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Law Firm Kaye, Scholer, Lincoln S & (and) L and the OTS

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I. INTRODUCTION

"[B]anking agencies have an incentive to go after lawyers . . . . The regulators are, after all, receivers for the estates of failed thrifts . . . ."1

Between the last half of 1989 and June, 1992 banking regulators have obtained about $174 million from lawyers who they have sued for various infractions of their professional responsibility.2 Although the list of reported cases where federal regulators have gone after lawyers is sparse,3 the number of actions is growing. As of June, 1992 the Resolution Trust Corporation (RTC) or the Federal Deposit Insurance Corporation (FDIC) had suits pending against major law firms in Minneapolis, Minnesota; New York, New York; Dallas, Texas; Cleveland, Ohio and Los Angeles, California.4 In May, 1992 James S. Fleischer, an attorney in the Washington firm of Silver, Freedman and Taft agreed to pay $600,000 for rendering

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2. Edward Adams, Thrift Litigation Fallout; Suits Increasing; Firm Grip on Lawyers Sought, N.Y. L.J., June 18, 1992, at 5.
4. See Adams, supra note 2, at 5.
an unqualified legal opinion to Lincoln Savings and Loan. In April, 1992 a Pittsburgh law firm, Eckert, Seamans, Cherin & Mellot agreed to settle an FDIC malpractice suit for $24 million. In March, 1992, the Office of Thrift Supervision (OTS) settled a $275 million claim against the New York law firm Kaye, Scholer, Fierman, Hays & Handler (Kaye, Scholer). This case focused attention on the standards applicable to a lawyer’s representation of an insured depository institution, particularly savings and loan associations, or as they are also referred to, thrifts.

This article will focus upon the Office of Thrift Supervision’s (OTS) actions against the law firm Kaye, Scholer. Part II will give some background on Lincoln Savings and Loan (Lincoln), the institution for whom Kaye, Scholer provided legal services. Parts III and IV will summarize procedures used and allegations made against the firm by the OTS, as well as the settlement reached. The addition of the concept of an “institution-affiliated party” by the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) which helps to direct attention toward lawyers will also be reviewed in Part IV. Part V will compare the ethical standards of the Model Rules of Professional Conduct (Model Rules) with the charges against Kaye, Scholer. The federal regulations which the firm was charged with violating will be identified and a concluding comment will be made in Part VI.

5. OTS Action Against Outside Lawyer for Lincoln Signals Disturbing Trend, Industry Lawyers Say, BANKING ATT’Y (BNA), Feb. 1, 1993, at 4 [hereinafter Disturbing Trend]. The OTS did not charge that Fleischer provided a legal opinion based on facts that the lawyer knew to be untrue. Thus, it has been suggested that Fleischer’s situation could mean that an attorney has a duty to verify all “assumed” facts before providing an opinion. Id.


7. A number of other firms were reported to be defendants or potential defendants in actions by the Resolution Trust Corporation (RTC) growing out of the Lincoln Savings and Loan debacle. Included are Jones, Day, Reavis & Pogue (Rita Jensen, Jones Day Challenges the RTC Allegations, NAT’L L.J., May 6, 1991, at 27); Atlanta firm Troutman, Sanders, Lockerman & Ashmore; Phoenix firm Mariscal, Weeks, McIntyre & Friedlander; and Chicago firm Sidley and Austin (Rita Jensen, Lincoln Case — RTC Seeks to Sue Troutman Sanders, NAT’L L.J., Aug. 5, 1991, at 3); see also supra text accompanying note 5.

8. The phrase “depository institution” includes all federally insured commercial banks and savings and loan institutions.

9. See infra notes 114-117 and accompanying text.
II. LINCOLN SAVINGS AND LOAN

The collapse of Lincoln is the most expensive savings and loan failure to date, with total costs to American taxpayers estimated to be not less than $2 billion.\(^\text{10}\)

Charles Keating was chairman and chief executive officer of American Continental Corporation (ACC), the parent holding company of Lincoln Savings and Loan Association (Lincoln). ACC, an Ohio corporation, was headquartered in Phoenix, Arizona and was involved in single family home construction. In 1984 ACC acquired Lincoln which at that time was engaged in the traditional thrift industry business of providing funds to purchasers of single family dwellings. Lincoln was a California state chartered entity and apparently Keating was attracted to it because "the California legislature had embarked on a course aimed at deregulating the state's thrift industry . . . ."\(^\text{11}\)

Although Keating did not hold an office in Lincoln, he and ACC exercised strong control over it. Thus, after ACC assumed control, Lincoln changed its orientation. It invested directly in equity securities and scaled back on its financing of single family home acquisitions. "It took equity participations in emerging new businesses and made a number of high risk loans to individuals engaged in speculative endeavors."\(^\text{12}\) Five years after ACC acquired Lincoln, the Federal Home Loan Bank Board (FHLBB)\(^\text{13}\) decided to appoint a conservator for Lincoln because of its conclusion that Lincoln was "unsafe and

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12. Id. at 908.
13. The principal regulator of thrifts prior to the 1989 legislation known as the thrift bail-out law (FIRREA) was the Federal Home Loan Bank Board (FHLBB). 12 U.S.C. § 1811 as amended by Act of Aug. 9, 1989, 12 U.S.C. § 1811 nt. (Supp. III 1991). After FIRREA, the Office of Thrift Supervision (OTS) was created and received the supervisory responsibilities over savings and loan associations. Defendant Wall, in the case involving the unsound banking practices of Lincoln, was then Director of the OTS. However, the regulatory actions against Lincoln were just prior to the enactment of FIRREA, which was signed by the President on August 9, 1989. The FHLBB appointed a conservator for Lincoln on April 14, 1989 and a receiver on August 2, 1989.
unsound” and that there had been a dissipation of its assets.\textsuperscript{14} About four months after the conservator was appointed, the FHLBB then appointed a receiver for Lincoln based on its conclusion that Lincoln was insolvent.\textsuperscript{15} The decisions were lawfully made ex parte and without any notice to Lincoln or ACC, its holding company.\textsuperscript{16} However, under applicable law, the adversely affected institution could contest the conclusions of the federal agency.\textsuperscript{17} Lincoln and ACC chose to do that. An evidentiary hearing took almost a full month,\textsuperscript{18} and the court was called upon to determine whether or not the decisions of the FHLBB were “arbitrary and capricious.”\textsuperscript{19} The court noted that it was to defer to the agency’s judgment and pointed out that the FHLBB had considerable discretion.\textsuperscript{20}

The plaintiff Lincoln disputed the conclusions of the FHLBB that it engaged in unsafe and unsound practices and that it had become insolvent. As the holding company, plaintiff ACC also had an intense interest in the fate of Lincoln. But, according to District Judge Stanley Sporkin, “by virtue of its insurance of Lincoln accounts, the federal government’s interest in Lincoln is many times that of ACC.”\textsuperscript{21} The FHLBB’s case against Lincoln was based upon its position that Lincoln improperly upstreamed funds to its parent ACC through several imprudent transactions. The court reviewed a number of these transactions, including a tax sharing agreement under which Lincoln sent $94 million upstream to ACC for taxes even though Lincoln owed no taxes. Another transaction was the Memorex deal: Lincoln sold to Company A its Memorex stock for $1 million; Company A sold the stock to Lincoln’s parent ACC for $2 million; and then ACC sold it to Company B for $11 million. Thus the holding company received a huge profit from stock originally owned by its subsidiary. Judge Sporkin

\begin{itemize}
  \item \textsuperscript{14} 12 U.S.C. § 1464(d)(6)(A) (1933) authorizes the appointment of a conservator or receiver for insolvency, for dissipation of assets or earnings, for unsafe or unsound conditions, for violation of a cease and desist order, or for concealment.
  \item \textsuperscript{15} Notice of Charges and of Hearing for Cease and Desist Orders, at 2, ¶ 2, Mar. 1, 1992, In re Peter Fishbein, OTS AP 92-19 [hereinafter Notice of Charges].
  \item \textsuperscript{16} 12 U.S.C. § 1464(d)(6)(D).
  \item \textsuperscript{17} Id.
  \item \textsuperscript{18} 743 F. Supp. at 904 n.3.
  \item \textsuperscript{19} Under the Administrative Procedure Act, this is the standard used when a court reviews the actions of an administrative agency. 5 U.S.C. § 706(2)(A) (1966).
  \item \textsuperscript{20} 743 F. Supp. at 904.
  \item \textsuperscript{21} Id. at 905.
\end{itemize}
KAYE, SCHOLER, LINCOLN S&L AND THE OTS

commented that "[t]he way ACC acted toward Lincoln in this and other transactions discussed in this opinion is akin to an adult taking candy from a helpless child." 22 The court stated that "ACC manipulated Lincoln's earnings for its own purpose and to the ultimate financial detriment of Lincoln," 23 and concluded that the FHLBB action of appointing a conservator and then a receiver was "supported by substantial evidence." 24

This decision by Judge Sporkin in Lincoln Savings and Loan Association v. Wall, 25 which upheld the federal takeover of the thrift, was delivered in August, 1990. It was followed about six months later by a state 26 conviction of Charles Keating, 27 the former CEO of ACC, Lincoln's holding company. A jury in California convicted him in December, 1991 on 17 of 18 fraud counts. 28 He was sentenced to 10 years in prison and fined $250,000 for failing to disclose the financial condition of ACC and Lincoln to bond buyers. 29 The bond sales program also proved to be costly to Keating and to lawyers. 30

The bonds were subordinated debentures of ACC that were "sold in the lobbies" of its subsidiary, Lincoln Savings and Loan. 31 The bondholders alleged that the bonds were drafted "to resemble certificates of deposit or savings accounts,

22. Id. at 915.
23. Id. at 914.
24. Id. at 919. The court noted that Lincoln could not recoup any of the money it sent upstream to its holding company because ACC had filed for bankruptcy on April 13, 1989. Id. at 910. That was one day before the FHLBB appointed a conservator. See In re American Continental Corp., 105 B.R. 564 (Bankr. D. Ariz. 1989).
26. Keating and his son were found guilty in a federal trial which involved a 73 count indictment alleging racketeering and fraud, among other claims. Keating, Son Convicted in Billion-Dollar S&L Fraud Case, Chi. Trib., Jan. 17, 1993, § 1, at 3.
28. Id.; see also Laurie Kretchmar, Another CEO Told: Go to Jail, Fortune, May 18, 1992, at 113.
31. Id. After the Lincoln situation, on October 7, 1992, the Office of Thrift Supervision issued a final rule to prohibit thrifts from selling from the thrift's offices their own securities or those of an affiliate. 12 C.F.R. § 563.76 (1992); see also Sales of Securities at Savings Association Offices, 57 Fed. Reg. 46,085 (1992) (codified at 12 C.F.R. §§ 563, 563g).
which was designed to lend to investor confusion."^32 Of course, subordinated debentures of a holding company are not insured, while accounts in a savings institution are.^33 Thus, selling the bonds in the lobby of the savings and loan may have helped to create confusion.^34

The number of ACC bondholders was substantial, as were the claimed losses: 20,000 people in a class action alleged losses totaling $288.7 million.^35 Bondholder lawsuits originally named as defendants more than 95 individuals and various companies including some law firms.^36 One defendant was the law firm Jones, Day, Reavis & Pogue. It settled in March, 1992 for $23 million.^37 Another law firm which capitulated was Sidley and Austin which, in May, 1991 agreed to settle for $4 million.^38 In March 1990, the Los Angeles firm Parker, Milliken, Clark, O'Hara & Samuelian agreed to a payment of $14.3


^34. One writer explained:
In early 1986, Lincoln needed the approval of the state's savings and loan department to lease space to its parent so that ACC's employees could sell the bonds in Lincoln's lobbies. In an attempt to assuage concerns expressed by state S&L officials, the bank's former in-house lawyer, David I. Thompson, wrote a letter to the agency in January 1986, claiming that Kaye, Scholer and another leading law firm approved "every step of the process" of Lincoln's bond sales program. The letter, obtained by the National Law Journal, is under court seal. Jensen, supra note 32, at 1.


^36. Id. For a case involving certification of the class, see In re American Continental Corp./Lincoln Sav. & Loan Sec. Litig., 140 F.R.D. 425 (D. Ariz. 1992). For the case holding that preference litigation against purchasers of ACC subordinated debentures could not go forward, see In re American Continental Corp., 142 B.R. 894 (Bankr. D. Ariz. 1992).

^37. See Tim Smart, Jones Day: Did It Do Its Duty in the Keating Affair, Bus. Wk., May 4, 1992, at 120; see also Rita H. Jensen, Jones Day Trial in the Lincoln S&L Debacle, Nat'l L.J., Mar. 9, 1992, at 2. "The key allegation against Jones Day is that in 1986 the firm aided and abetted the thrift's creation of misleading documents so that the thrift could obscure its true financial condition to regulators during a crucial regulatory audit." Id.

Kaye, Scholer faced the bondholders' accusation that it helped ACC and Lincoln's Keating to deceive federal regulators about the financial stability of the thrift. The suit was settled for $20 million in June, 1990.40

The number of law firm defendants in the bondholders' action appear to lend credence to the charge leveled at Keating that he played "round robin with the 77 law firms he . . . hired, using them for short terms under the continual threat of being replaced if they didn't go along with . . . [his] wishes."41 Some finger pointing occurred from Jones, Day, Reavis & Pogue to the group that was apparently Lincoln's last law firm: Kaye, Scholer.42 It is the latter that is destined for an historic place in any discussion of a law firm's duties while representing a federally insured thrift institution. Just as Keating may "symbolize for many the savings and loan crisis of the 1980s,"43 Kaye, Scholer may come to symbolize what lawyers ought not do in representing a federally insured depository institution.

III. The Freeze or Asset Preservation Order

"The Kaye Scholer order required a quarter of most partners' share of firm earnings to be escrowed . . . ."44

Simultaneous with its filing of charges against Kaye, Scholer the OTS filed a temporary cease and desist order against the firm and some of its individual members.45 The order required notice to OTS before expenditures in excess of


43. Stevens, supra note 29.


$5,000; required an escrow of a percentage of partners' share of firm earnings; prohibited any change to terms of existing insurance policies; called for notice of a partner's withdrawal; prohibited any distribution to withdrawing partners; and prohibited any changes in the Kaye, Scholer partnership. The order did provide for the payment of principal and interest on debt, reasonable and ordinary operating expenses and necessary capital expenditures of less than $50,000. While the OTS press release called it a "freeze," the General Counsel of the agency, Harris Weinstein, called it "an asset preservation or protection order." Formally, it is known as a temporary cease and desist order. The order was issued pursuant to 12 U.S.C. § 1818(c)(1), which permits banking authorities to issue temporary cease and desist orders "pending completion of ... proceedings." The law provides for court review of the order within ten days of its service. If there is a failure to obey the temporary cease and desist order, the regulatory agency can go to a United States District Court for an enforcement order.

The issuance of the Kaye, Scholer asset freeze order prompted intense comment. One concern is that it was used to force a settlement of the charges. Another is that a justification for the order — that Kaye, Scholer's insurance was chang-

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46. Id.

47. Id.


50. 12 U.S.C. § 1818(c)(1) (1992). The statute provides the OTS with a mechanism to maintain the status quo during an administrative hearing: Whenever the . . . agency shall determine that the violation . . . or practices, specified in the notice of charges . . . is likely to cause insolvency or significant dissipation of assets or earnings of the depository institution, or is likely to weaken the condition of the depository institution or otherwise prejudice the interests of its depositors prior to the completion of the [administrative hearings in the cease and desist proceeding] . . . the agency may issue a temporary order requiring . . . such party to . . . take affirmative action to prevent or remedy such insolvency, dissipation, condition, or prejudice pending completion of such proceedings . . . .

51. Id.

52. 12 U.S.C. § 1818(c)(2).

ing — was not the firm’s fault. Another factor was that no prior court hearing was held before the freeze was imposed. Then there is the matter of the standards applicable to the issuance of such orders, and that the order was applied against the entire firm, rather than just to the individual lawyers who worked on Lincoln matters. Finally, the order was apparently the first issued against outside counsel for a thrift institution.

As to the settlement, Kaye, Scholer attorney Bernard W. Nussbaum has suggested that the freeze order directed the attention of the firm’s lenders to the underlying OTS charge and it was the bankers’ refusal to continue lending to the firm which prompted a quick settlement.\(^5^4\) Kaye, Scholer was apparently dependent upon revolving lines of credit from banks for its operating expenses early in the year. The freeze order was issued March 1 and the final settlement came about a week later.

As one basis for the temporary cease and desist order, the OTS charged that Kaye, Scholer “threatened to amend its professional liability insurance policy so as to impair collectibility of any judgment requiring restitution.”\(^5^5\) Kaye, Scholer insisted that excluding any claims relating to Lincoln Savings and Loan was the insurer’s idea and could not in any event affect the existing claim of the OTS.\(^5^6\) As yet, the courts have not dealt with the “regulatory exclusion” in attorney’s malpractice insurance policies, although they are divided on the subject with respect to directors and officers’ policies.\(^5^7\) That provision excludes coverage for claims brought by a regulatory agency. Because a depository institution may not be financially

\(^{54}\) DeBenedictis, supra note 44, at 60.

\(^{55}\) Temporary Cease & Desist, supra note 45, at 10.

\(^{56}\) DeBenedictis, supra note 44, at 58.

\(^{57}\) See Susan Fortney, Attorneys’ Malpractice Policies: Regulatory Exclusions and Public Policy, 109 BANKING L.J. 116 (1992). The Eighth Circuit upheld a regulatory exclusion policy against a charge that it violated public policy goals. St. Paul Fire & Marine Ins. Co. v. FDIC, 968 F.2d 695 (8th Cir. 1992). The court ruled that a provision in FIRREA, now in 12 U.S.C. § 1821(e)(12)(A), does not allow the regulator to override terms in directors’ and officers’ policies. The court pointed out that originally FIRREA had a provision that would have allowed the FDIC to override regulatory exclusions, but the provision was deleted before the law was enacted. On directors’ and officers’ liability insurance policies, see Linda Elam, Comment, Financial Institution Deposit Insurance — Directors’ and Officers’ Liability Insurance Policies — Public Policy Regarding Regulatory Exclusions, 59 TENN. L. REV. 305 (1992); see also FDIC v. American Casualty Co., 975 F.2d 677 (10th Cir. 1992); FDIC v. American Casualty Co., 61 U.S.L.W. 2377 (Colo. Jan. 5, 1993).
responsible when the regulators and others seek to recoup claimed losses, lawyers' insurance policies may be critical.\textsuperscript{58}

To the extent cease and desist orders are designed to ensure ability to respond to an ultimate judgment, changes to insurance which affect that ability would appear to be grounds for an order.

The OTS General Counsel was not much concerned with the argument that temporary cease and desist orders are permissible \textit{without} any prior judicial review and thus violate due process. Rather, he noted that "24 of 25 judges who have examined OTS asset preservation orders have upheld them."\textsuperscript{59}

The most important decision on a temporary cease and desist order calling for restitution involved a United States Supreme Court denial of review about a month \textit{after} the Kaye, Scholer order. The Ninth Circuit, in \textit{Spiegel v. Ryan},\textsuperscript{60} upheld a temporary cease and desist order that required Thomas Spiegel, the former chairman of a state chartered S&L in Beverly Hills, California to make restitution of about \$21 million. Plaintiff Spiegel went to court the day after the order was issued and argued, \textit{inter alia} that he was deprived of due process because there was no \textit{pre}deprivation hearing. The Ninth Circuit rejected this claim and judged the action on three factors:

1) governmental interest;  
2) need for prompt action; and  
3) standards controlling the agency discretion.\textsuperscript{61}

The court found an important governmental interest in the need to fight depository institution insider abuse and protect the public funds at risk because of deposit insurance. The need for prompt action was found in the fact that the plaintiff was charged with specific actions (misappropriation of corporate assets) detrimental to the thrift. The court was impressed that the statute involved an industry which is highly regulated and

\textsuperscript{58} "The legal market has seen in the last five years probably the 12 or 13 largest legal malpractice settlements and judgments in history." Donna Gill, \textit{Targeting Lawyers: Legal Mal in the '90s}, \textit{Chi. Law.}, Sept. 1992, at 1, 18. The statement is that of Brian Redding, associate loss prevention counsel of Attorney Liability Assurance Society, Inc. ("ALAS"). The ALAS is a large insurer of attorneys, operating in 45 states and covering 377 law firms.

\textsuperscript{59} DeBenedictis, \textit{supra} note 44, at 60. OTS counsel Weinstein also has reported that the OTS underwent a nine week investigatory process before the order was issued against the law firm. \textit{Weinstein Defends Enforcement Action, Asset Order Against Kaye, Scholer Firm}, 58 \textit{Banking Rep.} (BNA) 611 (1992).

\textsuperscript{60} 946 F.2d 1435 (9th Cir. 1991), \textit{cert. denied}, 112 S. Ct. 1584 (1992).

\textsuperscript{61} Id. at 1439. The court relied upon the three factors listed in \textit{Fuentes v. Shevin}, 407 U.S. 67 (1972) to determine if a deprivation prior to a hearing was permissible.
that the agency had to find plaintiff’s action was “likely to cause” dissipation, weakening of condition or some prejudice before issuing an order. Finally, the court was impressed that the post deprivation hearing was prompt. Thus, Spiegel has undercut the due process argument against the asset preservation order.\footnote{62}

Although Spiegel and other decisions involve the thrift industry,\footnote{63} in a case involving trademark protection, the court allowed an ex parte temporary restraining order which froze the assets of defendants charged with selling counterfeit reproductions of the plaintiff’s Reebok athletic shoe.\footnote{64} One difference of course, is that the Kaye, Scholer order was issued by the agency and not by a court as was the order in Reebok, even though ex parte.\footnote{65}

The New York Bar Association proposed that the statute applicable to the thrift industry, be amended to provide for \textit{prior} approval of a federal judge before law firm assets can be frozen.\footnote{66} While it is understandable that the New York bar acts

\footnote{62. Other cases have also rejected the idea that a predeprivation hearing is necessary. In FDIC v. Mallen, 486 U.S. 230 (1988), the Supreme Court held that an indicted bank president was not entitled to a hearing prior to suspension. Franklin Sav. Ass’n v. Director, 934 F.2d 1127, 1140 (10th Cir. 1991) held appropriate the appointment of a conservator without a prior hearing.}

\footnote{63. See RTC v. Cruce, 972 F.2d 1195 (10th Cir. 1992) (preliminary injunction freezing assets of wife of director and officer of failed thrift based on his fraudulent conveyance to her); Parker v. Ryan, 959 F.2d 579 (5th Cir. 1992) (former director and shareholder of savings bank had assets frozen; upheld); FSLIC v. Ferm, 881 F.2d 1083 (9th Cir. 1989) (unpublished disposition; available in Westlaw) (pre-FIRREA preliminary injunction freezing assets of ex-wife of former president and sole shareholder of thrift); di Stefano v. United States Dept. of the Treasury, 787 F. Supp. 292 (D.R.I. 1992) (former president received salary in violation of agreement with OTS; temporary cease and desist order requiring restitution upheld); Paul v. United States Dept. of Treasury, 763 F. Supp. 568 (S.D. Fla. 1990), \textit{aff’d sub nom}, Paul v. Ryan, 948 F.2d 1292 (11th Cir. 1991). In mid-1992 the Office of the Comptroller of the Currency issued its first temporary cease and desist orders (asset freeze) against 10 national bank officials in Connecticut. \textit{OCC Issues First Freeze Orders Against National Bank Officials}, 58 \textit{Banking Rep.} (BNA) 1147 (1992).}

\footnote{64. Reebok Int’l Ltd. v. Marnatech Enter., 737 F. Supp. 1521 (S.D. Cal. 1989).}

\footnote{65. The statute relied upon by the OTS, 12 U.S.C. § 1818(c)(1), does not, according to one view, permit a freeze of assets. Resort should be made to 12 U.S.C. § 1818(i)(4) which authorizes a restraining order only after a court has acted.}

\footnote{66. See \textit{New York Bar, supra} note 53, at 2. The bar was concerned that a freeze order would be used to force a settlement and might deprive clients of representation. Weinstein of the OTS dismissed the New York Bar group’s
in the interests of its constituency, focus upon law firms seems unnecessary, as freeze orders apparently have not been routinely used against lawyers or law firms. Most temporary cease and desist cases have dealt with insiders rather than an outside law firm. Moreover, one can question what it is about law firms that requires them to be given any additional protection that others are not. It could be argued that a government agency could try to bring an industry to its knees by attacking counsel that advise that industry. However, such an approach requires one to assume that nefarious motives surround agency action. In addition, an effort to treat lawyers differently from others is not likely to gain much general support. Moreover the Kaye, Scholer freeze order was against a particular firm and there is no evidence that lawyers or law firms generally are at risk. Also, the existing statute allows an aggrieved person to go into court within ten days of the temporary cease and desist order. In the Spiegel case, the plaintiff was in court the next day after the order.

The OTS freeze order against Kaye, Scholer was the first time it had been used against lawyers and, significantly, Kaye, Scholer did not challenge it. In Spiegel the order required restitution the day after the order was served. In Kaye, Scholer, the firm was expressly permitted to make expenditures for operations including capital expenditures. There was provision for individual unnamed partners to seek relief from the order. Thus, it does not appear to be far afield from the temporary order upheld in Spiegel.

However, it can be argued that the entire law firm should not be made to suffer for the actions of individuals from the comment because it was "flawed and is entitled to no credibility." ABA, OTS Square Off on Lawyer Liability in Moves Toward Debate, Possible Battle, 59 BANKING REP. (BNA) 268 (1992).

67. See cases cited supra note 63.

68. As one commentator has noted, "With more than three hundred lawyers and an excellent track record Kaye Scholer . . . is an unlikely candidate for financial ruin." Stewart, supra note 53, at 15. Robert J. Kielty, the general counsel for American Continental Corp (ACC), the holding company for Lincoln, was the subject of a temporary cease and desist order based on allegations that he had transferred assets to his wife one week before ACC filed bankruptcy. OTS Issues Cease-And-Desist Order Freezing Assets of Keating Associate, 59 BANKING REP. (BNA) 440 (1992).

69. Although the statute provides for prompt court review of the temporary cease and desist order, requiring the aggrieved party to take the initiative does require it to shoulder the burden of proof to demonstrate that the order should not have been issued. See di Stefano v. United States Dept. of Treasury, 787 F. Supp. 292 (D.R.I. 1992).

70. Temporary Cease & Desist, supra note 45, ¶ 16c.
firm who represented Lincoln. If those individuals engaged in conduct that justified a temporary cease and desist order, then arguably the freeze should have been against them only. That position does not take into account that fees from the representation of Lincoln undoubtedly went to the firm and not directly to the individual lawyers. In addition, the partnership form of doing business means that partnership assets are available for claims against the entity.\textsuperscript{71} Since the individuals alleged to have engaged in wrongful activities functioned on behalf of the firm, it hardly seems compelling to argue that the asset preservation order could not go against the entire firm.

The asset preservation order was in aid of the principal action, which sought restitution from Kaye, Scholer.\textsuperscript{72} If the temporary cease and desist order was in fact used to force a settlement, then arguments against the freeze have some justification. Obviously the purpose of temporary orders is to preserve the status quo. To the extent they go beyond that and act coercively to impel a settlement, such orders can not be justified. Presumably in a court hearing seeking to overturn a temporary order, the aggrieved party could demonstrate no good faith basis for the order, other than to force a settlement.

In other reported cases where freeze orders involving depository institutions were upheld, it was an insider who had arguably dealt directly with funds of the institution. In Spiegel,\textsuperscript{73} the plaintiff was the former chairman of the depository institution and he was charged with misappropriating corporate assets. In Parker v. Ryan\textsuperscript{74} it was a former shareholder and director and in Paul v. Office of Thrift Supervision\textsuperscript{75} it was the former chairman of the board. One can question the use of asset preservation orders against outside lawyers like Kaye, Scholer since it does not appear that they dealt directly and improperly with the funds of the thrift they advised as was the charge against the insiders in Spiegel, Parker and Paul. But one basis for the OTS position is that the law firm's actions caused loss to the thrift, and thus since it was liable for restitution, the firm also could have its assets preserved for any ultimate judgment.

\textsuperscript{71} \textsc{Harry G. Henn \& John R. Alexander, Laws of Corporations} § 24 (3d ed. 1983).

\textsuperscript{72} 12 U.S.C. § 1818(b)(1) is the basic provision for cease and desist actions and provides for orders "to take affirmative action to correct or remedy the conditions resulting from . . . such violation or practice."

\textsuperscript{73} 946 F.2d 1435 (9th Cir. 1991), cert. denied, 112 S. Ct. 1584 (1992).

\textsuperscript{74} 959 F.2d 579 (5th Cir. 1992).

\textsuperscript{75} 763 F. Supp. 568 (S.D. Fla. 1990).
against it.\textsuperscript{76} In other areas, prejudgment attachment is permissible.\textsuperscript{77} Concerns about prejudgment preservation of law firm assets do not appear to be any different from concerns about the preservation of assets of any party. The critical question should be the showing that must be made before any such order can be issued.

The statutory standards that undergird a temporary cease and desist order for thrifts is problematic as applied to Kaye, Scholer. One must show that the conduct complained of

1) "is likely to cause" insolvency, dissipation of assets or earnings, or
2) weakening of the condition of the depository institution, or
3) prejudice to the depositors.

In the Kaye, Scholer situation, the asset preservation order was issued March, 1992. However, the institution which the firm advised had been closed since 1989, so the "likely to cause" insolvency or dissipation of assets was not applicable. The temporary cease and desist process is designed to ensure that one who might ultimately be required to take affirmative action be in a position to do so. To the extent that the OTS had to use insurance funds to pay off Lincoln depositors it then stood in the position of the depositors,\textsuperscript{78} and the statutory standard also looked at what was "likely to cause" prejudice to depositors. Also, to the extent Lincoln did not have sufficient resources to pay off depositors not covered by federal deposit insurance, then those depositors suffered prejudice. The lat-

\textsuperscript{76} OTS counsel Weinstein indicated the regulator’s claim against Kaye, Scholer was based first, upon losses Lincoln suffered from the time it should have been shut absent Kaye, Scholer’s conduct and secondly, upon the amounts lost by Lincoln on direct investments it made having received a favorable opinion from Kaye, Scholer that direct investments were permissible. Beck & Orey, \textit{supra} note 40, at 73.

\textsuperscript{77} In the 1990 Crime Control Act there is a provision permitting the FDIC or conservators appointed by the Office of the Comptroller of the Currency or the Office of Thrift Supervision to ask the court for an order to place a person’s assets under control of a court appointed trustee. \textit{See} 12 U.S.C. § 1821(d)(18)-(19). In \textit{FDIC v. Cafritz}, 762 F. Supp. 1503 (D.D.C. 1991), the FDIC acting as receiver of a Washington bank placed assets of a real estate developer under control of a trustee. Included were sums Cafritz had paid to a law firm as a retainer for future legal services.

\textsuperscript{78} “In an oft-quoted speech delivered at Southern Methodist University, Mr. Weinstein described the federal insurer as standing in the shoes of the depositor such that the duties of a fiduciary flow through the depositors to the federal insurer.” Helms, \textit{supra} note 6, at 285.
ter, however, probably would never share in any recovery from Kaye, Scholer received by the federal regulators.

Finally, the concurring opinion in Spiegel noted that one has the opportunity to seek "full judicial review of the appropriateness"\(^779\) of a temporary cease and desist by invoking the court's action within ten days of the order. Since Kaye, Scholer did not do so, there is no record contrary to that established by the OTS. Thus it is difficult to conclude that the order was wrongly issued.

IV. ENFORCEMENT OPTIONS; CHARGES AGAINST KAYE, SCHOLER; SETTLEMENT

"The civil enforcement powers of the federal banking regulators have been enhanced and expanded dramatically over the last three years."\(^80\)

The enforcement options available to federal bank and thrift regulators include cease and desist orders; suspension, removal and prohibition orders; civil money penalties; involuntary termination of insurance for an institution; and capital directives. Prior to the 1989 law enacted as part of the "bail-out" of thrift institutions, the legal enforcement mechanisms did not specifically mention lawyers. Rather, prior to 1989 the law indicated that persons "participating in the conduct of the affairs" of insured depository institutions were subject to enforcement.\(^81\) When, in 1989 Congress adopted the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA),\(^82\) the category of "institution affiliated party" (IAP) was inaugurated. The law provides that enforcement action can be taken against such persons.\(^83\) The category includes agents, officers, directors, employees, controlling shareholders, and independent contractors.\(^84\) Lawyers are specifically included in

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81. The Federal Deposit Insurance Act of 1934, 12 U.S.C. §§ 1811-32 (1934) is applicable to institutions insured by the Federal Deposit Insurance Corporation (FDIC). Criminal statutes prohibiting misapplication of bank funds refer to persons "connected in any capacity with" a bank. See 18 U.S.C. § 657. It has been held that an outside lawyer retained to close loans was "connected." United States v. Payne, 750 F.2d 844 (11th Cir. 1985).
the term "independent contractor." The law provides for enforcement proceedings against "any attorney . . . who knowingly or recklessly participates 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" an insured depository institution.85 Kaye, Scholer was charged with being both an IAP and a person "participating" in the conduct of the affairs of Lincoln. It may be that both designations were used to capture both prior law on participating persons and the FIRREA innovation for IAP.

The enforcement actions sought against Kaye, Scholer were a temporary cease and desist order (the asset freeze discussed above); a permanent cease and desist order; and an order prohibiting certain partners from participation in affairs of an insured depository institution. A cease and desist order is one by which the party may be forbidden from engaging in specified conduct or may be required to follow certain practices.86 It is usually commenced by a notice of charges which outlines the facts.87 Then an administrative hearing is held. If

85. 12 U.S.C. § 1813(u). Normal lawyering activities of outside counsel should not constitute participation in the affairs of an institution so that legal violations, breaches of fiduciary duty or participation in unsafe or unsound practices which occur without the lawyer should not be actionable. Since in most instances lawyers are not the decision makers, a distinction could be drawn between "advice," document preparation and "participation." "The FDIC has assured attorneys that the legislative history of FIRREA adequately indicates that legal advice alone is not actionable . . . ." Helms, supra note 6, at 283. However, there was a consent to an OTS restitution order in the case of an outside attorney who issued a legal opinion to Lincoln that it could pledge its assets to guarantee the debt of an ESOP (employee stock option plan) of its parent holding company, ACC. Id. See also note 161 infra. The OTS asserted that the lawyer had "participated" in the affairs of the thrift and was an "institution affiliated party" (IAP) by giving this opinion. Some commentators question whether rendering an opinion should be enough to cause one to be an IAP or a participating party. Disturbing Trend, supra note 5, at 4.

86. See, e.g. Stanley v. Board of Governors, 940 F.2d 267 (7th Cir. 1991); Burke v. Board of Governors, 940 F.2d 1360 (10th Cir. 1991); FDIC v. Bank of Couthatta, 930 F.2d 1122 (5th Cir. 1991); Abercrombie v. Clarke, 920 F.2d 1351 (7th Cir. 1990); Hoffman v. FDIC, 912 F.2d 1172 (9th Cir. 1990); Saratoga Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 879 F.2d 689 (9th Cir. 1989).

87. One can be charged with unsafe or unsound practices, with violations of law, or with violation of a written agreement entered into with a regulatory body. 12 U.S.C. § 1818(b)(1). In Kaye, Scholer, it was alleged
an order is issued, it can include a requirement to take "affirmative action" to correct conditions, or it can provide for restitution, reimbursement, indemnification or guaranty. An order of prohibition or removal prevents a person from participating in the conduct of the affairs of an institution. The regulator must give notice and then an administrative hearing is held. FIRREA dramatically changed prior law in that it authorizes industry wide prohibition orders which would prevent a person not only from involvement with the institution with which he or she was affiliated at the time of the order, but also any other institution. Three requirements must be met in order for a removal or prohibition order to issue:

1. violation of a law, cease and desist order or written agreement;
2. financial gain to the individual subject to removal or prohibition or loss to the institution as a result of the individual's violation; and
3. the individual's action must show a wilful disregard for the soundness of the institution or it must have involved personal dishonesty.

Two Kaye, Scholer partners consented to prohibition orders and orders debarring them from practice before the Office of Thrift Supervision.

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88. 12 U.S.C. § 1818(b)(1)-(6). Prior to FIRREA, this was an area of controversy. In del Junco v. Conover, 682 F.2d 1338 (9th Cir. 1982), bank directors were required by the Office of the Comptroller of the Currency to indemnify their bank for losses from loans made over the lending limits. However, four years later in Larimore v. Conover, 789 F.2d 1244 (7th Cir. 1986) an en banc court held that banking regulators could not issue an order of indemnification. Rather, judicial action was required. FIRREA changed this and confirmed that regulators could require indemnification or restitution.

89. 12 U.S.C. § 1818(e)(2); see also FDIC v. Mallen, 486 U.S. 230 (1988); Greenberg v. Board of Governors, 986 F.2d 164 (2d Cir. 1992); Jameson v. FDIC, 931 F.2d 290 (5th Cir. 1991) (order against person no longer affiliated with insured institution is proper); Sunshine State Bank v. FDIC, 783 F.2d 1580 (11th Cir. 1986).


91. Id. at (e)(1)(A).

92. Id. at (e)(1)(B).

93. Id. at (e)(1)(C).

The firm represented ACC, the holding company of Lincoln, starting in 1977 and provided services to the thrift from its acquisition by the holding company in February, 1984 until April, 1989 when the thrift was closed by federal regulators. However, the regulators appeared to be particularly interested in Kaye, Scholer’s representation of Lincoln in connection with Lincoln’s direct investments in July, 1985 and with respect to the 1986 and 1988 examinations. It may have been that Kaye, Scholer was targeted by federal regulators in part because in June, 1986 when the firm began to represent the thrift in connection with an examination, it was partner Peter Fishbein, a litigator with no prior bank or thrift regulatory experience, who spearheaded the legal team. Apparently, Fishbein initially demanded that all requests for information from the regulators be directed to an attorney in New York.

The claims made against Kaye, Scholer in the Notice of Charges can be grouped into four basic allegations. First, it was alleged that in making certain statements, the firm failed to disclose information to the regulators which resulted in providing the regulators with false and misleading information; second, the OTS alleged the firm failed to fulfill its fiduciary duties to Lincoln S&L; third, the firm allegedly gave incompetent advice because of its reliance on certain documents; and finally, the firm was alleged to have engaged in conflicts of interest.

The conflicts charge is based on Kaye, Scholer’s representation of one of its lawyers as borrower and the thrift as lender, and that the loan itself was on terms and conditions not in compliance with Lincoln’s policies. Also, the conflicts charge emanates from representing both ACC, the holding company, and Lincoln, the insured depository institution subsidiary.

The provision of incompetent advice was alleged to result from the fact that the law firm relied upon backdated documents in advising Lincoln that its direct investments were legally grandfathered. It was charged that Kaye, Scholer knew that the documents had been backdated to make it appear that

96. In its press release announcing a settlement of the charges against Kaye, Scholer OTS said that “a significant majority of the partners of the law firm, including members of its Banking Practice Group, were without involvement in the acts that led to the OTS charge.” Office of Thrift Supervision, OTS, Kaye Scholer Agree to Settle All Charges, OTS News 92-25, Mar. 8, 1992.
97. Beck & Orey, supra note 40.
99. Id. ¶ 52.
they had been created before the pertinent grandfather date. The charge that the firm failed to fulfill its fiduciary obligations was premised on the fact that the lawyers should have told Lincoln's board of directors that the conduct of Keating and other persons affiliated with Lincoln was problematic; that they should have told such persons that their duty ran to Lincoln and that they had an obligation to see that the thrift was operated safely. Providing false and misleading information to the regulators was based in part on information given to the regulators about Lincoln's underwriting and documentation system and about the reasons for resignation of Lincoln's auditor. A number of charges relate to the claim that Kaye, Scholer failed to disclose various items, among them: information about Lincoln's net worth; that loan files often had adverse information removed and favorable documents created and added to the files; that the characterization of one transaction as a joint venture masked the fact that it was in reality a loan; information about the thrift's participation in financing a tax shelter.

The Notice of Charges against Kaye, Scholer was filed on March 2, 1992. On March 5, 1992, OTS filed a motion seeking to have enforced subpoenas directed to Kaye, Scholer. On March 8, 1992 Kaye, Scholer agreed to settle the charges. Originally, OTS sought $275 million in restitution and a cease and desist order. The settlement was for $41 million and a consent order. Kaye, Scholer agreed, inter alia, that legal

100. Id. ¶¶ 22-25.
101. Id. ¶¶ 52-58.
102. Id. ¶¶ 36-44. For example, it was charged that Kaye, Scholer did not tell regulators that the resignation of auditor Arthur Anderson & Co. was related to concerns that the accounting firm had with some of Lincoln's practices.
103. The OTS sought documents and testimony concerning the firm's representation of Lincoln employees that the firm claimed were protected by the attorney-client privilege. OTS, on the other hand, claimed that the material was covered by a "crime fraud" exception to the attorney-client privilege which allows disclosure if the person seeking the material has some evidence that legal advice was sought for an illegal objective. The action seeking enforcement of the subpoena was separate from the charges filed against the firm three days previously. The subpoenas were originally issued in 1991 and the last action was three months before the enforcement action was filed. Office of Thrift Supervision, OTS Moves for Enforcement of Kaye Scholer Subpoenas, OTS News 92-24, Mar. 5, 1992.
105. Apparently about half of the settlement amount, or $20.5 million, was covered by the firm's insurance policy. See Edward Adams, Repercussions of
opinions about whether or not an insured depository institution has complied with federal statutes or regulations would be prepared under the supervision of a banking partner with at least ten years banking law experience;\textsuperscript{106} that legal opinions on unresolved questions "shall explicitly include in its advice that the directors and officers of the institution must address \ldots the effect of the transaction on the safety and soundness of the \ldots institution"\textsuperscript{107}; that it would not represent both the holding company and a savings and loan association where their interests may be adverse and where there is risk of loss to the depositors or federal deposit insurance;\textsuperscript{108} not to knowingly make any misrepresentations or omit any material information in communications to federal regulators;\textsuperscript{109} and not to "impede the direct access of examiners to documents, officers or employees of an insured depository institution \ldots"\textsuperscript{110}

The law firm's settlement was fast — about a week after the charges were announced. While some have alleged that the asset preservation order or "freeze" contributed to the quick settlement, it may have been because the charges against Kaye, Scholer were based on alleged violations of existing principles.

V. LAWYERS ETHICAL OBLIGATIONS AND THE KAYE, SCHOLER CASE

"The standards for attorneys practicing before the OTS derive from two sources: first, longstanding, generally applicable standards under the \ldots Model Rules of Professional Conduct; second, regulations of the agency \ldots."\textsuperscript{111}

The Kaye, Scholer case helped to focus attention on the role of the legal profession in the thrift industry, and indeed all depository institutions. However, its precedent-setting impact
on the ethical rules governing a lawyer's conduct may be slight as the case did not rest upon novel views of lawyers' ethical obligations. In bringing charges against Kaye, Scholer, the OTS did not specify any particular rules from the A.B.A. Model Rules of Professional Conduct (Model Rules) governing the conduct of attorneys.\(^{112}\) While the charges spoke of "reckless unethical and improper conduct,"\(^{113}\) the OTS relied upon its own regulations. These regulations required record keeping by savings institutions,\(^{114}\) prohibited aiding and abetting the violation of laws, rules or regulations administered or promulgated by the Office of Thrift Supervision,\(^ {115}\) prohibited unethical or improper professional conduct,\(^{116}\) and specifically prohibited false or misleading statements or omissions to the Office of Thrift Supervision.\(^ {117}\)

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\(^{113}\) Notice of Charges, supra note 15, ¶ 57.

\(^{114}\) The Notice of Charges alleged that the firm violated 12 C.F.R. § 563.17(1)(c). This is now 12 C.F.R. § 563.170(c) (1992) which reads:

(c) Establishment and maintenance of records. To enable the Office to examine savings associations and affiliates and audit savings associations . . . each . . . shall establish and maintain such accounting and other records as will provide an accurate and complete record of all business it transacts, and the documents, files, and other material or property comprising said records shall at all times be available for such examination and audit wherever any of said records, documents, files, material, or property may be.

\(^{115}\) 12 C.F.R. § 513.4(a)(4) provides for censure or denial of the right to practice before the OTS of any person found "[t]o have willfully violated, or willfully aided and abetted the violation of, any provision of the laws administered by the Office [refers to OTS] or the rules and regulations promulgated thereunder."

\(^{116}\) 12 C.F.R. § 513.4(a)(3) allows the Office to censure or deny a person the privilege of practicing before it if the person has been found "[t]o have engaged in any dilatory, obstructionist, egregious, contemptuous, contumacious or other unethical or improper professional conduct before the Office."

\(^{117}\) 12 C.F.R. § 563.18 (b)(1)(2), which the OTS cited in its Notice of Charges against Kaye, Scholer, is now 12 C.F.R. § 563.180 (b)(1) (1992) and it provides:

(b) False or misleading statements or omissions. No savings association or director, officer, agent, employee, affiliated person, or other person participating in the conduct of the affairs of such association nor any person filing or seeking approval of any application shall knowingly: (1) Make any written or oral statement to the Office or to an agent, representative or employee of the Office
It should be remembered that the provisions relating to an IAP authorize enforcement against persons who knowingly or recklessly participate in a breach of a fiduciary duty or violate any law or regulation. For the contours of the term "fiduciary duty," OTS apparently looked to the Model Rules, even though those rules were not specifically cited. Of course, the Model Rules are not available as the basis of a cause of action.\(^{118}\) However, in determining whether any new obligations were imposed upon lawyers as a result of the Kaye, Scholer case, it is helpful to assess the charges against the Model Rules, which are established guideposts on attorneys' ethical standards. That exercise can also help determine the accuracy of the OTS's general counsel Weinsten's view that Kaye, Scholer rested on settled principles.\(^{119}\) Consideration also must be given to the scope of the federal regulations that Kaye, Scholer is charged with violating. The federal regulations relied upon prohibit improper professional conduct and aiding and abetting. Violations are a predicate for denying a person the right to practice before the OTS. The regulations say nothing explicitly about being used a basis for a restitution order. Other regulations require not only maintaining records, but making them available for examination and audit. Then there is a prohibition against making false and misleading statements or omissions. While it is questionable if the regulations could independently impose sanctions for their violation, FIR-
REA elevated them to an important status by allowing enforcement against one who violates regulations.120

The OTS alleged conflicts of interest, giving incompetent advice, failing to advise Lincoln's Board of Directors about improper activity, and providing false and misleading information to regulators by failing to disclose certain information. Each of these will be examined against the Model Rules to consider what Rules might have been implicated by Kaye, Scholer's behavior.

A. Conflict of Interest

The OTS charged that Kaye, Scholer had a "conflict of interest in representing both Lincoln and ACC."121 It felt that the interests of ACC, the holding company and Keating, its chairman, were placed above that of the insured depository institution, Lincoln Savings and Loan. It also alleged that the interests of ACC and Lincoln were adverse, and further that the law firm failed to disclose the conflict or obtain the consent of the board of directors of Lincoln to the joint representation. The Kaye, Scholer position was that it did not perceive "any conflict of interest in representing a parent and its wholly-owned subsidiary in defending the subsidiary's conduct before a regulatory agency."122 Another alleged instance of conflict of interest was that Kaye, Scholer represented both Lincoln and one of its lawyers who obtained a loan from Lincoln.

The Model Rules applicable here are 1.7 and 1.8. The former prohibits representation of one client where it may be "directly adverse" to another client. However, the clients can consent to the representation.123 Model Rule 1.7 appears to have been violated in the representation of both the holding company and the thrift since their interests were adverse. For example, Lincoln lost the value of its shares in Memorex. It first acquired the shares at $1.00 per share; they were sold to

120. It will be assumed that the OTS could have proven that Kaye, Scholer recklessly and knowingly violated the OTS regulations. "Knowing" and "reckless" behavior is mandated in order to satisfy FIRREA provisions on an IAP.


123. MODEL RULES, supra note 112, Rule 1.7.
an outsider at $10 per share when they were worth $32 per share. The Memorex shares were then sold to ACC, the thrift’s parent, which in turn sold them to an outsider for $167 per share. If Lincoln had sold the shares directly to the entity to whom its holding company sold them, the thrift would have made $166 per share. Instead the benefit went to its parent ACC. Thus, the two entities had conflicting interests.

Another situation was the tax sharing agreement under which the holding company received $94 million from the thrift calculated on the basis of assumed taxes. However, the fact is that Lincoln did not have to pay taxes at all, so it was out the $94 million and its parent was enriched to that amount. Here again, the interests of the two parties were conflicting.

The adversity of interest can be seen in the instance in which bonds of the holding company ACC were sold in the lobby of the thrift. Some Lincoln depositors and former depositors bought those bonds. While deposits in the thrift were covered by federal deposit insurance, an investment in the holding company was not. Although it could be argued that the thrift had no direct interest in where its depositors and former depositors put their money apart from the thrift, a difference is apparent between an insured deposit and an investment in uninsured bonds. To the extent that a thrift depends upon the continued good will of its depositors, and to the extent that depositors believed that the savings and loan endorsed the bonds being sold in its lobby and/or that the bonds were insured, then there was a conflict between the thrift and its holding company. The one wishes to cultivate insured depositors; the other to cultivate risk-taking investors.

124. See Lincoln Sav. & Loan Ass’n v. Wall, 743 F. Supp. 901 (D.D.C. 1990); see also, Rita H. Jensen, Walking a Tightrope in Lincoln Imbroglio, Nat’l L.J., Jan 29, 1990, at 8 (“OTS lawyers contend the purchases were a ruse that would allow Lincoln to sell its parent company’s valuable stock at bargain basement prices without seeking bank board approval.”).

125. 743 F. Supp. at 909.

126. The law firm was relied upon when Lincoln’s in-house counsel wrote to state regulators about the bond sales. Approval from the California department regulating savings and loans was needed in order for the thrift to lease space in its lobby to its parent. A letter from that counsel said: “In describing the sales program, we wish at the outset to emphasize that every step in the process of structuring the sales program was reviewed by Kaye Scholer and Jones, Day, Reavis & Pogue of Los Angeles.” Jensen, supra note 32, at 29. “Keating was sentenced . . . for duping Lincoln depositors into buying high-risk junk bonds issued by ACC. When Lincoln, ACC’s prime asset, cratered, those bonds became worthless, and people lost their life savings. That might never have happened without Kaye, Scholer’s help.” Beck & Orey, supra note 40, at 79.
The Model Rules would allow joint representation if the clients consent. In the Kaye, Scholer situation there was no consent. Moreover, the comments to Rule 1.7 indicate that "when a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances, the lawyer involved cannot properly ask for such agreement or provide representation on the basis of the client's consent." Where there is an insured depository institution and an uninsured holding company which is intent on upstreaming funds to it from the depository, a disinterested lawyer might well conclude that representation of both is improper. Kaye, Scholer's view that there was nothing improper in representing a holding company and its subsidiary did not focus enough on the unique characteristics of an insured savings and loan and its parent. In the latter situation, deposit insurance is at risk rather than simply the investment capital of investors in both the subsidiary and the parent. Thus, the assertion in Kaye, Scholer's ethics expert's opinion that the firm "could not reasonably have recognized a conflict of interest between Lincoln and its parent, ACC, while responding to the 1986 Examination" seems disingenuous. However, that opinion refers only to the 1986 examination and yet the joint representation commenced before then and continued after that examination. Some of the matters which OTS claimed should have been disclosed to the thrift's directors were matters in which the parent's interests took precedence over those of the insured depository institution. Considering the insured status of the thrift and that depositors' funds were at risk, rather than just risk capital, Kaye, Scholer should have been alert to how the thrift was being treated in transactions with the parent. Judged in the light of Model Rules 1.7 and 1.8, the OTS charges against the law firm of conflict of interest based on representing both ACC, the holding company and the thrift Lincoln did not plow any new ground.

Nor does it appear there is anything novel about OTS's concern with Kaye, Scholer representing both the thrift and its

127. Model Rules, supra note 112, Rule 1.7 cmt.
128. Summary of the Expert Opinion of Geoffrey C. Hazard, Jr., ¶ 9, at 19 (Feb. 19, 1992) (available from Kaye, Scholer) [hereinafter Hazard Opinion]. This document states the opinions that Hazard would offer and is dated before the date of the Charges. "Hazard has been criticized for basing his verbal opinion on summaries of OTS documents prepared by Kaye, Scholer attorneys. Firm attorneys also drafted a written summary of his verbal opinion, which Hazard approves and stands by." James Podgers, Changing the Rules, A.B.A. J., July 1992, at 53, 54.
own lawyer in a loan to that lawyer. Model Rule 1.8, prohibits business transactions between lawyer and client unless three conditions are met: 1) the terms are fair and reasonable to the client and are understandably transmitted to the client in writing; 2) the client has an opportunity to seek the advice of independent counsel; and 3) the client consents. In commenting on this provision, the Model Rules state that the provision "does not, however, apply to standard commercial transactions between the lawyer and the client for products or services that the client generally markets to others, for example, banking or brokerage services . . . ." It would seem this exclusion for banking services would be applicable. Certainly the transaction between lawyer and client should be the same as or substantially similar to that with others. But the facts alleged by the OTS were that the loan to the Kaye, Scholer lawyer was "not in compliance with Lincoln's applicable loans policies and procedures." In addition, the loan was for the entire purchase price of a New York piece of property (itself distant from the trade area of the thrift); the appraisal was done without a physical inspection of the property; some of the stocks and bonds pledged as security were not endorsed or delivered to Lincoln; and the loan application was incomplete.

It was alleged that the lawyers aided and abetted the thrift in a violation of law. Presumably, one violation was that the loan was in excess of the maximum loan to value ratio which an insured thrift could make. So even without resort to the Model Rules, the OTS was on solid ground. OTS did not have to fashion a new rule for the situation of Kaye, Scholer's dual representation of its attorney and the thrift. Regulations prohibit anyone from aiding and abetting a violation of the law or regulations. It is assumed that the violation that was aided and abetted was the prohibition against making a loan in excess of the loan to value ratio. Of course, one can wonder to what extent Kaye, Scholer had anything to do with the terms of the loan. It may not have been directly involved. This is an area of uncertainty. However, since the charges were not the subject of a hearing or trial, it is assumed that they could have been

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129. Model Rules, supra note 112, Rule 1.8.
130. Id. Rule 1.8 cmt.
132. Id. ¶¶ 172, 173, 176.
133. See 12 C.F.R. § 545.6-2 (1983) (at this time the applicable loan to value ratio was 90%).
proven. Even if the OTS had relied upon the Model Rules, it appears that the dual representation could be unlawful. In an Illinois case in which a lawyer represented both parties to a loan transaction, he was suspended from practice for a year.\textsuperscript{135} Although Kaye, Scholer asserted that the loan was made at a competitive interest rate, was completely secured and that there was no loss on the loan,\textsuperscript{136} this does not address the issue of whether or not the loan violated regulations and whether the law firm “aided and abetted” any violation. The charges of conflict are based on previously established principles and do not raise novel questions. Here, too, no new ground was broken by the regulator.

B. Incompetent Advice

The OTS charged that Kaye, Scholer provided Lincoln “legal advice without having the requisite professional knowledge and expertise and by knowingly disregarding the facts . . . .”\textsuperscript{137} The first charge points up that the Kaye, Scholer team representing Lincoln were litigators and not the Banking Practice Group. The firm pointed out, that while Kaye, Scholer represented Lincoln the thrift “obtained regulatory advice from other law firms . . . .”\textsuperscript{138} The issue is squarely presented: Was Kaye, Scholer required to function as counsel expert in thrift regulatory matters or as litigation counsel? The firm saw its role as the latter, and believed it had a duty to be adversarial which meant taking positions provided “there is a basis for doing so that is not frivolous . . . .”\textsuperscript{139} Whether or not Kaye, Scholer correctly relied upon Model Rule 3.1 depends in part on whether the issue about direct investments was raised in a “proceeding.” The Model Rules do not suggest a definition. It could plausibly be argued that the rule applies only to contested, adversarial matters and not to a request for approval of certain actions submitted to a regulatory agency. It can be assumed that Kaye, Scholer has identified the correct rule, but that does not answer the precise question: Could the firm dis-

\begin{itemize}
  \item \textsuperscript{135} \textit{In re Demuth}, 533 N.E.2d 867 (Ill. 1988).
  \item \textsuperscript{136} See Cohen, supra note 122, at 216.
  \item \textsuperscript{137} Notice of Charges, supra note 15, ¶ 35a.
  \item \textsuperscript{138} Hazard Opinion, supra note 128, at 13.
  \item \textsuperscript{139} Id. at 16. The Kaye, Scholer position was based on Model Rule 3.1 which it claimed was a standard “governing the duties of litigation counsel . . . .” Id. That rule states that a lawyer shall not assert or controvert an issue in a proceeding “unless there is a basis for doing so that is not frivolous . . . .” Model Rules, supra note 112, Rule 3.1.
\end{itemize}
regard the fabricated and backdated documents for its position on Lincoln's direct investments?

In the beginning of 1985 direct investments by insured savings institutions were limited with an exception for "grandfathered" transactions. Those transactions had to be definitively planned as of December 10, 1984. In order to take advantage of the grandfather date, it was alleged that Lincoln fabricated and backdated documents, including board of director consents. Lincoln initially requested that its regulator grant it an exemption from the direct investment limitation which was denied in June, 1985. In July, 1985 Kaye, Scholer was hired in connection with the direct investments. The firm knew, it is alleged, that fabricated and backdated documents were the basis for Lincoln's position that it had "definitively planned" the transactions as of the grandfather date. In issuing a legal opinion that the direct investments were grandfathered, the OTS alleged the firm knowingly disregarded the facts. Kaye, Scholer took the position that the validity of its conclusions regarding direct investments was not affected by the validity or invalidity of the director consents. Also, the firm said the pertinent inquiry was when the thrift had "definitive plans" regarding direct investments and not the date of board action. If it is true that the fabricated and backdated documents (which are more than just the director consents mentioned by Kaye, Scholer) played no part in the conclusion reached by the firm, its position based on Model Rule 3.1 may have merit. To the extent the OTS grounded its claim on the validity or invalidity of the advice (i.e. if its position is that a lawyer could not reach a conclusion on the matter without taking into account the fabricated and backdated documents,) its position also has merit. Thus, it is difficult to reach a conclusion as to whether or not the firm's position was "frivolous," and consequently outside of Rule 3.1.

Model Rule 1.2(d) allows a lawyer to "assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law." But it prohibits a lawyer from assisting a client in conduct that the lawyer knows is criminal or fraudulent. Could Kaye, Scholer have violated this rule by disregarding fabricated and/or backdated documents in giving

141. Show Cause, supra note 10, at 27.
143. MODEL RULES, supra note 112, Rule 1.2.
144. Id. The Model Rules define fraudulent as "conduct having a
its opinion? In situations where attorneys themselves were involved in fabricating or backdating documents, they have been subject to disciplinary action. There is not a major distinction between doing the deed oneself and knowingly relying on the evidence after someone else has done the deed. So a strong argument can be made in favor of the OTS position that disregarding evidence that is known to be falsified also taints the advice given based on that evidence.

It is difficult to come to a conclusion about this allegation since all the facts are not known. If Kaye, Scholer was relying upon some valid independent evidence that Lincoln had satisfied the grandfather date and applicable law would simply discount the fabricated evidence, then the firm’s disregard of the fabricated documents, while reprehensible, may not violate an ethical principle. On the other hand, if the positive independent evidence is vitiated by fabricated and/or backdated documents, the opinion given would have been erroneous. But one does not need to move in circles since Kaye, Scholer did more than simply ignore the tainted evidence. It provided copies of the backdated consents to the federal examiners to support its conclusion that the direct investments had been grandfathered. Thus, it affirmatively relied upon documents that it knew were fabricated. To that extent, it assisted the client by using fraudulent documents. That would be a violation of Model Rule 1.2(d). Moreover, the commentary to

145. See In re Chernik, 777 P.2d 631 (Cal. 1989) (attorney present while chairman of real estate company explained mechanics of using backdated promissory note for unlawful tax deduction; probation for 3 years); In re Chira, 727 P.2d 753 (Cal. 1986) (attorney backdated documents for tax shelter; probation for 3 years); In re Stern, 529 N.E.2d 562 (Ill. 1988) (attorney backdated letter to show his belief that he had complied with an order; censure); In re Price, 429 N.E.2d 961 (Ind. 1982) (attorney placed settlement in trust account so client could maintain low asset status); In re Nash, 568 N.Y.S.2d 936 (N.Y. App. Div. 1991) (attorney backdated separation agreement; 1 year suspension); In re Insogna, 493 N.Y.S.2d 662 (N.Y. App. Div. 1985) (attorney backdated separation agreement; suspended for 6 months); In re Finger, 431 N.Y.S.2d 71 (N.Y. App. Div. 1980), cert. denied, 450 U.S. 922 (1980) (attorney disbarred for filing false and fraudulent affidavit); In re Bybee, 629 P.2d 423 (Utah 1981) (attorney changed bail bond to performance bond; suspended for two months).

146. Show Cause, supra note 10, at 21.

147. In 1986, Kaye, Scholer stated to the examiners that Lincoln had planned to make the direct investments in compliance with the law. In September, 1988 Kaye, Scholer gave the regulators backdated documents and did not mention that the documents “had been fabricated and falsified by Lincoln employees.” Id. at 28-29.
Model Rule 1.2 says that "a lawyer is not required to pursue objectives or employ means simply because a client may wish that the lawyer do so." Even though Lincoln may have wanted Kaye, Scholer to utilize the documents, the law firm was not obliged to "employ means" that the thrift desired.

Model Rule 1.1 on competency provides that "[a] lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." Professor Charles Wolfram has noted that "enforcement of competence standards has been generally limited to relatively exotic, blatant, or repeated cases of lawyer bungling." Disregarding factors that should be considered in rendering a legal opinion could arguably be incompetence. In this situation, Kaye, Scholer has argued that the fabricated and backdated items were "immaterial" to its conclusion. If indeed they were, then it would be difficult to argue that disregard of immaterial facts is incompetency. Use of the fabricated and backdated documents may, instead of a violation of rules on competency, be a violation of rules on assisting a client in fraud. There is a negative visceral reaction to any knowing use of fabricated and backdated documents. The better course of action in this situation would have been to simply refuse to go to the regulators once again on the issue. After all, on a prior occasion the regulators had denied an attempt to grandfather the transaction. In Kaye, Scholer's behalf, it could be argued that with an institutional client, there may be individuals who erroneously believed they could help the cause by fabricating evidence and the actions of a few individuals should not be attributed to the institution. This argument has, however, recently been discounted in an attorney liability action.

It appears that the OTS also charged incompetency in part because Kaye, Scholer used litigators and not regulatory lawyers. It alleged a lack of "the requisite professional knowledge." A case related to Lincoln Savings & Loan and Kaye, Scholer

148. MODEL RULES, supra note 112, Rule 1.2 cmt.
149. Id. Rule 1.1.
150. CHARLES WOLFRAM, MODERN LEGAL ETHICS § 5.1 (1986).
151. FDIC v. O'Melveny & Myers, 969 F.2d 744 (9th Cir. 1992).
152. In commenting on how financial institution counsel can deal with regulators, a former deputy director of enforcement at the Federal Home Loan Bank Board said "I really don't recommend focusing on, 'We're going to fight it out in court, and we're going to get our due process, and its going to be wonderful,' because that's not what's going to happen." Work Out Problems with Agencies Early, Regulators, Attorneys Tell ABA Listeners, 59 BANKING REP. (BNA) 264 (1992).
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Scholer is that in which the OTS obtained $600,000, the highest restitution amount to date against a single attorney, based on an opinion which the attorney issued. In an earlier case, the OTS brought an enforcement action against Sherman & Howard, the law firm which advised Silverado Banking, Savings and Loan Association, the Denver institution with which Neil Bush was affiliated. The basis of the action was advice given by the firm. In a consent settlement the firm agreed to seek advice from OTS when necessary to determine compliance with federal law.

The Kaye, Scholer settlement contained provisions that an opinion on compliance with banking statutes or regulations should be prepared under the supervision of a banking partner. Also, when providing a legal opinion on an unresolved issue, Kaye, Scholer is to explicitly advise the board of a depository institution that it must take into account safety and soundness issues and that the officers and directors should take into account possibly "seeking advice and guidance from the . . . primary federal regulator." The order specifically stated the content of Kaye, Scholer's advice on unsafe and unsound practices. These situations indicate that regulators are having some success in focusing upon the content of advice given.

153. The attorney is James S. Fleischer, formerly with the Federal Home Loan Bank Board. He gave an opinion in 1985 indicating that Lincoln could pledge assets to guarantee debt of an ESOP (employee stock ownership plan) of its parent ACC. At the time, according to Fleischer, he did not believe that the Employees Stock Option Program was controlled by ACC and thus it was not an affiliate of Lincoln. That belief was apparently based on assurances from Kaye, Scholer. Lawyer Will Pay $600,000 in Restitution in First Such Enforcement Action by OTS, 58 BANKING REP. (BNA) 960 (1992).

154. See Thrift Lawyers Can Be Regulated By OTS, Senior Agency Official Says, 56 BANKING REP. (BNA) 1204 (1991) [hereinafter Thrift Lawyers]. Six months earlier, a court ruled that a complaint against the same law firm, Sherman & Howard, stated a cause of action. The court indicated an argument could be made that an attorney must offer advice when a client is making a "legally unacceptable decision." FDIC v. Wise, 758 F. Supp. 1414, 1419 (D. Colo. 1991). In another case, a Mississippi law firm, Ingram, Matthews agreed to reimburse fees received. It had advised a failed thrift that it could invest in an unemployment compensation firm and the thrift consumated the investment without required regulatory approval. Thrift Lawyers, at 1204.


156. Id. ¶ 9. The advice should indicate that an unsafe or unsound practice embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be unacceptable risk of loss or damage to an institution, its shareholders, its depositors, or the insurance fund. Id.

157. OTS chief counsel Weinstein has said that the agency "is determined to make sure that legal advice provided to thrift officials is
While the contours of the obligation to provide competent advice are unclear, the regulators can argue that specialist knowledge may be required. In commentary to Model Rule 1.1 regarding competency, it is stated that "[e]xpertise in a particular field of law may be required in some circumstances."\(^{158}\) It may be that OTS believes that lawyers with expertise in financial institution regulatory matters would not have relied upon the fabricated and backdated documents. If so, that belief is questionable. The pertinent distinction is not between litigators and regulatory lawyers, but rather lawyers (with any specialty) who would disregard backdated documents and those who would not. Kaye, Scholer's positions, as expressed in the summary of Professor Geoffrey Hazard's expert testimony which it distributed, are premised upon the belief that the standards for litigators are different from those for non-litigators. But even if the question of grandfathered direct investments was in litigation, it would not have been permissible to rely upon the backdated and fabricated documents. Model Rule 3.3(a)(4) states a lawyer "shall not knowingly offer evidence that the lawyer knows to be false."\(^{159}\) If, as the charges indicate, Kaye, Scholer knew the documents were false, the fact that the lawyers were litigators thus does not provide any added comfort. The OTS relied upon its "aiding and abetting" regulation\(^{160}\) and to the extent that Kaye, Scholer helped Lincoln to evade the direct investment limitations of the law (including a prior regulatory disapproval of the investments) then the OTS was on firm ground.

C. Failure to Advise Board and Individuals

Another allegation of the OTS was that Kaye, Scholer failed to advise the Lincoln board of directors that Keating and others were not acting in the best interests of the thrift or that the Lincoln officers and directors were engaged in unlawful conduct.\(^{161}\) The charges labelled this "unethical and improper consistent with the agency's goals of safe and sound savings institutions."

*Thrift Lawyers*, *supra* note 154, at 1204.

\(^{158}\) *Model Rules*, *supra* note 112, Rule 1.1 cmt.

\(^{159}\) *Id.* Rule 3.3.


\(^{161}\) Notice of Charges, *supra* note 15, ¶¶ 52, 55. It was also alleged that the lawyers failed to advise the Lincoln officers and directors of their own fiduciary duties to Lincoln depositors. *Id.* ¶ 54. This charge suggests the specific content of advice that should have been given. However, Kaye, Scholer could question this allegation since it saw itself as litigation counsel and not regulatory counsel. So the firm might well dispute its obligation to
professional conduct" but the OTS chief counsel subsequently relied upon Model Rule 1.13(b)(3) for the notion that lawyers must inform the directors of a corporate client of legal violations and Model Rule 1.16 to suggest attorney withdrawal if there is criminal or fraudulent conduct. Model Rule 1.13 relates to organizational clients and establishes that the client is in fact the entity represented although it acts through authorized agents. It sets out a number of options where a lawyer knows that someone associated with the organization is violating or will violate law and substantial injury to the organization may result. The lawyer is required to "proceed as is reasonably necessary in the best interest of the organization." However, none of the options mentioned, including referral to the board, are specifically required.

Model Rule 1.16 (b) allows withdrawal from representation where the client uses the lawyer's services to perpetrate a crime or fraud. However, withdrawal is not mandatory. It says a lawyer may withdraw rather than that he/she shall withdraw. One can question the effectiveness of counsel withdrawal on the cessation of any nefarious activity by Lincoln. Apparently a variety of law firms were utilized by the thrift.

The OTS charges against Kaye, Scholer did not allege a failure to withdraw where required, but rather a failure to inform the board. To the extent that this allegation suggests that Kaye, Scholer's disregard of fabricated and backdated documents could be said to improperly utilize a lawyer's services. Also, the failure to disclose and the misrepresentations discussed below might be targeted.

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162. Id. ¶ 57.
163. Attorneys Can't Claim Privilege as Agent of Their Clients, OTS' Chief Counsel Argues, BANKING ATT'Y (BNA), May 25, 1992, at 5 [hereinafter Attorneys Can't Claim Privilege].
164. MODEL RULES, supra note 112, Rule 1.13(b).
165. WOLFRAM, supra note 150, § 13.7. "None of the listed options is mandatory; indeed, a lawyer could fail to select any one of them, by designing still another option . . . fully comply with the rule." Id. at 745.
166. MODEL RULES, supra note 112, Rule 1.16. Kaye, Scholer's disregard of fabricated and backdated documents could be said to improperly utilize a lawyer's services. Also, the failure to disclose and the misrepresentations discussed below might be targeted.
167. See supra text accompanying note 41.
168. Wolfram suggests that any measures taken under Model Rule 1.13(b) cannot include notification of public agencies. WOLFRAM, supra note 150, § 12.7. However, the OTS included a number of charges against Kaye, Scholer based upon its failure to disclose certain information to the regulators. See infra text accompanying notes 190-208.
Scholer was required to make this gesture, it goes beyond the language of the model rules.

Also, it is questionable whether any information which Kaye, Scholer could have given the Lincoln board about Keating would have made a difference. Judy Wisher, a C.P.A. and the board chairman, president and chief executive officer of Lincoln and president of ACC, the holding company, settled a Securities and Exchange Commission fraud charge, pleaded guilty to federal criminal charges and also entered into a consent agreement with OTS under which a judgment of $25 million was entered. In addition, a restitution order to the Resolution Trust Corporation (RTC) for $25 million was entered. The ninth circuit decision in FDIC v. O'Melveny & Meyers indicates, however, that a corporate client has an identity distinct from wrongdoing officers and thus it may not avail a firm to point out that a high ranking officer/director would not likely heed advice from the firm.

Although OTS did not announce a new rule relating to information that must be given to a board of directors, the comments of its chief counsel extend the Model Rules about board disclosure into required action rather than an option available to an attorney. Thus, the regulators went beyond the confines of the rule to the extent they imply a strict requirement to go to the board about wrongdoing officials. What is important, however, is the underlying recognition that attorneys must take some action when faced with a constituent of a corporate client like Keating. The OTS position puts a firm in a peculiar position. An entity controlled by a dominant, but wrongdoing, constituent may well discharge any attorney who attempts to call the board's attention to improprieties. The

169. Among the items which should have been called to the attention of the board, according to the OTS charges, were: the high risk nature of the real estate development business; that the thrift's assets were overvalued; accounting treatment was designed to conceal the thrift's violation of the direct investment rule; certain real estate transactions were fictitious; documents were created subsequent to the time loans were funded. Notice of Charges, supra note 15, ¶ 52-57.


171. 969 F.2d 744 (9th Cir. 1992).

172. Id. The court stated: "We conclude that ADSB has a corporate identity distinct from that of its wrongdoing officers." 969 F.2d at 751. Involved was the position of a law firm that it had no duty to disclose information that entity officials already knew and were trying to conceal. The court rejected that argument and said the insiders' conduct was not attributable to the corporation.
lawyer must then weigh the benefits and detriments of continuing the representation. If he or she calls the matter to the board's attention and then withdraws when the board fails to take action, it seems that the Model Rules will be satisfied. If he or she remains silent and continues the representation, drastic action like that which faced Kaye, Scholer may well result. Nonetheless, the OTS action points out that a lawyer's duty runs to the corporate entity, rather than a constituent. That principle is not new.\footnote{173}{See, e.g., Lane v. Chowning, 610 F.2d 1385 (8th Cir. 1979) (holding that attorneys representing a corporation are in a fiduciary capacity to the corporation); Skarbrevik v. Cohen, England & Whitfield & Stuart Comis, 282 Cal. Rptr 627 (Ct. App. 1991) (minority shareholder could not recover against corporate attorney based on dilution of stock; duty of attorney was to corporation); Felty v. Hartweg, 523 N.E.2d 555 (Ill. App. Ct. 1988) (minority shareholder could not state cause of action against corporate attorney for failure to disclose improper conduct of officer; attorney's obligations ran to corporation and not shareholder).}

D. Failure to Disclose and Misrepresentation

A group of allegations against Kaye, Scholer are those that charged the firm failed to disclose numerous items to the regulator.\footnote{174}{See infra text accompanying notes 190-208.} One issue raised by these allegations is whether lawyers must become "whistle blowers."\footnote{175}{See generally Helms, supra note 6.} Another is whether lawyers are expected to disclose client confidences. However, most of the items that Kaye, Scholer was alleged to have failed to disclose were linked with an allegation that it made actual misrepresentations. Thus, in the instances where the firm actually said something, the inquiry is whether the something that was said constituted a misrepresentation because it failed to disclose something else about the matter. Also, there is the question of whether or not statements made were truthful, because there was contrary evidence that the firm failed to disclose.

The firm was charged with failing to tell the regulator of the real reason for the resignation of Lincoln's outside auditor, Arthur Andersen & Co.\footnote{176}{Notice of Charges, supra note 15, 36-44.} Two months before the auditing firm resigned, Kaye, Scholer interviewed a partner with the accounting firm who told the lawyers several things, among them that "Lincoln looks like most of the other S&L's that have failed . . . ."\footnote{177}{Id. at 16.} The law firm sent to ACC/Lincoln's Keating a copy of its memorandum of the interview with the accounting
partner and told Keating that the interview gave "some insight into what may have motivated" the auditing firm’s decision to resign. Just a few days after the resignation, the law firm stated to the regulators that it did not result from any concerns the accounting firm had with Lincoln's operations. The regulators viewed this statement as inaccurate because it felt the accounting firm had expressed concerns about the operations which Kaye, Scholer failed to disclose.

The law firm made representations about Lincoln's financial success which, it was alleged, failed to disclose material facts about linked and/or fictitious transactions about which Kaye, Scholer knew. It was charged that the law firm knew that documents were removed for loan files and others created and added, that it knew that misleading underwriting summaries were created, and that there were deficiencies in the underwriting process. Nonetheless, it was charged that the firm made misrepresentations such as that there was "no basis for the conclusion that Lincoln’s high yield bond underwriting is inadequate" or that in "making real estate loans, Lincoln has always undertaken very careful and thorough procedures to analyze the collateral and the borrower."

In another instance, the claims against Kaye, Scholer related to whether Lincoln’s arrangement with Conley D. Wolfswinkel on a particular transaction should be a loan or a joint venture. The OTS charged that the law firm "knew from its

178. Id. at 17. The regulators had access to memos the firm sent to Keating because the receivership of Lincoln put a regulator in charge of the thrift. As such, the regulators now held the attorney-client privilege and could waive it. See the discussion of the Odmark and Weintraub cases and this issue in Helms, supra note 6, at 311-16.


180. "Lincoln's managerial skill, its sound diversification of investments and its prudent underwriting are all demonstrated by the unqualified success of its investment program. That success cannot fairly be attributable to change or excessive risk taking." Id. ¶ 70.

181. The OTS cited a statement from an internal memo and stated that "Kaye Scholer recognized ‘linked transactions’ remain the greatest area of concern. . . . We know that Charlie [Keating] will probably continue to do these transactions to support ACC’s real estate business, but these deals may be a powder keg which could explode if the FHLBB analyzes them carefully." Id. ¶ 67.

182. Id. ¶¶ 76-78. One Kaye, Scholer internal memo asserted that "prior to the 1986 Board examination, ACC's [sic, actually Lincoln’s] loan files ran the spectrum from disaster to non-existent." Id. ¶ 76.

183. Id. ¶¶ 84-87.

184. Id. ¶¶ 94-100.

185. Id. ¶ 101.

186. Id. ¶ 88.
own investigation, however, that the facts differed from those assumed by the accounting firms. Thus Kaye, Scholer knew that its statements regarding the 'close scrutiny' and 'careful review' [by accountants] were false and misleading."

At the end of December 1984, Lincoln purchased the Hotel Pontchartrain in Detroit, Michigan, and transferred it to a Lincoln subsidiary. The subsidiary became the general partner of a tax shelter limited partnership composed of Keating and other insiders of ACC. Another Lincoln subsidiary then granted the tax shelter limited partnership a line of credit. The regulator said the transaction was illegal because of affiliate issues and safety and soundness questions. It charged Kaye, Scholer with making false and misleading representations about the transaction by failing to disclose facts. The items that Kaye, Scholer allegedly knew included the lack of material in the files and the law firm's own concerns about safety and soundness and affiliate transactions.

The claims of failing to disclose and making false and misleading statements were not based on any Model Rules of Professional Conduct. However the Rules are important to the extent that they deal with the question of whether a lawyer must disclose matters about which he/she acquires knowledge in the course of representing a client. The Model Rules to examine are 1.6 on confidentiality, 3.3 requiring candor toward a tribunal, and 4.1 about truthfulness in statements to others.

The confidentiality principle in rule 1.6 is often seen as a cornerstone of the lawyer-client relationship. It is thought that because they know confidences will not be disclosed by a lawyer, clients will be more forthcoming. Rule 1.6(a) prohibits

187. Id. ¶ 136.
188. Id. ¶ 159.

Lincoln's funding of the Pontchartrain, including the line of credit, was illegal in several respects. Because [the tax shelter] was an affiliated person of Lincoln . . . [loans to the tax shelter] were prohibited affiliated transactions . . . . This was also in violation of the FSLIC's conflict of interest policy . . . and was an unsafe and unsound practice.

Id. The OTS relied upon 12 C.F.R. §§ 563.43, 584.3, and 571.7 as well as its view of what was unsafe and unsound.

189. Internal Kaye, Scholer memos made after an examination of files relating to the Pontchartrain matter stated that the "file lacks virtually all required materials . . . . The loan has serious problems concerning (a) safety and soundness and (b) affiliate transactions . . . . Possibly more serious are the affiliate issues . . . ." Id. ¶¶ 160(a)(b)(c).

190. MODEL RULES, supra note 112, Rules 1.6, 3.3, 4.1. Rule 8.4(c) deems it professional misconduct for a lawyer to "engage in conduct involving dishonesty, fraud, deceit or misrepresentation."
a lawyer from revealing "information relating to representation of a client unless the client consents after consultation . . . and except as stated in paragraph (b)." The exceptions in paragraph (b) include preventing a client from doing a criminal act likely to result in death or bodily harm and where the lawyer is defending himself. Neither of the two exceptions apply to the type of disclosures that the regulators thought should have been made in the Kaye, Scholer situation.

Model Rule 3.3 is entitled "Candor Toward the Tribunal." It is questionable whether a federal regulator to whom one responds in connection with an examination and not at a hearing is a "tribunal." However, it will be assumed that Model Rule 3.3 is applicable to the Kaye, Scholer situation. Model Rule 3.3(a)(1) prohibits one from knowingly making "a false statement of material fact or law to a tribunal." The comments to the Rule suggest that "[t]here are circumstances where failure to make a disclosure is the equivalent of an affirmative misrepresentation." In applying this section, one must ask whether any of the assertions made by Kaye, Scholer were misrepresentations. For example, Kaye, Scholer said there was "no basis" for adverse conclusions about bond underwriting. Since the firm knew about deficiencies in the underwriting process, its statement that there was "no basis" would be too expansive, according to the regulator's view. Another part of Rule 3.3(d) deals with failing to disclose in ex parte proceedings and requires the lawyer to "inform the tribunal of all material facts known to the lawyer . . . whether or not the facts are adverse." The OTS apparently viewed the Lincoln situation as non-adversarial while Kaye, Scholer did not. There is certainly justification for Kaye, Scholer to see

191. Id. Rule 1.6(a).
192. An earlier draft of the Model Rules had two exceptions that could have been the basis of an argument that Kaye, Scholer had to disclose. One permitted confidences to be disclosed where necessary to prevent a fraudulent act that the lawyer believed would result in injury to a financial interest and another would have allowed it to "rectify the consequences" of a fraudulent act. See Helms, supra note 6, at 297.
193. Since the Kaye, Scholer lawyers who represented Lincoln were litigators it is perhaps appropriate to evaluate their conduct in light of principles governing contested adversarial proceedings.
194. Model Rules, supra note 112, Rule 3.3.
195. Id. Rule 3.3 cmt.
196. Id. Rule 3.3(d).
197. The two points of view are summarized in Podgers, supra note 128, at 54. Kaye, Scholer says it was litigation counsel and such counsel has no affirmative duty to disclose confidential information. The agency position
the regulator as the opposite party to Lincoln and thus not viewing the situation akin to an *ex parte* proceeding. But if the situation were *ex parte*, the Model Rules would then require disclosure of material facts. The point of dispute then would be about which facts are material.

Another rule may be applicable here and it does not explicitly require "whistle blowing."[198] It is the rule which governs a lawyer's relationship with others outside of the litigation context.[199] Model Rule 4.1 is titled "Truthfulness in Statements to Others" and prohibits a lawyer from knowingly making a false statement of material fact or law to a third person.[200] The comment points out that there is "no affirmative duty to inform an opposing party of relevant facts."[201] Thus the inquiry here is whether in any of the situations relied upon by the OTS, Kaye, Scholer's actual statements were false because they failed to disclose an item. Lawyers generally practice the art of telling the truth attractively and so Kaye, Scholer could argue that in some of the instances noted, it was simply doing that, rather than making a false statement. However, Rule 4.1 says that one should not fail to disclose material facts when necessary to avoid a fraudulent act by a client, unless prohibited by the confidentiality rule.[202] It appears that in the Kaye, Scholer situation many of the transactions had already been completed and nothing the law firm could have done would prevent fraudulent acts by the parties involved. Yet, there is the question of whether the firm could have avoided any deception of the regulators.

The Model Rules define fraud or fraudulent as "conduct having a purpose to deceive and not merely negligent misrepresentation or failure to apprise another of relevant information."[203] To the extent that it could be said that Lincoln was

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198. For a discussion of whistle blowing, see Helms, *supra* note 6.

199. See Hazard & Hodes, *supra* note 112, § 4.101. Hazard and Hodes find inconsistencies in Rules 1.2(d), 1.6 and 4.1(b). Thus, they suggest a lawyer must speak if his or her silence would assist client fraud. The confidentiality principle would not prevent the lawyer from speaking because the authors claim that speaking out is "required by law" in Rule 1.2(d).


201. *Id.* Rule 4.1 cmt.

202. Wolfram asserts that in dealing with the interrelationship between 4.1 and 1.6 one runs into a "meaningless semantic puzzle." Since 4.1 excepts from disclosure confidential information of 1.6, the rule is a "closed loop." See Wolfram, *supra* note 150, § 13.5.8.

attempting to deceive the regulators by not telling certain facts, then it could be argued that the lawyers needed to disclose to prevent that deception by its client. However, Model Rule 1.2(d) prohibits a lawyer from assisting a client in conduct that is fraudulent. Thus, a question is whether zealous advocacy, such as Kaye, Scholer believed it was doing, assisted the client in fraudulent conduct.

An ABA Opinion shortly after the Model Rules were adopted stated that a "lawyer is under a duty not to mislead the Internal Revenue Service deliberately, either by misstatements or by silence or by permitting the client to mislead." In other cases where disclosure was required by other laws, attorneys were required to be forthcoming. SEC v. National Student Marketing dealt with specific requirements for disclosure in the Securities Acts of 1933 and 1934. United States v. Goldberger & Dubin involved a statute dealing with money laundering which required any person receiving more than $10,000 in cash to identify the payor's name. It was ruled that lawyers were required to provide the names of clients who had paid cash fees. These cases seem to suggest that specific requirements to disclose in laws external to the Model Rules can be applied against attorneys. There is such a regulation that covers the Kaye, Scholer situation.

By virtue of regulations, insured thrifts had obligations, including not to make false or misleading statements. The

204. It is questionable whether a lawyer will be able to continue representing a client when the lawyer acts in a whistle blowing capacity. In Balla v. Gambro, 584 N.E.2d 104 (Ill. 1991) an in house attorney of a company that distributed kidney dialysis equipment told the president that he would report to the Food and Drug Administration when the company accepted a shipment of equipment that did not conform to regulations. The court ruled that he did not have a claim for retaliatory discharge, even though it noted that he was required under Model Rule 1.6(b) to reveal the company's intention to sell misbranded or adulterated dialyzers. The court felt that employers might limit their communications to counsel if retaliatory discharge were available to attorneys. In dissent, Justice Freeman said, 'We cannot continue to delude ourselves . . . that attorneys' ethical duties, alone, are always sufficient to guarantee that lawyers will 'do the right thing.' " 584 N.E.2d at 113.


206. 457 F. Supp. 682 (D.D.C. 1978) (lawyers who knew that merger documents had material omissions were required to disclose).


208. 935 F.2d 501 (2d Cir. 1991).

209. Lawyers have similar duties. See MODEL RULES, supra note 112, Rule 8.4 which describes the lawyer's duty not to engage in fraud, deceit or misrepresentation.
OTS charged Kaye, Scholer with violating that requirement, among others. The prohibition against omissions and providing false and misleading statements that Kaye, Scholer was charged with violating was in a regulation applicable to insured institutions as well as any "other person participating in the conduct of the affairs of such institution." Because the statute creating IAP prohibits violating a regulation, that provision could apply to lawyers Kaye, Scholer. It is also directly applicable to a "person participating" in the affairs of an insured institution. OTS claimed that Kaye, Scholer interposed itself between the thrift and the regulators and thus became bound by the same disclosure duties that the thrift had. It believed that an adversarial relationship would have existed if there had been a formal investigation or a Notice of Charges had been issued against Lincoln. On the other hand, law professor Geoffrey C. Hazard believed that the standards applicable in this situation were those relating to "a matter that has become adversarial and which involves a reasonable anticipation of possible litigation" and that Kaye, Scholer as litigation counsel was not required to make affirmative disclosures. The essence of the dispute is the role that Kaye, Scholer lawyers played. OTS believed that the firm took on the disclosure obligations of its client Lincoln and distinguished acting as an advocate on

210. The other regulations used were those relating to record keeping and disclosure; unethical professional conduct; and willfully aiding and abetting violations. See supra notes 114-17 and accompanying text.


212. The OTS said that "the interposition of the firm between the regulators and the institution separates this case from any other that we have seen. Because of this conduct, we alleged that Kaye, Scholer was not just the lawyer for, but was also the agent of Lincoln in the examination process." Attorneys Can't Claim Privilege, supra note 163, at 5.

213. See Podgers, supra note 128. Of the Lincoln situation, the OTS chief counsel said: "What in the ordinary course is the examination by the regulator of the books, records and employees of a federally insured institution was largely limited to a review of documents selected or created by the lawyers." Id. at 54. One of the regulations relied upon by the OTS in the Kaye, Scholer situation was one that required books and records to be maintained and provided that those documents, files and materials should be available for the agency to examine and audit "at all times." 12 C.F.R. § 563.17 (1986) (current version at 12 C.F.R. § 563.170(c) (1992)). Kaye, Scholer determined what documents the regulator could see and presumably that was the basis for the allegation against Kaye, Scholer charging it with violating that regulation.

214. See Podgers, supra note 128, at 55.

one hand and presenting the factual information on which the regulator must act on the other hand.\textsuperscript{216} The OTS position has some support in the regulation requiring that documents be maintained and giving OTS access at any time. It appears that the OTS does not wish to interact with lawyers until the matter has reached what the regulator might consider an adversarial situation.\textsuperscript{217} A former banking regulator has suggested that lawyers press for sufficient time between notice and a meeting with regulators so that the lawyer will not inadvertently run afoul of regulations requiring disclosure.\textsuperscript{218} While the requirements for institution disclosure are explicitly stated in regulations, the OTS insistence upon attorney disclosure in the Kaye, Scholer circumstance is novel. OTS may well be on firm ground in charging that Kaye, Scholer had the disclosure obligations of its client, but the issue is whether or not it will take that approach with other lawyers. The refusal to give a private letter opinion because an attorney had failed to disclose information suggests the OTS will take an aggressive posture.\textsuperscript{219} Because FIRREA covers IAP (which includes attorneys) and prohibits violations of regula-

\textsuperscript{216} OTS chief counsel Weinstein said in remarks prepared for the A.B.A. meeting in August, 1992: “The lawyer is acting as advocate in arguing for the best result for the client, but the lawyer may also be acting as the client’s agent in presenting the factual information on which the agency will base its decision.” \textit{ABA, OTS Square Off On Lawyer Liability in Moves Toward Debate, Possible Battle}, \textit{59 Banking Rep.} (BNA) 268, 268 (1992) [hereinafter \textit{ABA, OTS Square Off}].

\textsuperscript{217} “In circumstances other than formal litigation, however, such as approvals of applications for license, mergers, or a determination on whether to bring an enforcement action — the line between simply presenting the facts and arguing as an advocate is less clear.” \textit{Id.} In April, 1992 the Deputy Director for Regional Operations at OTS wrote to chief executive officers and requested that attorneys not be brought to the agency when an appeal of agency actions is being made. \textit{OTS Presses for Changes in Attorney Representation During Bank Examinations}, \textit{1 Bank Governance L. Rep.} 654 (1992).

\textsuperscript{218} A former deputy director of enforcement at the Federal Home Loan Bank Board has said, “It’s a little tough not to make a misrepresentation just for lack of knowledge.” \textit{ABA, OTS Square Off}, supra note 216, at 268.

\textsuperscript{219} The inquiry was whether a thrift could indemnify employees who served as fiduciaries of the association’s pension plan or persons who were officers and directors of other subsidiaries. In response, the OTS pointed out that the letter of inquiry did not disclose Department of Labor allegations of violations by the Committee governing the pension plan. The OTS said “In view of your failure to disclose these matters . . . we decline to provide any substantive response to your request.” \textit{OTS’s Weinstein Rebukes Attorney Who Failed to Disclose Material Information in Seeking an OTS Legal Opinion}, \textit{1 Bank Governance L. Rep.} 1161 (1992). The OTS rested upon its regulation applicable to any “director, officer, agent, employee, affiliated person, or
tions (which includes that requiring disclosure) the OTS is on solid ground. When judged against the confidentiality principle, it is likely that this scheme can still be upheld, for attorneys have no right to make false and misleading statements. In Kaye, Scholer as in the recent letter ruling, a statement was made. Its completeness was the issue. Weinstein says that "[o]nce the attorney reveals information secured in privileged circumstances, there is no right to mislead."220 The lawyer is now faced with a choice: Whether he/she shall remain completely silent or speak. If information is given, and leaving something out makes the information given misleading, then disclosure may be required by regulation, if not rules of attorney conduct.

VI. Conclusion

One is tempted to say that the whole Kaye, Scholer/OTS matter is an aberration. . . . Kaye, Scholer should not be read for any more than it really is. On the other hand, it should not be read for any less than a reaffirmation of the seriousness with which the government regulators view the role of counsel in insured financial institutions.221

The Kaye, Scholer case should not be cause for alarm. The OTS alleged that the actions of the law firm were such as to make it both an entity that "participated in the conduct of the affairs" of Lincoln and an "institution-affiliated" party (IAP).222 The latter was a concept introduced by FIRREA in 1989. Before an attorney can be responsible in enforcement proceedings as an IAP, there are several hurdles a regulator must clear. First, the attorney's action must be knowing or reckless. While the statute does not define those terms, it would seem that mere negligence would not suffice. Secondly, the attorney must participate in one of three things: (1) a violation of law or regulation; (2) a breach of some fiduciary duty; or (3) an unsafe or unsound practice. Thirdly, the attorney's action must occasion more than a minimal loss or involve a significant adverse effect on an insured depository institution.223

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220. Podgers, supra note 128, at 54.
223. See supra note 85 and accompanying text. The actions of Kaye, Scholer took place before FIRREA. However, the OTS charged the firm with participation in the affairs of Lincoln which was a standard before FIRREA.
Two of the regulations which Kaye, Scholer was charged with violating are those which form the basis for censuring or disbarring an attorney from practice before the OTS. These are regulations prohibiting unethical or improper professional conduct and prohibiting willful aiding and abetting the violation of laws, rules or regulations. Two other regulations place affirmative obligations to maintain records and to refrain from false or misleading statements or omissions.

The regulations do not define what is improper professional conduct so reference to the Model Rules seem appropriate. In the Kaye, Scholer situation the charges of conflict of interest, giving incompetent advice and failing to advise the board of directors of Lincoln do not involve any novel principles. The Model Rules cover the charges. Since there was no adversarial, litigated resolution of the charges, one has to assume their truth. Based upon the allegations made, and judging them by the Model Rules, Kaye, Scholer’s actions in the above mentioned three areas were improper professional conduct.

The last area — that of misrepresentation by failing to disclose — is more troublesome. The failure to disclose alone does not appear to violate the Model Rules. However, if that failure assists client fraud, it is a violation. From all the facts and circumstances surrounding the Lincoln situation, it appears that the thrift was attempting to deceive the regulator. So it is quite plausible that Kaye, Scholer’s actions assisted the thrift. The OTS also coupled the allegations about failure to disclose with allegations that statements were made which became misrepresentations by failing to disclose. Did those statements thereby become false or misleading? Again, since there was no trial, it has to be assumed that the statements did in fact mislead the regulator.

If Kaye, Scholer participated in the conduct of the affairs of the institution as the OTS charged, it was bound to comply with the regulation which prohibited any false or misleading statement or omission. The OTS charged that Kaye, Scholer acted as an agent for Lincoln. That allegation was separate from its charge that Kaye, Scholer provided legal representation for Lincoln. The agency charge focused attention on the

224. See Jensen, supra note 32. Some think that the delay in ruling Lincoln insolvent “added $1 billion to the size of the thrift’s losses.” Id.

225. The bondholders claimed that the firm should be responsible for the delay in the regulator’s taking action because Kaye, Scholer argued with the regulator about its criticisms of Lincoln.
firm's actions that may have gone beyond the role of counsel to which the agency was more accustomed. It was probably significant that the firm "interposed" itself between the regulator and the thrift, requiring that all communications flow through an attorney in New York. The law firm was the provider of facts to the regulator. Also, the persons who handled Lincoln's affairs with the regulators were litigators who took an aggressive, adversarial position on behalf of the thrift.

The Kaye, Scholer situation may have helped to focus close attention upon attorneys who represent financial institutions. Almost a year before the Kaye, Scholer charges were filed, the deputy chief counsel for special projects at the OTS suggested that "reviews by OTS show directors and officers have been and are being advised and directed in a way that results in substantial losses to their institutions." Although the Kaye, Scholer charges caused a big wave on the ocean of lawyer responsibility, the case does not involve novel theories. There was nothing in the charges or in the settlement that focused upon the need for any whistle blowing by attorneys, if that means disclosing to the regulators unlawful activity by an insured depository institution. What appears from the Kaye, Scholer case is that the lawyers were not mindful of the insured status of Lincoln. An insured depository is not like the corporation where those who stand to lose upon sharp practices may be just the shareholders who have put up risk capital. Rather, the parties who must be satisfied are depositors. They seek a return of money placed for safe keeping in an insured institution either from the institution itself or the deposit insurance fund. To the extent that the Kaye, Scholer case prompted lawyers to think more carefully about how they represent insured depository institutions, it has had a beneficial effect.

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226. See Notice of Charges, supra note 15, ¶ 45: "Fishbein interposed Kaye Scholer between Lincoln and the FHLBB [Federal Home Loan Bank Board] with respect to all factual matters relating to the 1986 Examination of Lincoln."

227. See Beck & Orey, supra note 40.

228. "Insider fraud and abuse was a significant factor in many of the thrift failures in the 1980s and 40% of thrift failures were due to some form of fraud or insider abuse." Jeffrey M. Winn, Fidelity Insurance and Financial Institutions in the Post-FIRREA Era, 109 Banking L.J. 149 (1992).

229. Thrift Lawyers, supra note 154, at 1204.