STINSON

Dear Ethics Lawyer™

The Legal Ethics Project. Supporting professionalism with information.

Q: Dear Ethics Lawyer,

I am sending this to you from my hotel after day one of a two-day mediation. I am representing a business (Seller) that sold an industrial facility to another business (Buyer). In the subsequent lawsuit, Buyer alleges that after the sale they discovered ground water contamination from trichloroethylene (TCE) when doing testing related to expansion of the purchased facility. Clean-up costs are estimated at $6 million. During the sale, Seller's President had signed representations and warranties that disclaimed any knowledge of VOC contamination of the type that would include TCE. Seller had used the facility for purposes that would not ordinarily result in the use or spill of TCE, so Buyer had not done ground water testing prior to the sale. However, after the suit arose, Seller's President admitted to me that when Seller had purchased the facility from a different entity ten years prior, he had been made aware of a "small" TCE spill by a previous owner, that he had never thought would come to light when signing the contract with Buyer. This is why we had pressed for an early mediation, to settle the case before the fact of Seller's knowledge of the condition came to light in discovery. Seller reluctantly authorized settlement up to the full amount of $6 million in order to avoid this being turned into a fraud case with even larger potential damages, and reputational harm to Seller and its President, but indicated that I should only use the full amount of the authority as a last resort if it couldn't be settled at a lower number.

In any event, toward the end of a long day one of the mediation, after several back and forth sessions, the mediator asked whether we were at all concerned that discovery would reveal any knowledge by the Seller of the contamination. Before I could jump in to obfuscate the answer, Seller's President blurted out that he was not at all concerned about that. The mediator then said that he believed he could get the matter resolved for $3 million, a number we had offered, if we would assure the other side that this was our "best and final" offer and the full extent of the authority I had. Sensing a win for the client here, I confirmed that this was all the higher that we could go. Those were conveyed to the Buyer, and we agreed to return on day two simply to write up the terms of the settlement. But now, I am having concerns, both about the President’s statement, which I didn’t participate in but which I know to be untrue, and whether I overstepped in saying that $3 million was all that we would pay. On the other hand, these were settlement negotiations, and nobody really believes what others say in presenting their position. That’s why settlement negotiations are generally not admissible later, right? Have I don’t anything wrong here?

A: You are right to have concerns. There are two parts of Model Rule 4.1 that apply. Rule 4.1(a) states that a lawyer representing a client shall not knowingly “make a false statement of material fact or law to a third person.” Comment 2 to the rule qualifies this in a fairly ambiguous way in the context of negotiations:

This Rule refers to statements of fact. Whether a particular statement should be regarded as one of fact can depend on the circumstances. Under generally accepted conventions in negotiation, certain types of statements ordinarily are not taken as statements of material fact. Estimates of price or value placed on the subject of a transaction and a party's intentions as to an acceptable settlement of a claim are ordinarily in this category, and so is the existence of an undisclosed principal except where non-disclosure of the principal would constitute fraud. Lawyers should be mindful of their obligations under applicable law to avoid criminal and tortious misrepresentation.

Here, the issue is whether your statement confirming that “$3 million dollars is all that we will pay” in response to a question specifically asking you to confirm that as your “best and final” and the full extent of your authority, when you know you actually have $6 million in authority is a false statement of material fact, or a “statement of intention as to an acceptable settlement.” This is close to the line, in my judgment a little too close. It would have been far better if you had said something like “where things stand today, $3 million is our offer” or something else that more clearly dodged the question the mediator was asking.

But you have an even bigger issue with Rule 4.1(b), which states that a lawyer shall not knowingly “fail to disclose a material fact when disclosure is necessary to avoid assisting a…fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.” Here, you remained silent when your client representative stated that he had no concern that knowledge of the contamination would be discovered, when you knew that not only was he very concerned about that, but that in making the statement he was trying to cover up an underlying fraud in the transaction in order to achieve a more favorable outcome in the mediation. By failing to correct your client’s statement, you are likely running afoul of Rule 4.1(b) unless Rule 1.6 prohibits disclosure. It does not. Rule 1.6(b)(2) and (3) relating to preventing client fraud or injury from client commission of fraud permit disclosure in these circumstances.
So, what should you do now? First, talk to your client and explain the consequences of proceeding to consummate a settlement based upon a fraudulent statement. Explain that you may be required to make a disclosure in order to avoid violating Rule 4.1. If necessary to facilitate discussion, or to seek independent legal advice (by the client and/or by you concerning your ethical obligations), or to refer the matter to higher authority within the company, such as the Board of Directors under Rule 1.13, you should use some excuse to adjourn the mediation before consummating the deal, with a promise to pick up the issue at a later date.

The Ethics Lawyer

About Dear Ethics Lawyer

The twice-monthly "Dear Ethics Lawyer" column is part of a training regimen of the Legal Ethics Project, authored by Mark Hinderks, former managing partner and counsel to an AmLaw 132 firm; Fellow, American College of Trial Lawyers; and speaker/author on professional responsibility for more than 25 years. Mark leads Stinson LLP's Legal Ethics & Professional Responsibility practice, offering advice and "second opinions" to lawyers and law firms, consulting and testifying expert service, training, mediation/arbitration and representation in malpractice litigation. The submission of questions for future columns is welcome: please send to mark.hinderks@stinson.com.

Discussion presented here is based on the ABA Model Rules of Professional Conduct, but the Model Rules are adopted in different and amended versions, and interpreted in different ways in various places. Always check the rules and authorities applicable in your relevant jurisdiction – the result may be completely different.