27

ATTORNEY LIABILITY FOR CLIENT FRAUD: LESSONS FROM THE CONVICTION OF OUTSIDE COUNSEL IN THE REFCO FUND

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INTRODUCTION

In December 2007, the Department of Justice announced the indictment of Joseph Collins for his role in the fraud at Refco, Inc., that resulted in the company's bankruptcy. Collins was a partner at the Mayer Brown law firm and served as outside counsel to Refco for many years. In July 2009, Collins was convicted of securities fraud and other related charges. A few months earlier, however, a court dismissed all securities fraud claims against Collins in a class action lawsuit. As this case demonstrates, although outside counsel may not currently face significant risk of liability from a private action,[1] the risk of criminal liability still exists. Previously, this risk had not received significant attention because outside counsel in the scandals at Enron, Worldcom, and others, were not indicted.

The Department of Justice claims that this case does not represent a significant shift in its policy. The U.S. Attorney announcing the indictment stated that these "charges should be no cause for concern for the vast majority of outside counsel who conduct themselves lawfully. It is not a crime to have a client who commits a crime."[2] Even if the government is not changing its policy, this case provides a useful opportunity to review outside counsel's potential liability and ethical obligations when the officers of a client company are suspected of engaging in fraud.

I. THE BASIC FACTS[3]

Collins joined Mayer Brown in 1994 and brought Refco to the firm as a client at the time. For the next 10 years, Refco was Collins's largest client and the representation generated over $40 million in fees for the law firm. During this time, Collins worked closely with Phillip Bennett, the CEO of Refco. Bennett was also the CEO and a majority owner of Refco Group Holdings, Inc ("RGHI").

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1. At the time this paper was prepared, the private action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 was on appeal with the U.S. Court of Appeals for the Second Circuit.
2. Michael J. Garcia, United States Attorney for the Southern District of New York, "Prepared Remarks Concerning United States v. Joseph Collins," December 18, 2007, available at http://www.justice.gov/usao/nys/pressreleases/December07/collinsrefcousattorneygarciasremarks.pdf
3. The facts are based on the allegations in the Department of Justice's indictment of Collins and the facts as stated in the civil case *In re Refco, Inc. Securities Litigation*, 609 F. Supp. 2d 304 (S.D. N.Y. 2009).

Refco's fraudulent practices resulted from its financial problems. Refco was a financial services firm that extended credit to customers for use in margin trading. Due, in part, to its poor review of customers' credit-worthiness and trading practices, many of Refco's customers became unable to repay their loans. To hide these losses, Refco transferred the loans to RGHI and then recorded those transactions as receivables from RGHI. However, RGHI had no realistic ability to pay Refco.

Because these transfers were a related-party transaction that Refco did not want to disclose, Refco used "round-trip loans" to hide the transfers from its auditors. At the end of each fiscal year, Refco had one of its subsidiaries loan money to a third party and then the third party loaned that money to RGHI. RGHI could then pay the money it owed Refco. The end result was that Refco no longer had RGHI receivables, but instead had unsuspicious loans to a customer. At the start of the next fiscal year, the loans were repaid and everything was reversed. Third parties participated because the loans were designed such that the third party had no risk and profited from the interest on its loan to RGHI (which would be higher than the interest on the third party's loan from the subsidiary). Between 2000 and 2005, Refco engaged in 17 roundtrip loan transactions totaling over $5 billion. According to the indictment and civil complaint, Collins played a key role in drafting these transactions and negotiating with potential third party participants.[4]

One of the third parties was Bank für Arbeit und Wirtschaft ("BAWAG"). In addition to being involved in over $1 billion in roundtrip loans, BAWAG became a significant investor in Refco. In addition, in exchange for capital contributions from BAWAG, Refco agreed to give BAWAG certain rights to the proceeds of the sale of the company and the ability to convert those rights into ownership shares. Due to these agreements, BAWAG possessed the rights to approximately 47percent of the proceeds of the sale or a public offering of Refco. Collins was involved in the drafting of these agreements.

In 2004, Refco agreed to a leveraged buyout (LBO) involving a private equity fund, Thomas H. Lee Partners ("Lee"). At the end of the LBO, Lee would own 57 percent of Refco and RGHI would own the remaining 43 percent. According to the indictment, Collins was heavily involved in the LBO negotiations and assisted in concealing the BAWAG agreements from Lee. In addition, Collins concealed that Bennett planned to have RGHI buy the BAWAG rights. Collins also

4. Collins either did the work himself or supervised other Mayer Brown attorneys.

misled Lee into believing that RGHI owed Refco only $100 million (and not the actual amount of over $1 billion) and that a BAWAG overdraft loan to Refco was $500 million in excess working capital.

The LBO involved the sale of $600 million in notes and the plan to have an initial public offering (IPO) once the LBO was completed. During the course of these transactions, Collins participated in drafting documents filed with the SEC and distributed to potential investors. These documents failed to accurately state the extent of related party transactions and the true financial condition of Refco.

Two months after the IPO was completed, a Refco employee discovered $430 million in RGHI receivables. Within two weeks of this discovery, the finding was publicly disclosed, Refco's stock plummeted, and the company filed for bankruptcy in October 2005.

Bennett and other officers pleaded guilty to fraud and Bennett was sentenced to 16 years in prison. Collins was charged with one count of bank fraud, two counts of securities fraud, three counts of making a false filing with the SEC, four counts of wire fraud, and one count of conspiracy to commit the above acts.[5] In July 2009, Collins was convicted on the conspiracy count, two counts of securities fraud, and two counts of wire fraud. The judge declared a mistrial on the remaining counts.

II. REVIEWING COLLINS'S DEFENSE

Collins's Defense

Collins claimed that Bennett and others misled him and that he was unaware that his actions helped Refco hide its debt from Lee and others. Before he was indicted, Collins took and passed a polygraph test where he stated that he was unaware that Refco was committing fraud.[6] A generous reading of the facts and consideration of Collins's arguments at trial create the argument below.

Collins had no reason to suspect the misuse of the round trip loans. Similar loan transactions can be used for legitimate purposes and are not inherently illegal.[7] Because the loans did not appear to be unusual, Collins only supervised the drafting of these documents by

5. The SEC also filed a complaint alleging aiding and abetting violations of Section 10(b) and Rule 10b-5.
6. Susan Beck, *Mayer Brown in Crosshairs for Legal Work on Refco*, AMERICAN LAWYER, Nov. 4, 2008, available at http://www.law.com/jsp/article.jsp?id=1202425756944
7. Beck, *supra*.

associates at Mayer Brown. Collins claimed that he did not consider the business purposes of the round trip loans or ask anyone at Refco of their purpose because he did not believe that he had any obligation to do so from his role as outside counsel. In addition, these transactions were only a small part of the work that Collins did for Refco.[8]

With respect to the LBO, Collins was simply in over his head. He was a derivatives lawyer, not a mergers and acquisitions lawyer.[9] Because Mayer Brown had an "eat-what-you-kill culture" where partners were rewarded for the business they brought the firm, Collins resisted seeking the assistance of Mayer Brown partners that were more experienced with these deals.[10] Due to Collins's inexperience, he did not understand how his actions were causing misrepresentations to be made to Lee and others.

The Opposition to Collins's Defense

How could Collins not have known that the round trip loans were made to manipulate Refco's financial statements? There was no legitimate business purpose for a loan that guaranteed a third party a risk-free profit. These transactions only required a loan for a period of a few weeks and (sixteen out of seventeen times) that time period went from the end of one fiscal year to several days into the next fiscal year.[11] During this time, Collins had knowledge of the debt owed by RGHI to Refco, and the roundtrip loans involved both of these parties.[12] In addition, he had knowledge of (and drafted documents creating) Bennett's obligations on both sides of the transaction. After considering this evidence, the bankruptcy examiner stated "Indeed, rather than having any apparent business purpose, the transactions appear suspicious on their face."[13]

With respect to the LBO, the bankruptcy examiner found evidence that was consistent with an intentional misrepresentation of facts to Lee. For example, although Collins was fully aware of the

8. Mark Hamblett, *Defense Claims Refco Officials Lied to Mayer Brown Partner About Fraud*, N.Y. L. J., May 14, 2009, available at http://www.law.com/jsp/article.jsp?id=1202430689786&Defense_Claims_Refco_Officials_Lied_to_Mayer_Brown_Partner_About_Fraud
9. Beck, *supra*.
10. Beck, *supra*.
11. *In re: Refco, Inc., Final Report of Examiner*, July 11, 2007, at 234, 242-243.
12. Id. at 244-46.
13. Id. at 245.

transactions between Refco and RGHI, Collins affirmatively denied the existence of such transactions when asked about the possibility by Lee's attorneys during due diligence.[14] Collins also concealed the existence of BAWAG's potential ownership rights and other facts when responding to questions on these matters from Lee's attorneys that directly concerned these issues.[15]

As stated above, the jury found Collins guilty of five of the charges and the judge declared a mistrial on the remaining charges. Assuming that Collins did not initially set out to assist Refco in committing fraud, this raises the question of how he became so intimately involved in the fraud over time.

III. HOW DOES GOOD OUTSIDE COUNSEL GO BAD?

Collins was a well-respected, successful lawyer before the Refco bankruptcy. His reputation was untarnished. From the information that is publicly available, it seems that Collins's descent into wrongdoing followed a common path. Due to financial pressures, he pushed the boundaries of what he should have known was wrong. He was able to justify these actions to himself through rationalizations, but this started him down a path made that it easier to engage in further wrongdoing.[16]

Although there was no evidence that Collins directly benefited from the Refco fraud, such as through a personal ownership interest in the company, he did face significant financial pressures to assist Bennett. Commenting on the lack of direct financial interest, Collins's lawyer stated at trial: "Why would he give it up? Why would he risk it all?"[17]

14. Id. at 264.
15. Id. at 266.
16. For a overview of this process in organizations, see Blake E. Ashforth & Vikas Anand, *The Normalization of Corruption in Organizations*, 25 RES. ORG. BEHAV. 1 (2003); John M. Darley, *How Organizations Socialize Individuals into Evildoing*, in CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS (David M. Messick & Ann E. Tenbrunsel eds., 1996). See also Vikas Anand et al., *Business as Usual: The Acceptance and Perpetuation of Corruption in Organizations*, 19 ACAD. MGMT. EXEC. 9 (2005); Ann E. Tenbrunsel and David M. Messick, *Ethical Fading: The Role of Self-Deception in Unethical Behavior*, 17 SOC. JUST. RES. 223 (2004); Arthur P. Brief et al., *Collective corruption in the corporate world: Toward a process model*, in GROUPS AT WORK: THEORY AND RESEARCH 471 (Marlene E. Turner, ed., 2001).
17. Mark Hamblett, *Defense Claims Refco Officials Lied to Mayer Brown Partner About Fraud*, N.Y. L. J., May 14, 2009, available at http://www.law.com/jsp/article.jsp?id=1202430689786&Defense_Claims_Refco_Officials_Lied_to_Mayer_Brown_Partner_About_Fraud

The answer is that Refco paid Mayer Brown between $3 and $5 million each year in legal fees. These fees represented approximately half of what Collins billed each year.[18] This was not a client that Collins could afford to lose by challenging the CEO's actions.

As the bankruptcy examiner stated, the round trip loan transactions were suspicious and a reasonable attorney should have investigated their purpose for the organization. Collins, however, could rationalize his refusal to examine the business purpose. In this context, a rationalization is a way of thinking that allows someone to view actions they know are likely wrong as an acceptable exception to a rule or social norm. Thus, the person still views himself as a person of integrity. Here, Collins may have used the following common rationalizations. First, the round trip loan transactions by themselves (and not considered as part of a fraudulent scheme) were not technically illegal. These were valid contracts. Second, many other companies were using these types of transactions in some form. In other words, these methods seemed to be standard industry practice. Third, the transactions would not directly harm anyone at that time, and may not harm anyone at any time. For example, RGHI may be able to make the necessary payments to Refco in the future. Finally, as Collins argued at trial, it was not his responsibility to determine the purpose of these transactions. His job was narrowly focused on structuring the transactions as Bennett requested. If there were any problems with how the company used the transactions, it was the job of the auditors or in-house counsel, for example, to make that determination. This is the classic problem of diffusion of responsibility, where the more parties there are to potentially correct a problem, the less responsibility that any one party feels for taking action.

Once Collins used these rationalizations to allow himself to engage in these acts, he was on the slippery slope that made it easier to commit the same or worse acts in the future. These acts became routine and the ethical issues raised by the acts were lost.[19] A host of decision biases—such as discounting the future (and therefore the potential long-term adverse consequences) and loss aversion (not wanting to lose his largest client)[20]—further influenced this process and made it difficult for Collins

18. *Final Report of Examiner*, *supra*, at 232.
19. Tenbrunsel & Messick, *supra*, at 228.
20. For an overview of the these biases and their relation to business ethics, see Robert Prentice, *Teaching Ethics, Heuristics, and Biases*, 1 J. BUS. ETHICS EDUC. 57 (2004).

to get off the slippery slope. The end result was a course of action that appears "suicidal" to outsiders.[21]

IV. MAINTAINING ETHICAL BEHAVIOR WHEN YOU SUSPECT YOUR CLIENT OF FRAUD

Maintaining ethical behavior in the face of pressures to assist a client in committing fraud is challenging. It may be easy to fall on to the path that it appears Collins took, which was to rationalize behavior that he knew (or should have known) was contributing to a fraud. Although to an outsider this may appear as suicidal behavior, to the attorney facing the situation, avoiding direct knowledge of the fraud and taking a very narrow view of your responsibilities is often an easier course of action in the short-term than challenging the client. Being fully aware of your professional responsibilities and legal obligations,[22] and maintaining a healthy skepticism of your client (as would an auditor),[23] is an important part of ensuring that you do not follow Collins's path.

Under SEC rules adopted pursuant to Section 307 of the Sarbanes-Oxley Act, attorneys "appearing and practicing" before the SEC have an obligation to report "evidence of a material violation" of securities laws. This is an "up-the-ladder" requirement, which means the attorney should report the matter to the chief legal officer or chief executive officer, and then, if there is not an appropriate response, to report the violation to the Audit Committee or the full board of directors.[24] In a widely criticized definition, the rules define "evidence of a material violation" as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[25] This definition leaves ample room for a rationalizing attorney to convince herself that she has not yet obtained "credible evidence" of a "material violation."

For all attorneys—including those not subject to the SEC rules—the *Model Rules of Professional Conduct* establish similar obligations.

21. *See* Darley, *supra*.
22. For an extended overview (and the historical development) of an attorney's professional responsibilities and legal obligations in these situations, see, e.g., JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 204-205 (2006); Marc I. Steinberg, *The Corporate/Securities Attorney as a "Moving Target" - Client Fraud Dilemmas*, 46 WASHBURN L.J. 1 (2006).
23. *See* Coffee, *supra*, at 204-205.
24. 17 C.F.R § 205.3(b)(1)-(3)
25. 17 C.F.R. § 205.2(e).

Under Rule 1.13 (Organization as Client), an attorney that "knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization . . . shall proceed as is reasonably necessary in the best interest of the organization." Unless it is not in the organization's best interests, the attorney "shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law."[26] If that authority fails to act and the "lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization," then "the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization."[27] In addition, Rule 1.6 (Confidential Information) states that a "A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary . . . to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services" or "to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services." If the client persists in the illegal behavior, then Rule 1.16, allows, and may require, withdrawal from representation.

To a rationalizing attorney, these provisions may not significantly impact behavior. For example, Rule 1.6 is not a mandatory requirement, but permissive. Rule 1.13 requires knowledge, which may be avoided. Overall, there is not a duty to investigate what is not known.

The Collins case pushes attorneys to go beyond the basic requirements of these rules and investigate how clients are using their legal services. As many commentators have recognized, the competitive legal market puts pressure on outside counsel to please corporate management, to not ask questions, and to focus only on the technical

26. Rule 1.13(b).
27. Rule 1.13(c).

details of the assignment at hand.[28] The rationalization process described above takes this denial of responsibility to an even higher level. To an outsider—such as the jury in the Collins case—the circumstantial evidence makes it appear that outside counsel must have known of the fraud and had the motive to cooperate due to the client's legal fees.[29]

To avoid this trap, it is useful to follow some of the recommendations for outside counsel that a New York City Bar task force published in 2006.[30]

1. "Understand the Context of Assignments."[31] Counsel "should endeavor to be aware of the context in which and the purpose for which its services are being requested and used."

2. "Focus on risks to the client, not mere implementation."[32] The lawyer must provide the client with advice on the risks posed by a transaction or disclosure, and should not simply focus on implementing the requested action.

3. "Inquire when a concern arises."[33] A lawyer should not narrow her inquiry to simply "should I report up the ladder based on what I know right now?" (as may be required by SEC rules or professional conduct rules), but should make further inquiry to attempt to answer her concerns. As the Task Force stated:

> It is not a matter of seeing a "red flag" pointing to likely fraud. Rather, the impetus to inquire will arise at a lower threshold, when the client's conduct illuminates for the prudent lawyer a yellow light of caution: do not proceed without a better understanding of the client's plans and purposes.[34]

Using the above as guides on the proper role of outside counsel can help prevent an attorney from starting down a slippery slope.

28. See Coffee, *supra*, chap. 6. See also, N.Y. CITY BAR, REPORT OF THE TASK FORCE ON THE LAWYER'S ROLE IN CORPORATE GOVERNANCE 112-14 (2006), available at www.abcny.org/pdf/report/CORPORATE_GOVERNANCE06.pdf
29. *See* Steinberg, *supra*, at 25-26 (discussing circumstantial evidence in these types of cases).
30. N.Y. CITY BAR, *supra*, at 114-16.
31. Id. at 114.
32. Id. at 115.
33. Id. at 115-16.
34. Id. at 116.