ETHICS IN SETTLEMENT: THE EFFECT OF MATERIAL MISREPRESENTATION

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In federal courts across the United States, it is common for litigants and their counsel to be required to participate in either private mediation or court-ordered mediation before a U.S. magistrate judge. As the courts continue to require the parties to consider serious settlement possibilities in advance of trial, ethical issues may arise during settlement negotiations.[1]

Many ethical considerations can occur during settlement negotiations, but this article will address only one facet of those considerations: opinions versus material misrepresentations. Failure to follow the rules of ethics in this area can certainly lead to court-imposed sanctions on lawyers,[2] referral to the disciplinary committee of the court, and potentially the unraveling of the very settlement the parties worked to achieve.

Even though a lawyer is not required to disclose weaknesses in his or her client's case, the lawyer is prohibited from knowingly making a false statement of fact or law to a third party—including opposing counsel, a witness, or a mediator.[3] It is important to stress, however, that the rules do not prohibit hard bargaining, which includes expressing one's opinion.

Under generally accepted conventions in negotiation, certain types of statements are usually not taken as statements of material fact. Estimates of price or value placed on the subject of a transaction and the litigant's intention to accept a sum certain for settlement are usually in this category.[4] Nor is the existence of an undisclosed principal generally considered a material misstatement, except when nondisclosure of the principal would constitute fraud. For example, during a caucused mediation, it is not uncommon for counsel to provide a statement of his or her client's case, which includes a numerical demand or response to a settlement demand. The amount demanded or chosen in response usually is not factually the amount that the client would settle for. Similarly, a party participating in a negotiation also might exaggerate or emphasize the strengths of his or her factual or legal position and minimize or deemphasize the weaknesses. These types of remarks, often characterized as "posturing" or "puffing," are statements upon which parties to a negotiation ordinarily would not be expected to justifiably rely and should be distinguished from false statements of material fact.[5]

A misrepresentation can occur, however, if the lawyer incorporates or affirms another person's statement that the lawyer knows is false. A misrepresentation may also occur when a lawyer fails to act or makes "partially true but misleading statements or omissions that are the equivalent of affirmative false statements."[6] An example of a misrepresentation that contained an affirmative statement and material omission can be found in *Slotkin v. Citizens Casualty Co. of New York*.[7] In *Slotkin*, during settlement negotiations, the lawyer stated that, "to the best of his knowledge," his client's insurance potentially covered only $200,000. Documents in the lawyer's possession, however, showed the existence of a policy covering an additional $1 million. Based on the lawyer's misrepresentation of coverage, the plaintiff settled the case and later learned of the truth. Instead of moving to set aside the settlement, the plaintiff sued the defense lawyer, alleging, among other claims, that the lawyer was liable for fraud. The jury found for the plaintiff, but the trial judge granted the lawyer judgment as a matter of law. The Second Circuit reversed the lower court, concluding that the plaintiff had established sufficient scienter, which the court explained included "'a reckless indifference to error,' 'a pretense of exact knowledge,' or '(an) assertion of a false material fact susceptible of accurate knowledge but stated to be true on the personal knowledge of the representer.'" The lawyer who made the false statement was later disciplined.[8]

A clear factual misrepresentation by a lawyer who sent a written settlement demand is found in *Ausherman v. Bank of America*.[9] In *Ausherman*, the plaintiffs sued Bank of America, alleging that an unidentified employee of the bank fraudulently obtained and sold the plaintiffs' credit information to another person, who then gave it to an unauthorized individual. During the litigation, the bank was not able to determine which of its employees obtained the information, so the bank sought to discover the underlying factual basis for the allegation. After being met with evasive discovery responses and objections by the plaintiff's attorney, the magistrate judge permitted and presided over the plaintiff's counsel deposition to ensure compliance. During the deposition, the attorney admitted that he had lied about knowing the identity of the employee who had allegedly sold the credit information. The attorney also admitted that he had made the statement in his settlement demand letter as a means of enhancing the strength of his demand.[10] The judge not only assessed discovery sanctions against him but also referred him for

disciplinary action.[11]

Conduct leading to a favorable settlement may also constitute a material misrepresentation. In *Cresswell v. Sullivan & Cromwell*,[12] a judge held that a lawyer who intentionally omits material information from discovery may be personally sued for money damages by an adversary who settles for less than the true value of the claim as a result of the material omission. The defendant in *Cresswell*, the law firm of Sullivan & Cromwell, had defended a brokerage firm in a securities fraud action. In discovery responses, Sullivan & Cromwell denied that its client was being investigated by any regulators for the same conduct that formed the basis of the civil suit. The law firm withheld from production a recently received letter from the New York Stock Exchange concerning an investigation of the firm's client for the same conduct alleged in the civil case. After settling the case for a portion of its value, the underlying plaintiffs in the securities fraud action came to learn of the investigation and sued Sullivan & Cromwell, claiming that they were tricked by the nondisclosure. In denying Sullivan & Cromwell's motion to dismiss the case, the court held that the plaintiffs could affirm the earlier settlement and still seek further damages for the additional losses they had incurred because they relied on the misrepresentation. The court further held that defendant attorneys could be held liable for concealing the regulatory investigation.

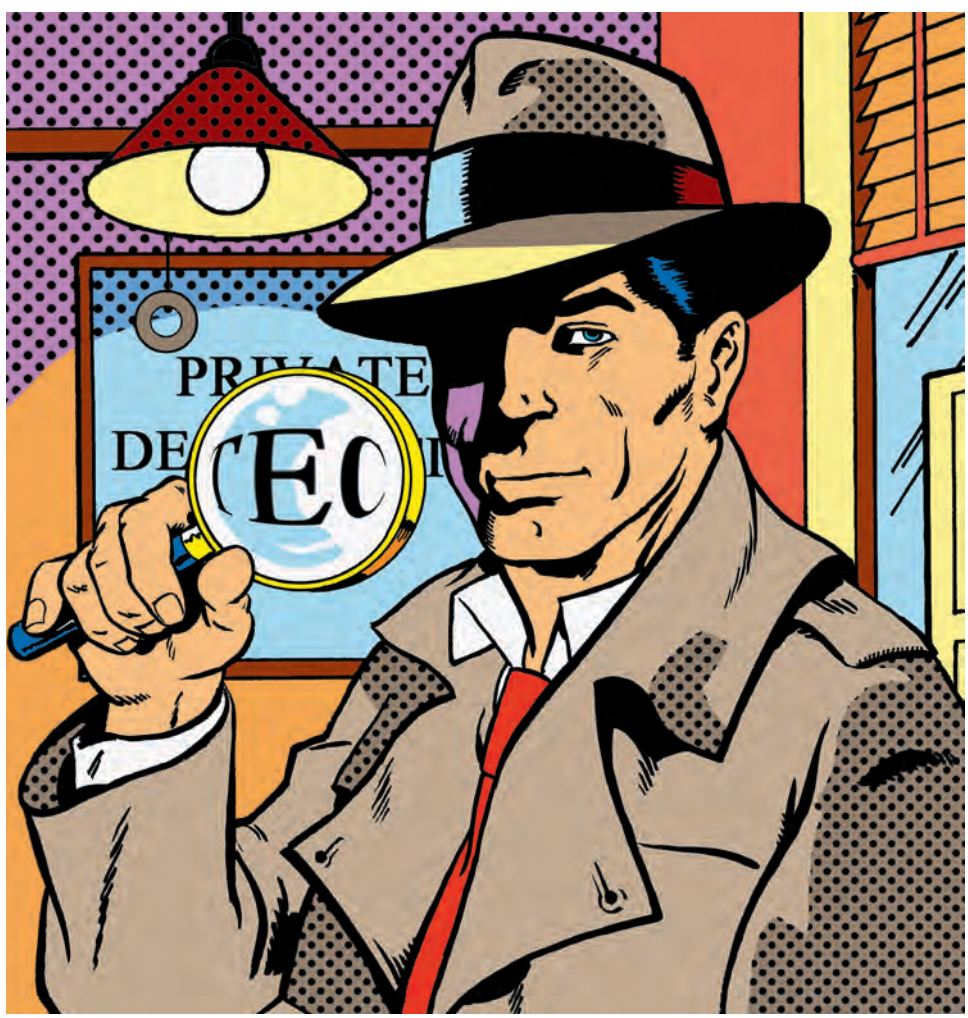
A material omission, such as failing to disclose a major event that has taken place during the litigation, may also result in the unraveling of a settlement agreement. In *Virzi v. Grand Trunk Warehouse & Cold Storage Co.*,[13] the court set aside a settlement agreement because the plaintiff's attorney had failed to disclose the death of his client. In a comprehensive ruling based on both DR 7-102 and the ABA's Model Rule 4.1, the court wrote the following:

> Here, plaintiff's attorney did not make a false statement regarding the death of plaintiff. He was never placed in a position to do so because during the two weeks of settlement negotiations defendants' attorney never thought to ask if plaintiff was still alive. Instead, in hopes of inducing settlement, plaintiff's attorney chose not to disclose plaintiff's death, as he was well aware that defendant believed that plaintiff would make an excellent witness on his own behalf if the case were to proceed to trial by jury.[14]

The *Virzi* court found that the nondisclosure of the plaintiff's death was a material misrepresentation, because the loss of his testimony "would have had a significant bearing on defendants' willingness to settle."[15]

Recently, in *Altman v. Securities Exchange Commission*,[16] a commercial litigation attorney who rarely practiced before the Securities Exchange Commission (SEC) was permanently barred from appearing before it as a result of the settlement tactics employed in negotiating a severance package for a client who was an employee of the company being investigated by the SEC. In settlement discussions with the company's attorney, the employee's attorney indicated that, if the company would pay up and settle the severance issue, his client would not cooperate with regulators, according to a recording made at the time of the conversation. The employee's attorney said during one telephone conversation, "Help me, help me not to do this," referring to his client's approaching the SEC. "I don't want to do this," the lawyer said.

The lawyer was suspended from appearing in front of the SEC for nine months; the disciplinary action was later modified to prohibit the lawyer from practicing before the commission. The lawyer appealed and argued that the SEC had overstepped its authority by unfairly reprimanding him for alleged violations of the New York lawyers' code of professional conduct. The lawyer further argued that the state disciplinary officials had not initiated disciplinary



proceedings, that he had never tried to extort money in exchange for his client's statements to the SEC, and that the U.S. Department of Justice had not brought criminal charges against him. Therefore, the lawyer argued, the discipline imposed by the commission should be reversed. The U.S. Court of Appeals for the D.C. Circuit affirmed the commission's decision, holding that the statements made by the lawyer were material to the SEC investigation and rightfully resulted in his disbarment from practicing before it.

In conclusion, while some level of puffery and posturing is expected during settlement negotiations, the material representations made during the discussions must be truthful and lawful. Moreover, case law suggests that failing to correct material misimpressions or permitting material omissions will not be condoned and could result in disciplinary action, sanctions, the unraveling of the settlement agreement, and a lawsuit against the concealing, untruthful, or manipulative lawyer.

As one judge said previously, "[p]racticing law transcends gamesmanship and making a buck. We should be trying to make a difference. The profession is more than a business, and should remain so. As professionals we should, while trying to solve our clients' problems, make every effort to avoid needless litigation."[17] The conduct employed in these cases certainly was not calculated to achieve that end. **TFL**

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Endnotes

[1]Local Rule 16.3 of the Local Rules of the U.S. District Court for the Eastern District of Louisiana provides as follows: "As officers of the court, counsel have a responsibility to minimize the expense of administering justice, refrain from burdening unnecessarily members of the public called for jury duty, and avoid inconveniencing witnesses unnecessarily. To these ends, they must conduct serious settlement discussions in time to avoid the expense to the public and litigants, and the inconvenience to jurors and witnesses, occasioned by settlements made on the eve, or at the outset, of trial."

[2]Litigants will often provide settlement position papers to magistrate judges in connection with settlement conferences. False statements in such papers probably violate Fed. R. Civ. Proc. 11(b)(2), (3), and (4).

[3]American Bar Association, Formal Ethics Opinion No. 94-387 (1994) and ABA, Model Rules of Professional Conduct, Model Rule 4.1.

[4]ABA, Formal Opinion No. 06-439 (2006).

[5]ABA, Model Rule 4.1.

[6]Barry R. Temkin, *Misrepresentation by Omission in Settlement Negotiations: Should There Be a Silent Safe Harbor?*, available at www.allbusiness.com/legal/973752-1.html#ixzz1ktROnDle.

[7]447 F. Supp. 253 (S.D.N.Y. 1978).

[8]614 F.2d 301, 314 (2d Cir. 1979).

[9]212 F. Supp. 2d 435 (D. Md. 2002).

[10]212 F. Supp. 2d at 439–441.

[11]*Id.* at 451, 456.

[12]704 F. Supp. 392 (S.D.N.Y. 1989).

[13]571 F. Supp. 507 (E.D. Mich. 1983).

[14]*Id.* at 511.

[15]After the decision handed down in the *Virzi* case, the ABA issued a formal ethics opinion setting forth its opinion on the issue. *See* ABA, Formal Ethics Opinion No. 95-397 (1995). In the opinion, the ABA concluded that a lawyer specializing in personal injury cases must disclose the death of the plaintiff before accepting a settlement offer. According to the ABA's Ethics Committee: "When a lawyer's client dies in the midst of settlement negotiations of a pending lawsuit in which the client was the claimant, the lawyer has a duty to inform opposing counsel and the court in the lawyer's first communication with either after the lawyer has learned of that fact." In part, the ABA reasoned that the death of a client terminates or at least changes the attorney's authority to act and that "a failure to disclose that occurrence is tantamount to making a false statement of material fact" within the meaning of Model Rule 4.1.161. The ABA committee concluded that the client's death means that "the lawyer, at least for the moment, no longer has a client, and, if she does thereafter continue in the matter, it will be on behalf of a different client."

[16]*Altman v. SEC*, No. 11-1067, 2011 WL 6266482 (D.C. Cir. Dec. 16, 2011).

[17]*Pendleton v. Cent. New Mexico Corr. Facility*, 184 F.R.D. 637 (D.N.M. 1999).

WHILE SOME LEVEL OF PUFFERY AND POSTURING IS EXPECTED DURING SETTLEMENT NEGOTIATIONS, THE MATERIAL REPRESENTATIONS MADE DURING THE DISCUSSIONS MUST BE TRUTHFUL AND LAWFUL. MOREOVER, CASE LAW SUGGESTS THAT FAILING TO CORRECT MATERIAL MISIMPRESSIONS OR PERMITTING MATERIAL OMISSIONS WILL NOT BE CONDONED AND COULD RESULT IN DISCIPLINARY ACTION.