogated to the rights of the insured.\(^\text{18}\)

In addition, Mr. Weinstein also advanced the notion of an attorney's duty to advise directors of a financial institution (which clearly do have a fiduciary duty to the institution) of their fiduciary duty\(^\text{19}\) and a duty to practice the "whole law."\(^\text{20}\) The "whole law" concept requires an attorney to consider the essence of all federal statutes and regulations, as well as "concepts of safety and soundness," "concepts of fiduciary responsibility" and "the principle that imposes hostility to law avoidance schemes."\(^\text{21}\)

Mr. Weinstein also articulated theories concerning the lessons of the savings and loan crisis and the professional responsibility of lawyers which drew the attention of the legal community. In a 1992 speech, Mr. Weinstein noted that an attorney should:

1-47 (1992) [hereinafter ABA TASK FORCE EXPOSURE DRAFT].
\(^\text{15}\) Id. pt. IV, at 3.
\(^\text{16}\) Id. at 4.
\(^\text{17}\) Id.
\(^\text{18}\) Id. at 7; see Fisher, supra note 12, at 4-5 (discussing various theories of liability expounded by Mr. Weinstein).
\(^\text{19}\) ABA TASK FORCE EXPOSURE DRAFT, supra note 14, pt. IV, at 5.
\(^\text{20}\) Id. at 9.
\(^\text{21}\) Id. at 9-10 (quoting Advice on How to Exploit Loopholes May Be Unethical, OTS' Weinstein Says, 56 Banking Rep. (BNA) 616, 617 (1991)).
AVOIDING LAWYER LIABILITY

Be sensitive to the role he plays and the arena in which he acts (a lawyer acting as adviser in a bank examination has a different role from one acting as litigator).

Practice the whole law (rather than exploiting loopholes) by considering the totality of the law and the underlying principles and purpose of legal restrictions.

Respond to the regulators honestly and comply with disclosure and other regulations concerning submissions to the federal regulators.

When advising a fiduciary, be fully aware of the fact that the fiduciary must act in the best interests of the financial institution and remind the fiduciary of his duty, especially when counselling a client in a gray area of the law.

Report any unlawful activity of an officer, director, or employee up the corporate chain of command and ultimately to the board of directors, if necessary.

Not knowingly further the unlawful activity of a financial institution, or its directors, or officers.\(^\text{22}\)

II. WEAKNESSES OF THE LIABILITY THEORIES

The ABA Task Force Exposure Draft outlines the problems inherent in Mr. Weinstein's new theories of lawyer liability. The Task Force points out that the "negative equity" theory is not founded on prior precedent.\(^\text{23}\) An extension of that concept to the private sector would require all corporations to conduct their business with consideration of the best interests of their insurance carriers, a concept which is clearly problematic.\(^\text{24}\) Additionally, the interest being asserted is contingent in nature.\(^\text{25}\) This is also the case with the bankruptcy creditor approach. Until an entity is actually insolvent, the rights of a creditor are merely contingent.\(^\text{26}\) There is great difficulty in determining at what point an attorney's duty to the creditors of an insolvent financial institution would arise. The ABA Task Force points out that "a substantial gray area exists in terms of defining the exact distance from the brink where the obligation—and potential liability in an enforcement action—attaches."\(^\text{27}\)

\(^{22}\) ABA Task Force Exposure Draft, supra note 14, pt. IV, at 10-11.
\(^{23}\) Id. at 17.
\(^{24}\) Id. at 17-18.
\(^{25}\) Id. at 19.
\(^{26}\) See id. at 20.
\(^{27}\) See ABA Task Force Exposure Draft, supra note 14, pt. IV, at 20.
In addition, any theory involving the subrogation of the government to the rights of the depositors suffers from the fact that, in the past, the duty of an attorney to act in the best interests of the insured financial institution and its shareholders has not extended to depositors. Finally, subrogation only occurs after an insured financial institution has failed and the depositors have been reimbursed for their losses. At that point, the government first succeeds to the rights of the depositors.

The ABA Task Force also criticizes Mr. Weinstein's theory of the "whole law," noting that the history of banking regulation is full of instances where creative bank regulatory lawyers utilized "loop-holes," such as the creation of "nonbank" banks, and the conversion of banking institutions between state and federal charters to take advantage of the special characteristics of each.

Perhaps the most frightening aspect of these newly expounded liability theories is the subjective nature of the duties. Such subjectivity will make it very difficult for an attorney to feel secure that he understands the duties he owes to others. In addition, the implementation of such duties would have a profoundly chilling effect upon the rendering of legal advice to financial institution clients. Attorneys would likely be unwilling to expound novel, albeit defendable, legal theories in "gray area" matters or unusual situations. Honest creativity may be sacrificed for an attorney's higher comfort-level.

III. CONFLICT OF INTEREST RULES AND PROFESSIONAL STANDARDS

Various attorney ethical rules are implicated in situations such as those in the Kaye, Scholer case. Questions arise as to when an attorney must disclose client misconduct to the board of directors of a financial institution or to the regulators, whether an attorney may withdraw, and whether he must do so in certain instances. Even the method by which an attorney withdraws is open to criticism. A discussion of the more relevant ethical rules follows.

28 Id. at 21.
29 Id. at 30.
30 Id. at 33-35.
31 Id. at 3.
A. Disclosure

The possible reporting of misconduct to third parties, whether to the directors of an institution or to the federal regulators, implicates the ABA Model Rules of Professional Conduct ("Model Rules"). Model Rule 1.6, concerning confidentiality and the disclosure of client confidences, allows a lawyer to reveal information relating to the representation of a client (i) after consent of the client; (ii) when impliedly authorized to carry out the representation; (iii) to the extent that the lawyer reasonably believes the disclosure necessary to prevent the client from committing a crime that the lawyer believes is likely to result in imminent death or substantial bodily harm; or (iv) to establish a claim or defense on behalf of the lawyer in a controversy with the client, as a defense to a criminal charge or civil claim against the lawyer based upon the conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client.

The question arises as to whether an attorney with knowledge of misconduct may inform the board of directors of the financial institution or the regulators of such misconduct. The Model Rules do not provide for disclosure to federal regulators in the absence of one of the above factors. Model Rule 1.13 makes it clear that, in corporate situations, the organization is generally the client. That rule provides for referral by the attorney of certain activities of an officer, employee, or other person associated with the organization to a higher authority in the organization, if the attorney knows that the activity or the refusal to act is a violation of a legal obligation to the organization or a violation of law which reasonably might be imputed to the organization. However, the rule requires the attorney to act as is reasonably necessary in the best interests of the organization. The rule does not require disclosure to the board of directors. In fact, the comment to the rule suggests that such disclosure is a permissible but unusual step which the attorney may take.\textsuperscript{32} The comment also notes that Model Rule 1.13

\textsuperscript{32} Model Rules of Professional Conduct Rule 1.13 cmt. (1993) ("[R]eview by the chief executive officer or by the board of directors may be required when the matter is of importance commensurate with their authority."); see Model Rules of Professional Conduct Rule 1.13. The Model Rule states, in pertinent part:

In an extreme case, it may be reasonably necessary for the lawyer to refer the matter to the organization's highest authority. Ordinarily, that is the board of directors or
neither expands nor contracts a lawyer's responsibilities under other rules, including the disclosure rules.

The current position of the OTS seems to be that, while the attorney may have a duty to report misconduct to the directors of a financial institution, this duty does not extend to reporting to the regulators absent special circumstances. However, the regulators have argued that Model Rule 1.13 requires the lawyer to attempt to change the offending conduct by talking to the perpetrator, and disclosing the problem up the chain of command to the directors, if necessary, to remedy the misconduct. Both the RTC and the OTS have taken the position that a lawyer's failure to inform the directors of misdeeds that are occurring may be the basis for lawyer liability.

B. Duty Not to Assist in Fraud

Model Rule 1.2(d) states that a lawyer may not counsel or assist a client in conduct that is criminal or fraudulent. Model Rule 4.1 states that while representing a client, a lawyer must not (i) make a false statement of material fact or law to a third person, or (ii) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting in the client's crime or fraud, unless disclosure is prohibited. Commentators have noted (under the prior version of the ABA's ethics rules, the Model Code of Professional Responsibility DR 7-102) that this rule should suffice to protect the interests of the regulators in not receiving fraudulent information through an attorney. The implication of higher ethical standards for attorneys of financial institutions is unnecessary in these commentators' view in order to protect the regulators.

similar governing body. However, applicable law may prescribe that under certain conditions highest authority reposes elsewhere; for example, in the independent directors of a corporation.

Id. (emphasis added).

33 See OTS Statement to ABA, supra note 7, at G-18 to G-20; ROBERT E. O'MALLEY ET AL., Financial Institutions Practice: Lawyers' Liability Issues, in ALAS LOSS PREVENTION MANUAL, at 5 (Feb. 1994); see also O'Malley, supra note 8, at 9; see also John L. Douglas & John K. Train, Kaye, Scholer Case: Lessons for Banking Lawyers and Clients, 11 BANKING POL'Y REP., May 4, 1992, at 1, 17 (attorneys' obligation to regulators is not to impead investigation). But see, e.g., Laborers in Different Vineyards? The Banking Regulators and the Legal Profession, REPORT BY THE ABA WORKING GROUP ON LAWYERS' REPRESENTATION OF REGULATED CLIENTS, pt. III, at 133-34 (1993) (discussing several cases with, at least, attorney disclosing improper client conduct to regulator agency).

34 See O'Malley, supra note 6, at 9.

35 Id.
The current version of this rule should provide sufficient protection, whereas a post-Kaye, Scholer rule might be counterproductive and even unconstitutional.\textsuperscript{36}

C. Withdrawal

Model Rule 1.16(a)(1) requires that an attorney withdraw from representation of a client if the lawyer's services will be used by the client and will result in a violation of the rules of professional conduct or law.\textsuperscript{37} An attorney may withdraw from representation if withdrawal can be accomplished without material adverse effect on the interests of the client and the client continues in conduct involving the attorney's services which the attorney reasonably believes is criminal or fraudulent or has used his services in the past to perpetrate a crime or fraud. In contrast, the OTS expects an attorney to withdraw his representation if the disclosure to the board of directors of the institution does not remedy the misconduct.\textsuperscript{38}

The comment to Model Rule 1.6 on confidentiality states that after withdrawing, a lawyer must continue to keep his client's confidences, except as provided in the rules. However, a lawyer may give notice of the fact of his withdrawal, and may also withdraw or disaffirm any opinion, document, or similar materials. This comment to Model Rule 1.6 has generated an especially interesting debate concerning whether this so-called "noisy withdrawal" comment allows an attorney, by his actions in withdrawing, to expose a client who has or intends to use the attorney's work product to commit a fraud.\textsuperscript{39}

D. Conflicts of Interest

Model Rules 1.7 through 1.10 concern conflicts of interest. The general rule concerning conflicts of interest is Model Rule 1.7, which requires client consent when a law firm intends to repre-

\textsuperscript{36} See Pitt & Johnson, supra note 9, at 7. [The authors] question whether such a broad rule of ethical transmogrification is either appropriate or necessary. Id. The resulting additional costs for liability insurance for lawyers and quasi-judicial proceeding might violate due process. Id.

\textsuperscript{37} See also MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6(A)(1) cmt. (1993) (concerning withdrawal); MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(B) (1993) (in connection with organizations) (emphasis added).

\textsuperscript{38} See O'Malley, supra note 6, at 9.

sent one client in a matter directly adverse to another client, or where the representation of a client may be materially limited by the attorney's responsibilities to another client, a third person, or the attorney's own interests. In either case, the attorney must reasonably believe that the representation will not adversely affect the relationship with the other client. The comment to Model Rule 1.7 requires that a law firm adopt reasonable procedures to determine the parties involved in both litigation and nonlitigation matters and whether there are actual or potential conflicts of interest.

The comment to Model Rule 1.7 also discusses the conflicts which may arise when an attorney is also a member of the board of directors of a client. The comment notes that the attorney could conceivably be called upon to render advice to the corporation concerning the activities of the board. The attorney should consider the frequency of such requests, the potential extent of the conflict, the effect of the attorney's resignation from the board, and the possibility of the corporation obtaining independent advice from another attorney in such instances. "If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director."40

A lawyer may also not "enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless . . ." the transaction and terms are fair and reasonable, fully disclosed in writing to the client and the client consents after reasonable time to consult with other counsel.41 The comment to Model Rule 1.8 specifically excludes the normal provision of services where the lawyer does not have special advantage. Presumably, this would be the case in many lending situations, although as discussed below, such interrelationship between a financial institution and a law firm or individual law partners is not recommended.

After termination of a relationship with a client, a lawyer may not represent another client in the same or substantially related matter in which the interests of the two clients are materially adverse, unless the former client consents. A lawyer also may not

41 Model Rules of Professional Conduct Rule 1.8 (1993) (lawyers potential conflict of interest with client may be overcome).
represent another client in a same or substantially related matter in which a firm with which the lawyer was formerly associated had represented a client whose interests are materially adverse and about whom the lawyer had acquired protected information, unless the former client consents after consultation. A lawyer may not use information relating to the representation of a former client or client of his present or previous firms, unless the information has become generally known or certain other rules permit or require such use. A lawyer may not disclose information relating to the representation unless certain rules permit or require such disclosure. In certain instances, the entire law firm is disqualified as a result of the conflict of one partner.42

Clearly there are many instances when an unwary law firm can fall into a conflict situation. Conflicts of interest may arise between a financial institution on the one hand and the holding company on the other. Law firms often do work for a financial institution in addition to advising the board of directors of the financial institution concerning regulatory matters. Should this “other work” be a problem, there may be a budding conflict of interest. In such instances, the engagement letter should clearly outline the various matters to be handled on behalf of the institution. Law firms should also consider creating complete lists of the various matters completed for a client and review this list periodically for developing conflicts of interest.

IV. THE CONSEQUENCES OF KAYE, SCHOLER ON LAW FIRM BANK REGULATORY PRACTICE: AVOIDING THE PITFALLS

Careful attention to established criteria for client acceptance and active management of the client relationship will be essential to minimizing the potential for liability.

A. Know Your Client

The days in which a law firm should consider accepting the business of any potential client which crosses its threshold are gone. Potential clients may mean lucrative fees and additional

42 See Model Rules of Professional Conduct Rule 1.9(b) (1993) (when attorneys will be barred from representing adverse parties of former clients of present or previous firm); see also Model Rules of Professional Conduct Rule 1.10(b) (1993) (firm disqualified when matter is substantially related and lawyer is privy to information).
business, but they may also bring with them the potential for suits against the law firm, charges of malpractice, and enormous risk. The current liability situation suggests that the best protection for a law firm wishing to avoid possible liability is to choose carefully what business the law firm should accept and what business poses too many threats to justify its engagement.

The question becomes how a law firm decides which clients have positive potential and which will be more risk than they are worth. A law firm now must devote time and energy to a review of the general reputation, financial standing and the standing among the regulators, auditors, and other lawyers of a potential client, prior to accepting the representation. A law firm should be wary of being called into a transaction in progress or without being given adequate lead-in time. The appearance that the law firm may have replaced an earlier law firm because it would agree to do for the client what another law firm would not, will be damaging whether or not true.

Finally, law firms will want to continue to monitor the financial and regulatory standing of their financial institution clients to ensure that they remain low-risk clients.

B. Specify the Extent of the Representation in Writing

A law firm can further protect itself by clearly defining the specific nature and scope of its representation of each client in its engagement letter. The letter should clearly define when the client

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43 ABA Task Force Exposure Draft, supra note 14, pt. VI, at 3-4.
44 Id. at 11.
45 See FDIC v. O'Melveny & Myers, 969 F.2d 744, 746-47 (9th Cir. 1992) (noting that Rogers & Wells was dismissed as counsel and replaced with O'Melveny & Myers soon after Rogers & Wells advised bank that audited financial statements were necessary for deal, though none were prepared), cert. granted, 114 S. Ct. 543 (1993).
46 See ABA Task Force Exposure Draft, supra note 14, pt. VI, at 9; O'Malley, supra note 6, at 4.
became a client and what purpose the representation serves. One area of particular danger involves loan transactions. A law firm working on a loan transaction for a financial institution should make clear that its representation does not include advice concerning the institution's compliance with regulatory lending limits or other regulations, if such is the case.\textsuperscript{48}

A law firm should not make the mistake of being lulled into a false sense of security simply by defining narrowly the scope of its representation of a particular client. The fact that the scope of representation covers one area only, may actually expose the law firm to additional risk because the firm may be unaware of all of its client's actions. The firm can easily become unconscious of its increasing role vis-à-vis a particular client and could, in an antagonistic situation with the regulators, be imputed to know more than it is actually aware. A firm should carefully monitor its ongoing relationships with its clients so as not to be inadvertently drawn into such an expanded scope of representation. It should be clear on what it is being asked to do in any given case. An affirmative determination to expand the scope of the representation of the client should be made if the breadth of legal representation is broadened.

Whenever a firm has decided to expand the scope of representation of a client, it should revise its engagement letter to reflect the expanded scope.\textsuperscript{49} In addition, extra attention should be paid to the nature and extent of matters in which the firm is advising the institution. An aggressive peer review process is particularly helpful in determining if the "aggregate of knowledge" accumulated through the many relationships raises the liability threshold of the firm. A detailed list of all matters performed for a client should be periodically updated and reviewed for conflict of interest situations and an overly expansive representation.

On the other hand, a law firm which acts as general counsel to a banking institution is much more likely to be viewed as agent of that institution. Many of the suits brought against law firms have included partners who acted as directors, stood to gain monetarily from various transactions, or acted as general counsel to the institution. Firms acting as general counsel or regulatory counsel, eas-

\textsuperscript{48} See O'Malley, \textit{supra} note 6, at 5.

ily viewed as "institution-affiliated parties," remain at the highest risk according to ALAS.  

C. *Do Not Speak as Your Client's Alter Ego*

One of the major criticisms leveled at the attorneys at Kaye, Scholer was their alleged efforts to position the firm between Lincoln Savings and the regulators. According to the regulators, by precluding the agency from having free access to the thrift, the firm became a spokesperson for the thrift and stepped into its shoes, thereby assuming its duty of complete disclosure.

This duty, it is reasoned, arises from the Code of Federal Regulations:

No savings association or director, officer, agent, employee, affiliated person, or other person participating in the conduct of the affairs of such association... shall knowingly: (1) make any written or oral statement to the [OTS]... that is false or misleading with respect to any material fact or omits to state a material fact concerning any matter within the jurisdiction of the [OTS].

While normally this duty extends only to the institution, it was argued by the regulators that Kaye, Scholer stepped into the shoes of Lincoln by positioning itself as the intermediary between the thrift and the regulators and by determining what information the regulators did and did not receive.

Attorneys who appear on behalf of or make submissions for financial institution clients should carefully clarify to the regulators that any factual representations are made by the client itself and that the attorney is merely relaying the communication, rather than acting as the client's alter ego. The lawyer should also attempt to make a reasonable inquiry concerning any infor-


51 12 C.F.R. § 563.180(b) (1993); see, e.g., Douglas & Train, supra note 33, at 17; O'Malley, supra note 6, at 7; Beck & Orey, supra note 4, at 74; Orey, supra note 4, at 81; Stevens & Thomas, supra note 4, at A6.

52 See Douglas & Train, supra note 33, at 17; O'Malley, supra note 6, at 7; Orey, supra note 4, at 81; Pitt & Johnson, supra note 9, at 6; see also O'Malley et al., supra note 33, at 4-5 (concerning Formal Opinion 93-375 of the ABA Standing Committee on Ethics and Professional Responsibility). Kaye, Scholer argued that it did not position itself between the regulators and the institution. See Liebold, supra note 7, at 193.

53 See Pitt & Johnson, supra note 9, at 7.
mation given to the regulators if the attorney has reason to believe that something is amiss. For example, if the attorney's general observations, knowledge about the institution, and basic market inquiries give him reason to doubt information being relayed to the regulators, he should take it upon himself to make further inquiry. Prior to making a submission on behalf of the client, the attorney, whenever possible, should send a draft to the client to receive verification and assurance that the statements made in the submission are correct and not misleading.

D. Remember the Arena in Which You Act

Peter Fishbein, the principal partner in the Kaye, Scholer case, was first and foremost a litigator. He viewed the bank examination process with the eye of a litigator. Allegedly, he admitted to the regulators that he had not read the governing banking regulations prior to representing the S&L in the examination. In their view, he had no bank regulatory experience, did not seek advice from the partners in his firm who specialized in bank regulatory work, and did not familiarize himself with the regulations of the new arena in which he found himself. Consequently, he allegedly treated the bank audit as litigation and viewed his ethical and legal obligations to his client as such. The OTS viewed his ethical responsibilities differently.

According to many commentators, Mr. Fishbein's allegedly contentious method of dealing with the regulators was critical to how the regulators later viewed Kaye, Scholer's actions. The act of Fishbein in sending a letter to the Federal Home Loan Bank Board of San Francisco requesting that all further correspondence with Lincoln be funneled through Kaye, Scholer "shocked" the regulators, who responded by writing back that this request "reflects a fundamental misunderstanding of the examination process. An examination is not civil litigation discovery. . . . Unfettered access, including the ability to appear at [a thrift] without advance notice is essential to the fulfillment of [the regulators']

54 Id.
55 Id.
56 See Beck & Orey, supra note 4, at 70.
57 See Kaye, Scholer's Big Mistake was to Interfere With Its Own Defense, Top U.S. Lawyers Suggest, 1 Bank Law. Liab. Rep. (Buraff) 1, 1-2 (Apr. 23, 1992) [hereinafter Kaye, Scholer's Big Mistake].
58 Id.
function." While there is continued debate whether lawyers practicing bank regulatory work have or should have a heightened standard of ethics, it is clear that a knowledge of the normal method of business of the particular arena in which an attorney is acting is invaluable in determining what actions will be most effective with the least risk.

E. Fully Utilize Your Firm's Talent

A firm should also provide checks for partners working in areas outside their usual area of practice. The creation of a system of peer review, whereby a partner in each practice area is made aware of the activities of all partners of the firm in such area, is recommended. The partner can therefore set the tenor of the firm's representation of clients and is more likely to be aware of conflicts of interest. In addition, a partner in each office should be in charge of monitoring the general activities of all partners for a particular client.

No longer should each partner be seen as an island unto himself. An "eat what you kill" firm mentality may prove simply too costly to the firm in general. A firm should stress the interdependence of each partner to the others and fully encourage the interaction between partners. This will help to ensure that no one partner is a "loose cannon" acting unwisely or outside the scope of his expertise.

59 See Beck & Orey, supra note 4, at 70 (quoting Letter from B.J. Davis, FHLB Director of Examinations, San Francisco, to Peter Fishbein, partner at Kaye, Scholer) (emphasis added); see also Orey, supra note 4, at 81.
60 ABA TASK FORCE EXPOSURE DRAFT, supra note 14, pt. VI, at 13.
61 See Kaye, Scholer's Big Mistake, supra note 57, at 2.
62 See O'Malley, supra note 6, at 6; see also ABA TASK FORCE EXPOSURE DRAFT, supra note 14, pt. VI, at 45-46. It is interesting to note that the Jones, Day settlement with the OTS:

- constituted the final disposition of all allegations for penalties and non-monetary administrative relief that could have been brought by the OTS against the Firm in connection with any aspect of its representation of [six specific thrifts], and no future proceedings shall be commenced against the Firm with respect to any penalties and non-monetary administrative claims that could have been alleged by the OTS against the Firm in connection with the Firm's representation of these insured depository institutions. . . . The OTS, however, expressly reserved the right to seek any and all non-monetary administrative relief as to present or former partners, other attorneys or employees of the firm individually in connection with any aspect of such person's participation in the Firm's representation of [the six thrifts].

While the “peer review” concept may seem distasteful to many lawyers at first, it is a critical function. The fact that the actions of one partner may be imputed to the whole firm and potentially involve risk to the private assets of each and every partner should serve to temper any distaste one might have concerning the review of one’s partners. In addition, if partners are encouraged to utilize and seek out the expertise of the firm whenever they have a specific issue, the interdependence will be viewed in a positive, community light, rather than as a policing function. As one commentator states: “[C]ross-selling . . . services—partners in one practice group introducing their clients to partners in other practice groups. It’s a good way to build business. But it may also be a good way to head off a professional liability suit. It’s something Kaye, Scholer conspicuously did not do at Lincoln.”

F. Review Your Document Retention Policy

In many instances, the receiver of a failed institution has been able to waive the attorney-client privilege of the institution and has had full access to law firm files related to the representation of the financial institution. ALAS, noting that the case against Kaye, Scholer was based in part on internal documents, suggests revision of firm document retention policies and advises that attorneys should avoid keeping handwritten notes, which often are misconstrued or taken out of context.

G. Avoid the Appearance of Conflicts of Interest

A law firm should seriously consider prohibiting or severely restricting the appointment of any of its partners to directorships of financial institutions. ALAS considers a partner in a law firm representing the institution also acting as a director of a financial institution to be a high risk activity. In the event that a law firm continues to allow firm partners to sit as outside directors of financial institutions, the firm, at a minimum, should require that the financial institution be healthy and should continue to monitor the health of the institution as long as the partner remains a

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63 See Orey, supra note 4, at 3.
64 See O'Malley, supra note 6, at 6.
65 See Insurer Reports Profits Up, supra note 50, at 3; O'Malley, supra note 6, at 4; see also ABA Task Force Exposure Draft, supra note 14, pt. VI, at 5.
Attention should be paid to the nature and extent of the relationships between partners in the firm and matters in which the firm is advising the institution. An aggressive peer review process is particularly helpful in determining if the "aggregate of knowledge" accumulated through the many relationships raises the liability threshold of the firm.

Even the mere appearance of potential conflicts of interest is highly risky. A law firm should not obtain credit from a financial institution or invest in a transaction which involves such a client. ALAS considers the "worst scenario" when a law firm represents both the borrower and the lender in a transaction and the borrower defaults. An additional danger is presented when the borrower is a client of a firm and the firm is acting as the lender's counsel. A law firm should have a system for identifying such client conflicts.

The fact that a law firm's partner is sitting on a financial institution's board of directors while the firm represents a client in negotiating a workout of a troubled credit is another scenario raising serious conflict issues. The firm and the partner-director should consider the nature and necessity of the partner-director's disclosure of the "interest" involved. The partner should consider recusing himself from participation in the board's discussion of the particular matter. On the other hand, the regulators may consider the "sitting out" of the partner-director to be depriving the institution of a valuable resource. Should the financial institution fail, the firm and the partner-director can expect to be carefully scrutinized.

Even the simultaneous representation of both a financial institution and its holding company may be risky. The OTS has warned against such representation. Indeed, some of the crit-
cisms leveled against Jones, Day, Reavis & Pogue ("Jones Day") in its settled case centered upon the allegation that there was a conflict of interest in Jones, Day's representation of both ACC and its subsidiary, Lincoln. The OTS alleged that Jones, Day violated its fiduciary duties to Lincoln in part because it did not inform the directors of Lincoln of the problems which it had uncovered, but rather informed the general counsel of ACC, and ACC was controlled by those perpetrating the fraud.70 This conflicts problem can and should be addressed in the engagement letter by disclosing the potential for such conflicts inherent in the situation and mapping out a procedure for their resolution. Both the client and its holding company should agree to the terms of such anticipated resolutions.

CONCLUSION

It remains to be seen which of the new theories of lawyer liability will become established law and which will remain part of the lore of law firm bank regulatory practice. However, regardless of the outcome of the debate among those in various areas of the legal profession concerning such theories, the increased exposure of firms with financial institution clients, is likely to be perceived for some time to come. However, as the preceding section noted, a firm can minimize its exposure through modification of some of its internal policies and procedures. That change in the internal practices of a law firm may be the most substantial legacy of what may become known as the "Kaye, Scholer Asset Freeze Scare."

requirements regarding fiduciary responsibility, or principals of safety and soundness and it concluded that the client should evaluate the matter in light of the question involved, the firm would so advise the client and would consider applicable rules of professional conduct. The letter is currently in the final stages of approval for nationwide use and is expected to be virtually identical to the tested draft letter.
