**Current Issues in Opinion Practice: Customary Practice and Ethics Issues Raised by Enron Examiner’s Report**

ABA Section of Business Law  
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A. Scope of the Examination

The Examiner’s investigation and analysis considered the role of Enron’s in-house and outside lawyers involved in the SPE transactions criticized in his prior reports. The Examiner’s Final Report to the Bankruptcy Court analyzed the participation and potential liability of certain of Enron’s in-house and outside counsel in those SPE transactions and in Enron’s related disclosures. The Report also examined the conduct of Enron’s attorneys in the Watkins Investigation.

As described in considerable detail in the Examiner’s Final Report, the Examiner concluded that sufficient evidence existed from which a fact-finder could conclude that certain of Enron’s attorneys involved in its SPE transactions (i) committed legal malpractice based on Texas Rule 1.12, (ii) committed legal malpractice based on negligence or (iii) aided and abetted the Enron officers’ breaches of fiduciary duty. The Examiner also expressly recognized that these attorneys have defenses to such claims that would be presented to the fact-finder or the court, as applicable, including that such claims are barred or reduced by the wrongful conduct of Enron’s officers under rules of comparative fault.

B. Examiner’s Standard

The Examiner was not the ultimate decision maker. The Examiner analyzed the evidence he was able to gather against the legal standards applicable to the issues identified in his Reports. The Examiner considered both direct evidence and the reasonable inferences that could be drawn therefrom.
In reaching the conclusions set forth in his reports, the standard applied by the Examiner was as follows:

Where the Examiner reaches the conclusion that there is sufficient evidence for a fact-finder to conclude that a claim (or an element of a claim) is satisfied, the Examiner has determined that in a legal proceeding regarding such matter, the proposition would be submitted to the fact-finder for decision. In most cases, the fact-finder would be a jury, although in equitable subordination actions the bankruptcy court serves as the fact-finder. The decision of the fact-finder would be made after evaluating the documentary evidence, the testimony and credibility of witnesses, and the reasonable inferences that may be drawn from the evidence.


C. Theories of Potential Liability

1. Legal Malpractice

An attorney – whether in-house or outside counsel – may bear liability to his or her client when he or she fails to exercise the competence and diligence normally exercised by attorneys in similar circumstances. See FDIC v. Mmahat, 907 F.2d 546 (5TH Cir. 1990). Such a failure, as well as reckless or knowing conduct that constitutes a breach of duty owed to the client, is generally referred to as legal malpractice. To prevail on a legal malpractice claim, a client plaintiff must prove: (i) the attorney owed a duty to the plaintiff; (ii) the attorney breached this duty; (iii) a causal link between the breach and the plaintiff’s injury; and (iv) damages resulting from the breach. See, e.g., Two Thirty Nine Joint Venture v. Joe, 60 S.W.3d 896, 904 (Tex. App. 2001). To establish the breach of a professional duty, the plaintiff must show that the attorney failed to act as an attorney of reasonable prudence would have acted in a similar situation, thereby breaching the relevant standard of care. See, e.g., Cosgrove v. Grimes, 774 S.W.2d 662, 664 (Tex. 1989).

At times, there may be more than one possible decision or course of conduct available to an attorney of reasonable prudence. “If an attorney makes a decision which a reasonably prudent attorney could make in the same or similar circumstance, it is not an
act of negligence even if the result is undesirable.” *Id.*, 774 S.W.2d at 665 (emphasis in original); *see also Lehrer v. Supkis*, No. 01-00-00112-CV, 2002 WL 356394, at *3 (Tex. App. Feb. 28, 2002); *Ellis v. Ellis*, No. 08-98-00370-CV, 2001 WL 83212, at *5 (Tex. App. Jan. 25, 2001). Because attorneys are not penalized for decisions that a reasonably prudent attorney could have made, the objective standard allows some latitude in making strategic and tactical decisions without the fear that an imperfect outcome will result in a finding of liability. *Cosgrove*, 774 S.W.2d at 664-65. An attorney is not a guarantor of results, and an attorney who makes a reasonable decision will not be held liable merely because the decision later proves to be imperfect. *Id*. The reasonableness of the attorney’s conduct is the issue and a plaintiff must rely upon expert testimony to establish the relevant standard of care, the corresponding breach and causation. *Streber v. Hunter*, 221 F.3d 701, 724 (5th Cir. 2000); *Anderson v. Snider*, 809 S.W.2d 505, 508 (Tex. App. 1990), *rev’d on other grounds*, 808 S.W.2d 54 (Tex. 1991).

A relevant rule of professional conduct generally may be considered by a fact-finder in understanding and applying the standard of care for malpractice. *See, e.g.*, *Two Thirty Nine Joint Venture*, 60 S.W.2d at 905; *Avila v. Havana Painting Co.*, 761 S.W.2d 398, 400 (Tex. App. 1988). Texas Rule 1.12 and ABA Model Rule 1.13 address an attorney’s role when he or she represents an organization (such as a corporation) and learns that a representative of the organization has committed or intends to commit a violation or a legal obligation to the organization (such as a breach of fiduciary duty) or a violation of a law which might reasonably be imputed to the organization (such as the dissemination of misleading financial information). Ordinarily, an attorney must comply with the directives received from the officers of the corporate client. In the circumstances set forth in Texas Rule 1.12 and ABA Model Rule 1.13, however, the attorney “must take reasonable remedial actions” that are in the best interest of the organization.

As pertinent to the Enron Examination, Texas Rule 1.12 stated during the relevant time period that those circumstances were as follows:

[W]henever the lawyer learns or knows that:
(1) an officer . . . has committed or intends to commit a violation of a legal obligation to the organization or a violation of law which reasonably might be imputed to the organization;

(2) the violation is likely to result in substantial injury to the organization; and

(3) the violation is related to a matter within the scope of the lawyer’s representation of the organization. Texas Rule 1.12(b).

Texas Rule 1.12(c) expressly provided that remedial action could may include “referring the matter to higher authority in the organization,” which “if warranted by the seriousness of the matter,” may mean the board of directors. In some circumstances, the attorney might have to withdraw from the representation. See Texas Rule 1.12(c)(3).

Texas Rule 1.2(b) – and ABA Model Rule 1.2(b) – also provided that an attorney may not participate in a client’s fraudulent conduct.

Thus, an attorney for a corporate client who knew that (i) an officer was engaging in wrongful conduct, (ii) substantial injury to the corporate client was likely to occur as a result of that conduct and (iii) the violation was within the attorney’s scope of representation, but failed to take appropriate affirmative steps to cause reconsideration of the matter – including referral of the matter to a higher authority in the company, including, if appropriate, the board of directors – would not have acted as an attorney of reasonable prudence would have acted in a similar situation. In some circumstances, the attorney would have to withdraw from the representation. See Texas Rule 1.15(a)(1); Texas Rule 1.02, cmt. 8.

2. Aiding and Abetting Liability

For an attorney to be liable for aiding and abetting, a fact-finder must first determine that a breach of duty or legal violation imputable to the corporation by one or more corporate officers, employees or representatives has occurred. See Kline v. O’Quinn, 874 S.W.2d 776 (Tex. App. 1994); Ernst & Young L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573, 583 (Tex. 2001). A fact-finder may then consider whether an attorney is liable to the corporate client for aiding and abetting that wrongful conduct if the evidence show that: (i) the attorney had actual knowledge of the wrongful conduct
(i) giving rise to the breach; (ii) the attorney gave substantial assistance to the wrongdoer and (iii) resulting injury to the corporate client was the direct or reasonably foreseeable result of such conduct. *Adena, Inc. v. Cohn*, 162 F. Supp. 2d 351, 357-58 (E.D. Pa. 2001); *Chem-Age Indus., Inc. v. Glover*, 652 N.W.2d 756 (S.D. 2002). Although there is some authority to the contrary, the actual knowledge standard is generally strictly construed – “should have known” or “suspicion” will not suffice. *Chem-Age Indus., Inc.*, 652 N.W.2d at 774. Also, “routine” services provided by the attorney will not constitute substantial assistance. *Id.* at 775.

A case that may be instructive arose in the context of an SEC enforcement action, where an attorney’s delivery of an opinion letter was held sufficient to establish a case of aiding and abetting a violation of the securities laws.¹ In *SEC v. National Student Marketing Corp.*, 402 F. Supp. 641 (D.D.C. 1975), the SEC alleged that officers and directors of National Student Marketing Corporation (“NSMC”) were parties to a series of transactions that resulted in the dissemination of false and misleading financial statements. An attorney, Katz, was alleged to have aided and abetted the issuance of the financial statements by rendering a legal opinion in connection with the sale to his clients of a NSMC subsidiary. *Id.* at 643.

The subsidiary at issue was losing money and represented a significant cash drain for the fiscal year ending August 31, 1969, so NSMC wanted to sell the subsidiary and remove its losses from NSMC’s soon-to-be-published financial statements. *Id.* at 644. The buyers told Katz, who was their attorney, that NSMC’s “failure to meet their estimated earnings will damage their reputation in Wall Street. . . . They want the deal badly . . . .” *Id.* The purchase and sale agreement was negotiated during November, but was backdated and the agreement was “made as of August 27, 1969”, to remove the subsidiary from NSMC’s financial statements for the fiscal year that ended August 31, 1969.  

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¹ Subsequently, of course, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the Supreme Court held that a private plaintiff may not maintain an aiding and abetting suit under § 10(b) of the Securities Exchange Act of 1934. That fact does not, however, necessarily render the reasoning set forth in *SEC v. National Student Marketing Corp.* insignificant.
1969. *Id.* The terms of the transaction were extraordinarily favorable to Katz’s clients. Most of the risks of the subsidiary’s business remained with NSMC.²

NSMC’s auditors requested an opinion letter from Katz, which he gave, stating that “[n]otwithstanding that the Closing of the Agreement took place subsequent to August 29, 1969, the parties explicitly intended that it be effective as of said date. I am of the opinion that, under the laws of the state of New York . . . title to all of the . . . stock of [the subsidiary] and all of the risks and benefits of ownership thereof passed to the purchasers as of August 29, 1969. . .” *Id.* at 645.

Katz moved for summary judgment on the SEC’s enforcement action on the basis that his participation in the transaction was limited to the preparation of a legal opinion on a narrow matter, that his role was peripheral and his knowledge, if any, of any scheme to mislead was so slight that as a matter of law he could not be held liable. Katz argued that his opinion was technically correct concerning the date the agreement was effective, and that any judgment about the economic reality of the transaction was a matter for the accountants. *Id.* at 646-47. The court disagreed, stating:

Katz’s arguments concerning the passage of title, however, ignore the overall factual picture which should have been readily apparent to him. He drafted the several documents . . . which constituted the entire . . . transaction. The Commission contends that the alleged sale, reported in the 1969 financials of NSMC, was actually a sham because of the underlying agreements which accompanied the ‘sale’. Although technically title to the shares of stock may have been transferred, the economic substance of the transaction did not transfer any of ‘the risks and benefits of ownership’ to the purchasers . . . .

. . . . Lawyers are not free to ignore the commercial substance of a transaction which could obviously be misleading to stockholders and the investing public.

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² A nonrecourse note was given for the purchase price, and the note was secured through certain shares of NSMC stock provided by NSMC’s president. *Id.* In addition, NSMC agreed to manage the subsidiary for 14 months after the closing and to provide all working capital it needed, and NSMC would be reimbursed for such services and advances from a portion of the subsidiary’s profits, if any. Moreover, the purchasers could terminate the subsidiary’s operations at any time during the 14 month period, and all associated expenses would be borne by NSMC. *Id.* at 645.
Courts have not hesitated to pierce through legalistic form in order to circumvent violation of the securities law.

....

[T]his Court rejects the proposition that a member of the bar can seek refuge behind a legal technicality, elevating form over substance, when he is a party to and fully familiar with the circumstances which indicate that an illusory transaction is being undertaken which could be utilized to mislead third parties. Katz’s focus on the narrow legal questions on which he opined is unrealistic in view of his participation in the total transaction which obviously had the possibility for misleading outsiders.

_{Id. at 647-48._}

Against this factual background, the court found that Katz could be found liable for aiding and abetting a breach of the securities laws because he knew NSMC intended to distribute misleading financial statements and the delivery of his opinion was essential for NSMC to achieve this result. According to the court, Katz’s motion for summary judgment should be denied.

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3 The Court stated:

[I]t can be inferred from the factual circumstances of this case that Katz either knew that NSMC planned to issue a false financial statement, or he ignored what should have been evident to him as a lawyer with some expertise in corporate mergers and acquisitions.

....

.... The defendant’s assertion that he had no idea that the... transaction would be fraudulently accounted for is belied by his intimate acquaintance with the entire transaction which revealed a transparent attempt to make it appear that [the subsidiary] had been sold for value in fiscal 1969 whereas in actuality, [the purchasers] had been paid to take a disappointing subsidiary off the hands of the parent corporation, as a result of negotiations which occurred months after the close of the fiscal year.

Katz, with knowledge that the auditors were relying on the opinion of counsel, stated that all ‘risks and benefits of ownership’ had passed to [the purchasers] as of the end of fiscal 1969, whereas he knew, from having drafted the documents, that the ‘sale’... had no real substance and that any reported gain would falsely enhance the financial posture of NSMC. He cannot credibly claim that he was unaware that NSMC was planning to mislead investors when at the very outset of the negotiations, he had in hand an analysis of the situation, furnished him by his clients in their October 24 memorandum.

3. Opinion Letters

Enron’s attorneys sometimes provided opinions to Enron in connection with Enron’s FAS 140 Transactions and certain other SPE transaction. Under Texas law, “an attorney can commit legal malpractice by giving an erroneous legal opinion or erroneous advice.” Kimleco Petroleum, Inc. v. Morrison & Shelton, 91 S.W.3d 921, 923 (Tex. App. 1993). To establish an attorney’s negligent breach of his professional duty, a client must show that the attorney in question failed to act as a reasonably prudent attorney would have acted in a similar situation, and the client would be required to rely upon expert testimony to establish the relevant standard of care.4

Attorneys provide legal advice to their clients both in writing and orally. Sometimes this advice takes the form of a formal opinion letter. However, the few reported decisions and virtually all of the literature on legal opinions are concerned with legal opinions given by an attorney to, or allegedly relied on by,5 a third party in

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4 In Texas, a lawyer is held to the standard of care that would be exercised by a “reasonably prudent attorney.” Veschi v. Stevens, 861 S.W.2d 291, 292 (Tex. App. 1993). Texas courts have held that expert testimony is necessary to establish the standard of care and any departure from it. See generally Hall v. Rutherford, 911 S.W.2d 422 (Tex. App. 1995); see also Streber v. Hunter, 221 F.3d 701, 722 (5th Cir. 2000) (“[e]xpert opinion testimony that the standard of care is higher for tax specialists because they “have been trained in . . . a fairly complex-- very complex area” is sufficient to defeat summary judgment); cf. Greenstein, Logan & Co. v. Burgess Mktg., Inc., 744 S.W.2d 170, 185 (Tex. App. 1987) (in the context of accounting malpractice, “expert testimony is usually necessary to establish the requisite standard of care and skill, a departure from that standard, and the causal link between the plaintiff’s damages and the accountant’s negligence”). To survive a summary judgment challenge once an expert opinion establishes that the defendant’s acts conformed to the standard of care, the plaintiff must offer expert testimony to contradict the defendant’s expert testimony. See Tijerina v. Wennermark, 700 S.W.2d 342, 347 (Tex. App. 1985), overruled on other grounds, 774 S.W.2d 662 (Tex. 1989).

5 Compare Vereins-Und Westbank, AG v. Carter, 691 F. Supp. 704 (S.D.N.Y. 1988) (under the principles of Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931), court determined that attorney could be liable to non-client for negligence in professional conduct in connection with opinion letter) with Hafner v. Infocure Corp. (In re Infocure Sec. Litig.), 210 F. Supp. 2d 1331 (N.D. Ga. 2002) (opinion letter given in connection with merger stated that it could be relied on only by target corporation, not shareholders, and that it was given pursuant to the Legal Opinion Accord of the ABA Section of Business Law, which expressly limits use of an opinion; court found that shareholders were represented
connection with the closing of a business transaction. It has been recognized that when rendering an opinion to a third party, attorneys perform a “different kind of function and accept a different type of responsibility . . . .” Accordingly, when using the literature or cases for opinions given to third parties to establish the standard of care with respect to client opinions, one must keep this difference in mind, because an attorney will generally have a different duty to his or her client than to a third party.

6 See, e.g., M. John Sterba, Legal Opinion Letters: A Comprehensive Guide to Opinion Letter Practice (3d ed. 2003); Donald W. Glazer, Scott FitzGibbon & Steven O. Weise, Glazer & FitzGibbon on Legal Opinions, § 1.1 at 3 (2d ed. 2001) (“Third party closing opinions are the subject of this book.”); Committee on Legal Opinions, Guidelines for the Preparation of Closing Opinions, 57 Bus. Law. 875 (2002); TriBar Opinion Committee, Third-Party “Closing” Opinions: A Report of the TriBar Opinion Committee, 53 Bus. Law. 591 (1998); Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions, Business Law Section, State Bar of Texas, 7, 8 (1994) (the “Texas Report”). The “goals of the Committee were primarily to encourage and express a consensus of Texas business lawyers with regard to . . . legal opinions rendered to third parties in business transactions. . . . Much of the discussion in this report centers on business transactions, and opinions which are delivered at a ‘closing’. However, the discussion as to the preparation of legal opinions, the standards for legal opinions, the ethical considerations involved, and potential liabilities for legal opinions relate generally to all legal opinions, regardless of the circumstances in which they are given.”). Glazer & FitzGibbon note that “[T]he various bar association reports reflect a remarkable consensus . . . Differences, however, . . . do exist . . . Our discussions with lawyers from states having older reports have left us with the strong sense that if they were to revise those reports today they would bring them into line in most areas with current practice. . . .” Glazer & FitzGibbon on Legal Opinions, at xlviii.

7 See, e.g., Texas Report at 15, 16 (“[L]awyers’ responsibilities differ significantly depending on the identity of the Opinion Recipient. . . . [I]f the Opinion Recipient is the Client, the Opinion Giver has a paramount duty, based on the professional responsibility of the attorney to the Client. . . . [L]awyers are often requested by their Clients to render an opinion to a third party as a condition to the consummation of a Transaction. In this context, lawyers perform a different kind of function and accept a different type of responsibility than when they perform or accept while rendering advice to their own Clients.”).

8 In addition, the Texas Report states that “[t]his report does not define or establish ethical or liability standards, and is not intended to be given effect in any disciplinary or liability proceedings,” id. at 8, rather, it was “to be published as an educational tool and a guide to
A report on legal opinions prepared by a committee of the State Bar of Texas (the “Texas Report”)\(^{10}\) states that:

Because of the importance of legal opinions to attorneys, as well as to their Clients, each attorney who prepares or reviews a legal opinion should exercise good professional judgment and give careful and thoughtful attention to the language and meaning of the opinion, as well as to any factual investigation and legal research necessary to support the opinion. \textit{Id.} at 14.

The Texas Report also notes that:

[D]ecisions of courts in other jurisdictions indicate that the standard [of care] includes two duties that clearly are fundamental to an attorney rendering an opinion: … ‘to possess knowledge of those plain and elementary principles of law which are commonly known by well informed attorneys, and to discover those additional rules of law which, although not commonly known, may readily be found by standard research techniques’ … [and] to conduct a reasonable investigation of the relevant facts necessary to support the opinion. \textit{Id.} at 38-39.

\begin{itemize}
\item Texas courts have not expressed a standard of care applicable particularly to the rendering of legal opinions, but have applied a standard applicable generally to the professional conduct of Texas lawyers. . . A lawyer is “not bound to possess and exercise the highest degree of skill, but is required to possess such legal knowledge and to exercise such skill and diligence as men of the legal profession commonly employ.” \textit{Id.} at 38.
\end{itemize}

\textbf{\textsuperscript{9}} Some of the differences noted by the Texas Report include the following:

\begin{itemize}
\item [A] lawyer giving an opinion to a third party non-Client does not owe the third party the same ethical duties that are owed a Client. For example, the Opinion Giver does not have an obligation to address legal issues outside the directly negotiated scope of the opinion, even if the Opinion Giver believes the legal issues could be important to the Opinion Recipient.
\end{itemize}

\textit{Id.} at 16 and 29.

Finally, a higher standard of care may apply to an attorney who opines or advises on a matter within a recognized legal specialty, such as tax law. *Id.; see also Streber v. Hunter*, 221 F.3d 701 (5th Cir. 2000) (affirming malpractice award against tax attorneys and finding that plaintiffs’ expert witness properly identified the higher standard of care applicable to tax specialists).

The duty to conduct a reasonable investigation typically refers to the process through which the issuing attorney establishes the factual basis for the opinion. Attorneys frequently rely on factual information provided to them from others (often corporate officers). In the context of opinion letters given to third parties, one commentator has summarized an attorney’s ability to rely on “facts” provided by another as follows:

> The principle is that, in rendering a closing opinion, the opinion preparers are entitled to rely on factual information provided by an appropriate source if they do not know the information to be untrue, the information does not appear irregular on its face and they do not know of circumstances that make reliance unwarranted.

*Glazer & FitzGibbon on Legal Opinions*, § 4.2.3 at 94-96.

Similarly, attorneys frequently rely on factual assumptions in rendering their opinions. The standard of care applicable to attorneys in the context of opinions given to third parties has been summarized as follows: “Opinion preparers are not permitted to base an opinion on an unstated factual assumption they recognize to be untrue or not to warrant reliance under the circumstances.” *Glazer & FitzGibbon on Legal Opinions*, § 4.3.4 at 115. Similarly, “[o]pinion preparers should not, however, rely on a stated assumption if they believe it will be misleading to the opinion recipient with regard to the subject matter covered.” *Id.* at 116.

The inability of counsel to rely on factual information from their client, or to base their opinions on “assumptions” that they recognize as untrue, is illustrated by the decision in *Kline v. First Western Government Securities, Inc.*, 24 F.3d 480 (3d Cir. 1994). In *Kline*, a law firm for a tax shelter promoter was sued based on alleged
misrepresentations and omissions contained in opinion letters. The law firm defended on several grounds, including on the basis that:

it cannot be held liable for an opinion letter in which it made explicit that it was basing its opinion on an assumed set of facts represented to it by its client and that it had conducted no independent investigation into whether those represented facts accurately reflected reality. *Id.* at 486.

The court responded:

We are unpersuaded by this argument.

. . . .

[W]hen a law firm knows or has good reason to know that the factual description of a transaction provided by another is materially different from the actual transaction, it cannot escape liability simply by including in an opinion letter a statement that its opinion is based on provided facts.

. . . .

These allegations clearly permit the inference that [the law firm] knew or had good reason to know that the factual assertions contained in its opinion letters did not reflect the substance of actual . . . transactions. As such, [the law firm’s] opinions, despite their disclaimers, fall squarely within the category of opinion letters that we have held to be actionable. *Id.* at 486-87.11

11 See also *Akerman v. Schwartz*, 947 F.2d 841, 843-44 (7th Cir. 1991) (“Schwartz gave the promoters an opinion letter reciting ‘facts’ that made this venture look legitimate -- that the four corporations were unaffiliated, that the equipment would be sold at market price, that all of the equipment would be placed in service by the end of 1983, and so on -- and concluding that the IRS would be unable to deny investors the $20,000 credit and $10,000 deduction per $10,000 unit of investment. The ‘facts’ so recited were fictions. Schwartz says that he told Robert Clemente, an associate at the law firm, to conduct the due diligence inquiry. Clemente recalls things differently, testifying at his deposition that Schwartz said he would check the facts personally. Whether the lack of inquiry was attributable to an Alfonse-and-Gaston routine or to utter indifference to the truth, there was no verification. The letter says that the law firm examined documents ‘as we deem relevant’ and relied on unnamed persons for unspecified facts. Although it added that ‘[w]e have not made an attempt to independently verify the various representations’, the letter also said that it was prepared ‘in a manner that . . . complies with the requirements of both the proposed Treasury Regulations [Treas.Reg. 230] and [the ABA’s] Formal Opinion 346.’ Both Regulation 230 and Opinion 346 require a lawyer to verify questionable assertions by the promoters. Assertions that every piece of equipment in an ethanol manufacturing business has a market value of precisely $100,000, that the
The foregoing principles, although they arose in a somewhat different context, may apply with even more force when an attorney gives an opinion to his own client. Texas Rule 2.01 states that “[i]n advising or otherwise representing a client, an attorney shall exercise independent, professional judgment and render candid advice.” Texas Rule 2.01.\textsuperscript{12} The comments note that “[a] client is entitled to straightforward advice expressing the lawyer’s honest assessment. Legal advice often involves unpleasant facts and alternatives that a client may be disinclined to confront . . . . [A] lawyer should not be deterred from giving candid advice by the prospect that the advice will be unpalatable to the client.” Texas Rule 2.01, cmt. 1.

4. Comparative Fault Defenses

Enron’s attorneys will undoubtedly assert several legal and factual defenses to any claims asserted against them. They may contend that the evidence is not sufficient to establish one or more essential elements of a claim (e.g., failure to meet the standard of care, or knowledge of an officer’s wrongful conduct). Enron’s attorneys will likely contend that the wrongful acts committed by Enron’s officers should be imputed to Enron. If the officers’ wrongful conduct is imputed to Enron, then Enron’s attorneys could assert that Enron’s wrongful conduct was greater than their own conduct at issue, and therefore claims by Enron should be barred or reduced under comparative fault rules.

D. Enron’s Attorneys

\textsuperscript{12} Similarly, as the preamble to Texas Rules points out, “a lawyer provides a client with an informed understanding of the client’s legal rights and obligations. . . . A lawyer acts as evaluator by examining a client’s affairs and reporting about them to the client or to others.” Comment 7 to Texas Rule 1.02 notes that “[a] lawyer is required to give an honest opinion about the actual consequences that appear likely to result from a client’s conduct.”
1. **Enron’s In-House Department**

   Enron had a large in-house legal department, consisting of approximately 250 attorneys. Mirroring the corporate organization, the structure of the legal department was decentralized. Enron’s General Counsel and a corporate legal department staff of less than ten attorneys directly handled legal matters at a corporate level, including oversight of Enron’s SEC filings. Each of Enron’s operating companies and business units then had its own legal department supervised by a general counsel, who reported to the head of the business unit he or she served and to the Office of the General Counsel.

   Enron’s SPE transactions typically were staffed with both in-house and outside counsel. The in-house counsel assigned to any particular transaction worked for the legal department for the Enron business unit responsible for the transaction, such as Enron Wholesale Services, Enron Global Finance or Enron Broadband Services. The in-house counsel working on the transaction then oversaw the selection and retention of outside counsel.

2. **Enron’s Outside Counsel**

   During the period pertinent to the Examination, Enron retained hundreds of outside law firms. Outside counsel was chosen based on the level of pertinent expertise within the law firm and availability. Although numerous law firms performed legal work on the SPE transactions, Enron generally retained certain preferred firms to act as its counsel on those transactions.

E. Relevant Conclusions Regarding Attorneys’ Potential Liability

   With respect to two law firms that acted as Enron’s counsel on SPE transactions criticized in the Examiner’s prior reports, the Examiner concluded that sufficient evidence existed from which a fact-finder could determine that those firms committed malpractice based on Texas Rule 1.12, aided and abetted a breach of fiduciary duty or committed malpractice based on negligence in connection with several transactions, assuming that such claims are not barred
by the conduct of Enron’s officers. The events or transactions where such liability may be found include the firms’ representation of Enron with respect to the following:

- The delivery of true issuance opinions in connection with certain FAS 140 Transactions in light of the law firm’s knowledge of several points – i.e., evidence exists that lawyers knew that (i) these opinions did not address the critical issues under FAS 140, as those lawyers understood those issues, (ii) Andersen was using its opinions to support Enron’s financial reporting and (iii) these transactions were significant to Enron’s earnings.

- In connection with other FAS 140 Transactions, the delivery of true issuance opinions in light of the law firm’s knowledge that Enron had no intention to relinquish control over, or the risks and rewards of, the assets transferred in certain of the FAS 140 Transactions to produce materially misleading financial statements.

F. Summary Description of FAS 140 Transactions

Enron’s FAS 140 Transactions were structured finance transactions that were intended to comply with either FAS 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Statement of Financial Accounting Standards No. 125 (Financial Accounting Standards Bd. 1996) (“FAS 125”), or its successor, FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Statement of Financial Accounting Standards No. 140 (Financial Accounting Standards Bd. 2000). FAS 125 was the accounting standard that governed securitizations of financial assets from January 1, 1997, until it was replaced by FAS 140, which became effective for transactions closing on or after April 1, 2001.

In its FAS 140 Transactions, Enron “monetized” a variety of otherwise illiquid assets, removing those assets from its balance sheet while at the same time retaining control over them.

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13 Due to the necessity to be brief, other SPE transactions discussed in Appendix C to the Final Report of the Examiner – “Role of Enron’s Attorneys” – are not discussed here. The entire report, including Appendix C to the Final Report, can be found at http://www.enron.com/corp/por/supporting.html.
with a view towards better timing the final sale of those assets. In the Second Interim Report, the Examiner concluded that these transactions were improperly used by Enron to record income from gain on sale of assets and erroneously report the cash proceeds from these transactions as cash flow from operating activities (or, to a lesser degree, from investment activities). Enron also failed to disclose adequately its obligations under the Total Return Swaps that were entered into as part of these FAS 140 Transactions, and to reflect indebtedness incurred. See Second Interim Report, Appendix M (FAS 140 Transactions).

An attorney’s willingness to provide certain legal opinions was, as a practical matter, crucial to Enron’s ability to complete the FAS 140 Transactions. See FAS 125, ¶23. The Audit Issues Task Force of the Auditing Standards Board issued an auditing interpretation, which stated: “A determination about whether the isolation criterion has been met to support a conclusion regarding surrender of control is largely a matter of law. This aspect of surrender of control, therefore, is assessed primarily from a legal perspective.” AU section 9336, Using the Work of a Specialist: Auditing Interpretations of Section 336 (AU § 9336) (AICPA, Professional Standards) (interpretations of Using the Work of a Specialist, Statement on Auditing Standards No. 73 (American Institute of Certified Public Accountants 1994) (AU § 336)). Andersen’s own internal publication14 stated that “[t]ransactions that would not require a legal letter are limited to transactions such as the simple sale of equity or debt securities.”15 If Andersen was not satisfied that the asset had been legally isolated, Enron (i) could not record a gain from the transfer of the asset, (ii) would be required to reflect the debt of the borrower-SPE on its balance sheet, and (iii) would be required to record the proceeds of the transaction as cash flow from financing activities.

In the FAS 140 Transactions, with few exceptions, Enron asked its outside attorneys to provide an opinion letter that Andersen would use to satisfy the isolation requirements of FAS 140.


In the vast majority of the FAS 140 Transactions discussed in the Examiner’s Report regarding the lawyers’ roles in Enron’s SPE Transactions, however, Enron asked its attorneys to deliver what the parties generally referred to as a “true issuance” opinion, rather than what the parties referred to as a “true sale” opinion. The difference between the parties’ use of these terms is illustrated by reference to a simplified diagram containing certain elements of Project Cornhusker, a transaction in which the law firm retained by Enron provided a true issuance opinion:

In one part of this transaction, NBIL (an SPE) transferred money to Northern Plains, and Northern Plains transferred a financial asset to NBIL. An opinion addressing whether the transfer of that asset was a true sale (rather than a transfer intended as collateral for a loan), and

16 This SPE is generically referred to as “Asset LLC” in later FAS 140 Transactions.

17 The entity that transfers an asset to Asset LLC is generically referred to as “Sponsor” in later FAS 140 Transactions.
whether, in the event of a bankruptcy of Enron or Northern Plains, the asset would be “property of the estate,” was generally referred to as a “true sale” opinion. In another part of this transaction, NBIL issued its Class B Interest to NBIL2 (an SPE)\textsuperscript{18} and NBIL2 assigned the Class B Interest to the Lenders as collateral for a loan made to NBIL2.\textsuperscript{19} An opinion addressing whether, in the event of a bankruptcy of NBIL, NBIL’s Class B Interest would be property of NBIL’s estate, and also whether, in the event of a bankruptcy of Enron, Northern Plains or any entity consolidated with Enron, the Class B Interest would be considered “property of the estate” in any of those bankruptcy proceedings, was referred to as a “true issuance” opinion. This transaction also involved a Total Return Swap. In the Total Return Swaps typically used by Enron in the FAS 140 Transactions, the net effect was that Enron retained all or nearly all of the economic risks and rewards of the asset transferred by the Sponsor, and became, in effect, obligated to pay the loan that funded the transaction.

The term “true sale” opinion was used to refer to an opinion addressing whether a bankruptcy court would find the transfer of the financial asset by the Sponsor to an SPE to be part of the bankruptcy estate of the Sponsor, Enron or Enron’s consolidated entities in the event one of them became a debtor in a bankruptcy case. The parties used the term “true issuance” opinion to refer to an opinion addressing whether equity (a class B interest) issued by an entity (an SPE) would be part of that entity’s or an affiliate’s bankruptcy estate in the event one of them filed bankruptcy.

An internal memorandum prepared at one law firm retained by Enron to handle certain FAS 140 Transactions\textsuperscript{20} – although not drafted until November 2000 – reveals a problem

\textsuperscript{18} This SPE is generically referred to as “Transferor LLC” in later FAS 140 Transactions.

\textsuperscript{19} In another version of similarly structured FAS 140 Transactions, a trust is inserted between Transferor LLC and the Lenders. The trust borrows 97% of the funds needed for the transaction, raises the remaining 3% denominated as equity and provides those funds to Transferor LLC in exchange for the Class B Interest in Asset LLC.

\textsuperscript{20} Internal memorandum, Author unknown, regarding Selected True Sale and Non-Consolidation Criteria, Nov. 2000 (the “Selected True Sale and Non-Consolidation Criteria Memo”) (draft dated 11/17/00). The memorandum suggests that the law firm would not be comfortable giving true issuance opinions in the future:
inherent in this transaction structure where a true issuance opinion is given but the law firm
would not be able to give a true sale opinion. “[A] ‘true issuance’ by an [SPE] would
accomplish little, in regard to the isolation of its financial assets from the original transferor, if
there had not been a true sale or contribution of the financial assets to the [SPE].”21

Although the true issuance opinion is rendered at the step following the
transfer of financial assets into the issuer, we believe that rendering a
true issuance opinion based exclusively on the relevant state statute
concerning issuances of ownership interests, while technically correct,
may not be responsive to the intent or purpose for which the true sale
opinion is required. In light of this position, while we may continue to
render true issuance opinions in transactions that are modeled on
earlier true issuance transactions, we believe it may be better to render
true sale opinions at the step preceding the issuance, rather than true
issuance opinions, for the following reasons: Such opinion is more
responsive to the requirements of FAS 125 and its replacement, FAS
140 . . . .

Selected True Sale and Non-Consolidation Criteria Memo, at 1-2.

21 An accountant at Andersen who worked on Enron matters agreed with this reasoning in an
April 9, 2000 memorandum that states:

It is important to note that it is essential to make sure that two separate transfers each
qualify as sales under SFAS 140 including (1) the transfer of the Financial Asset
from Enron Sub to Asset LLC and (2) the transfer of the B-Share from
Transferor LLC to Trust. The reason why sale treatment is key for the first
transfer/contribution is because Asset LLC must own the Financial Asset in the
first place before it can consider selling it . . . .

Memorandum from [], Andersen, to the Files, regarding Project Generic – Sale of Enron Sub’s
Financial Asset (a Hawaii 125-0 transaction), Apr. 9, 2000, at AB1128 00598–AB1128
00599.
Ethics Issues
by Charles E. McCallum
and Bruce C. Young

A. Background

1. The Model Rules of Professional Conduct (the “Model Rules”) set forth certain obligations, prohibitions, and other guidelines concerning a lawyer’s professional conduct. Failure to comply with the Model Rules is a basis for invoking the disciplinary process. Violation of the Model Rules does not necessarily give rise to a cause of action against a lawyer nor create a presumption that a legal duty has been breached. Model Rules Preamble and Scope, Section 20. The Model Rules (as amended) have been adopted by the ABA House of Delegates as a model set of professional standards for the regulation of the profession. While all but eight jurisdictions have adopted rules of professional responsibility based on the Model Rules, there are state to state variations, and in some jurisdictions the standards governing the profession are drawn from earlier formulations such as the 1969 Model Code of Professional Responsibility. The laws, court rules, regulations, codes of professional responsibility and opinions promulgated in each jurisdiction are controlling in that jurisdiction.

2. The Restatement (Third) of the Law Governing Lawyers (the “Restatement”) was published by the American Law Institute in 2000. The Restatement goes beyond the issue of
disciplinary proceedings and addresses the additional issues of disqualification and liability for malpractice. The Restatement draws significantly on decisional law.


4. The lawyer’s ethical obligations with respect to opinions rendered to his or her own client are found in the Model Rules generally. Query whether the extent of those obligations depend on the nature of the opinion – formal or informal, written or oral, qualified or unqualified, etc. In addition to over-riding obligations relating to the representation (such as the duty to avoid conflicts or to preserve the confidentiality of information relating to the representation), the lawyer must provide competent representation (Model Rule 1.1) and must act with reasonable promptness and diligence (Model Rule 1.3).

5. Opinions rendered to third parties at the request of the client are governed by Model Rule 2.3 (Evaluation for Use by Third Persons). An “evaluation” within the scope of Rule 2.3 may include a title opinion furnished to a prospective purchaser at the request of the client-vendor, an opinion regarding the legality of securities registered under the securities laws, or a typical closing opinion rendered in connection with a corporate or financial transaction. Although the third party to whom the opinion is rendered does not thereby become the client of the lawyer giving the opinion, the lawyer owes a duty to the third party to use care when the lawyer or (with the lawyer’s acquiescence) the client has invited the third party to rely on the
lawyer’s evaluation, provided that the third party is not too remote from the lawyer under applicable tort law to warrant protection. Restatement §51(2).

6. Special treatment has been given to legal opinions given at the request of a client for use (by giving them to third parties) in connection with the marketing of tax shelter investments. The Internal Revenue Service has promulgated in Circular 230, as part of its regulation of persons practicing before the IRS, rules applicable to such opinions. This issue is also dealt with in Formal Opinion 346 of the ABA Standing Committee on Ethics and Professional Responsibility. In the wake of recent allegations of abuse in the marketing of tax shelters, the Internal Revenue Service has proposed revisions to Circular 230.

7. A special form of “evaluation” is the opinion given by a lawyer to an auditor with respect to loss contingencies identified by the client. Such opinions are “governed” by the ABA Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information (1975).

B. Third-Party Opinions

1. Model Rule 2.3 provides as follows:

RULE 2.3 EVALUATION FOR USE BY THIRD PERSONS

(a) A lawyer may provide an evaluation of a matter affecting a client for the use of someone other than the client if the lawyer reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client.

(b) When the lawyer knows or reasonably should know that the evaluation is likely to affect the client's interests materially and adversely, the lawyer shall not provide the evaluation unless the client gives informed consent.

(c) Except as disclosure is authorized in connection with a report of an evaluation, information relating to the evaluation is otherwise protected by Rule 1.6.
To the same general effect is Restatement §95, but the Restatement also notes the lawyer’s duty of care to the third party.

2. Also pertinent to third party opinions is Model Rule 4.1, which provides as follows:

RULE 4.1 TRUTHFULNESS IN STATEMENTS TO OTHERS

In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

3. The lawyer’s duties to a third-party recipient of a legal opinion are different from the duties owed by the lawyer to his or her client. For example, duties concerning loyalty (avoidance of conflicts) and preservation of confidences run only to the lawyer’s client.

C. Scope Limitations and Factual Investigation

1. A lawyer generally must abide by a client’s decision concerning the objectives of representation, but an agreement for a limited representation does not exempt the lawyer from the duty to provide competent representation. Furthermore, the scope of a representation may be limited only to the extent reasonable under the circumstances. Model Rule 1.2(c). A limitation that prevents the lawyer from reaching conclusions upon which the client can rely is not reasonable. Model Rule 1.2, Comment [7]. If the client insists on unreasonable limitations on the scope of a lawyer’s representation, the lawyer may be compelled to withdraw under Model Rule 1.16(a)(1), and in any event would be permitted to withdraw under Model Rule 1.16(b)(1), (b)(4), or (b)(7).
2. The Comments to Model Rule 2.3 acknowledge that the scope of an investigation relating to an evaluation (third-party opinion) may be limited. Limitations that are material to the limitation must be disclosed as part of the evaluation. Comment [4] to Model Rule 2.3 provides as follows:

Ordinarily a lawyer should have whatever latitude of investigation seems necessary as a matter of professional judgment. Under some circumstances, however, the terms of the evaluation may be limited. For example, certain issues or sources may be categorically excluded, or the scope of search may be limited by time constraints or the non-cooperation of persons having relevant information. Any such limitations that are material to the evaluation should be described in the report.

3. As acknowledged and addressed in ABA and TriBar materials on legal opinions, a lawyer may negotiate with the opinion recipient concerning the form, assumptions, and scope of investigation underlying a third-party opinion. See Accord, Section 21; TriBar Report, Section 1.5. The limitations on scope or deviations from customary understandings and practices must be clearly stated in the opinion.

4. Two opinions of the ABA Standing Committee on Ethics and Professional Responsibility hold that scope limitations may require the lawyer to refuse to give an opinion or withdraw from the representation. Formal Opinion 335 (1974) addresses opinions given in the context of sales of unregistered securities. With reference to the lawyer’s responsibility to investigate facts Opinion 335 states:

In any event, the lawyer should, in the first instance, make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect; or are suspect; or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry . . . .

Where the lawyer concludes that further inquiry of a reasonable nature would not give him sufficient confidence as to all the relevant facts, or for any other reason he does not make the appropriate further inquiries, he should refuse to give an opinion.
Opinion 335 further indicates it is not appropriate simply to rely without question on facts provided by the client (presumably even if the lawyer clearly so states in the opinion).

A properly drafted opinion will recite clearly the sources of the attorney's knowledge of the facts. Where verification is otherwise called for, an attorney should make appropriate verification and should not rely on the use of such phrases as 'based upon the facts as you have given them to me' or 'apart from what you have told me, I have not inquired as to the facts.'

5. Formal Opinion 346 (1982) addresses tax shelter opinions, i.e., tax advice that is referred to either in tax shelter offering materials or in connection with tax shelter sales promotions directed at persons other than the lawyer’s client. Opinion 346 holds that a lawyer giving such an opinion cannot disclaim responsibility for inquiring as to the accuracy of facts, nor can the opinion be based on purely hypothetical facts:

A lawyer should not issue a tax shelter opinion which disclaims responsibility for inquiring as to the accuracy of the facts, fails to analyze the critical facts or discusses purely hypothetical facts.

6. A scope limitation that prevents a lawyer, in rendering a tax shelter opinion, from conducting the factual investigation required under Opinion 346 or that prevents a lawyer, in rendering an opinion relating to the sale of unregistered securities, from conducting the factual investigation required under Opinion 335 should be considered unreasonable and should not, under Model Rule 1.2(c), be accepted by the lawyer. Arguably the same result should follow for any opinion furnished to, or likely to be relied upon, by third parties who are not in a position to negotiate the form, content, and other aspects of the opinion. Should the result be different in the case of a negotiated opinion in which the party being furnished the opinion agrees to accept the limited inquiry and its consequences? What if the lawyer knows, or should know, that parties other than the opinion recipient will be relying on the opinion? Should a disclaimer in the opinion of liability to anyone other than the opinion recipient be effective if the lawyer knew (or
should have known) that, given the nature of the transaction and of the opinion, other parties (e.g., the opinion recipient’s shareholders or bankers) will in fact be relying on it? What if such use of the opinion is a significant reason for requesting it?

7. Where actual facts known to the lawyer are inconsistent with the assumed facts, it is easy to conclude that the lawyer should not issue the requested opinion. The more difficult setting is where the investigation is limited (because of considerations of cost or timing, for example), but the lawyer has no reason to believe that the actual facts are inconsistent with the assumed facts. To what extent is the lawyer’s prior knowledge of and relationship with the client furnishing the assumed facts relevant?

8. The TriBar Report states that:

If the opinion preparers identify information as “unreliable” they must find other information to establish the facts. Alternatively, they may include an express assumption regarding those facts in order to give the opinion. TriBar Report, Section 2.1.4.

The TriBar Report also provides that preparers should not rely on an unstated assumption if it is unreliable. However, a stated assumption has a different impact:

By way of contrast, stated assumptions, like opinion exceptions, put the opinion recipient on notice that the opinion preparers have not established the facts being assumed. Stated assumptions, therefore, shift to the opinion recipient the responsibility for confirming the assumed facts for itself or taking the risk that what is assumed might turn out to be untrue. As with opinion exceptions, reliance on a stated assumption is subject to the limitation described in Section 4.1(d) on rendering misleading opinions. TriBar Report, Section 2.3(c).

TriBar Report further provides (in Section 1.4(d)) that the risk of misleading an opinion recipient can be avoided by an appropriate disclosure (either within or outside of the opinion letter).
D. **Crime, Fraud, and Deceit**

1. A lawyer may not “assist a client in conduct that the lawyer knows is criminal or fraudulent.” Model Rule 1.2(d). The lawyer may not, for example, draft or deliver documents that the lawyer knows are fraudulent. Model Rule 1.2, Comment [10]. And if the lawyer discovers that client conduct that he originally supposed to be legally proper is in fact criminal or fraudulent, he must withdraw from the representation. Model Rule 1.16(a). In some cases withdrawal alone is not sufficient, and it may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm any “opinion, document, affirmation, or the like.” Model Rule 4.1, Comment [3].

2. Model Rule 4.1 provides that in the course of representing a client a lawyer may not “knowingly: (a) make a false statement of a material fact or law to a third person; or (b) fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.” Model Rule 8.4 states that it is “professional misconduct for a lawyer to . . . (c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation.” Although a lawyer must be truthful when dealing with others on a client’s behalf, she generally has no affirmative duty to inform an opposing party of relevant facts. A partially true but misleading statement or an omission that is the equivalent of an affirmative false statement constitute misrepresentations. Model Rule 4.1, Comment [1].

3. The 2003 amendments to Model Rule 1.6 permit the disclosure of information relating to a representation to the extent the lawyer reasonably believes necessary “(2) 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;” and “(3) 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.” In these circumstances (reasonably certain substantial third-party financial injury resulting from client crime or fraud using lawyer’s services) a disclosure otherwise required under Model Rule 4.1(b) is not limited by Model Rule 1.6.

4. The Model Rule 1.2 and 4.1(b) strictures apply when the lawyer has knowledge of a client crime or fraud that uses the lawyer’s services or which the lawyer is in some fashion assisting. Model Rule 4.1(a), and Rule 8.4, reach any false statement of fact or law by the lawyer, regardless of whether there is a client crime or fraud involved. While these Rules would not make an erroneous opinion a disciplinary violation, they would apply to the delivery of an opinion that is based on a false statement of facts or law. This could reach an assumption that the lawyer knows (or should know) is almost certainly contrary to fact. A false statement of law would presumably be a deliberate misstatement of a statute or judicial precedent.

5. The terms “knowingly,” “known,” and “knows” are defined in the Model Rules as denoting “actual knowledge of the fact in question.” The definition goes on to state that “a person’s knowledge may be inferred from circumstances.” Model Rule 1.0(f). A lawyer may not, in other words, ignore the obvious or turn a blind eye. “Reasonably should know” is a more demanding standard. It denotes that “a lawyer of reasonable prudence and competence would ascertain the matter in question.” Model Rule 1.0(j). Considering that what was obvious will be determined with the benefit of hindsight, there may not be much practical difference between what the lawyer is deemed to have known and what the lawyer reasonably should have known.
E. The Organizational Client

1. Under Model Rule 1.13, a lawyer engaged by an organization represents the organization “acting through its duly authorized constituents.” Rule 1.13(a). Generally, decisions made by constituents (officers, directors, employees, shareholders) of an organization must be accepted by the lawyer. But

   when the lawyer knows that the organization is likely to be substantially injured by action of an officer or other constituent that violates a legal obligation to the organization or is in violation of law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization.

Model Rule 1.13, Comment [3]. This requires the lawyer, unless he reasonably believes that it is not necessary in the best interest of the organization, to refer the matter to higher authority in the organization, including, if warranted, the highest authority that can act for the organization (usually the governing board). Model Rule 1.13(b). If the highest authority insists upon acting (or fails to prevent action) that is clearly a violation of law and that the lawyer “reasonably believes . . . is reasonably certain to result in substantial injury to the organization,” then the lawyer may (but is not required to) reveal information relating to the representation otherwise prohibited by Model Rule 1.6, but only to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization. Model Rule 1.13(c). To put it simply, the lawyer must, except with good faith reason, “report up” or “go up the ladder,” to (if necessary) the highest authority, and may, with good faith reason, “report out” or “blow the whistle” if the highest authority fails or refuses to act.

2. Model Rule 1.13(c)’s “reporting out” provisions do not apply to information acquired by the lawyer in the course of an organizational investigation of an alleged violation of
law, or in the course of the defense of the organization or one of its constituents against claims arising out of an alleged violation of law. Model Rule 1.13(d). Model Rules 1.13(b)’s “reporting up” obligation and Model Rule 1.13(c)’s “reporting out” exception would apply, however, to knowledge obtained by a lawyer in the course of preparing an opinion on behalf of an organizational client.

3. Similar provisions apply under SEC Rule 205, implementing Section 307 of the Sarbanes-Oxley Act. These apply only to lawyers “appearing and practicing before the Commission in the representation of an issuer,” but as those terms are defined would apply in many instances to knowledge obtained by a lawyer in the course of the preparation of an opinion.

February 18, 2004
Observations on Duties and Customary Practice in Rendering Third-Party Opinions and Opinions to One’s Own Client

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In reviewing the seemingly endless stream of articles, reports, complaints and court decisions flowing from Enron, one can, as with the Bible, find support for almost any position. It is necessary to analyze any aspect of the Enron debacle critically and systematically to identify the correct underlying theories of liability that should inform lawyers going forward. It is important to our analysis and the development of customary practice in rendering and interpreting opinions to focus on the posture in which actual and potential litigation arises. We also need to keep firmly in mind that the ethical duties owed to clients, although similar to those owed to third parties to whom we address legal opinions, generally extend over a longer time period and a broader range of issues.

Almost all opinion literature has focused on third party opinions. Very little has been written regarding opinions to one’s own client. Thus there is very little customary practice informing the rendering of opinions to one’s own client. Cases interpreting opinions to one’s own client have significantly involved securities law and potential rule 10b-5 liability. Following the Central Bank of Denver case, the opinion has been one of the hooks on which to hang primary violator liability. Whether the opinion was rendered within the parameters of articulated customary practice has not been developed and, although lip service may be given to
the Restatement of the Law Governing Lawyers and customary practice, a cogent analysis of customary opinion practice has been absent.

The outline that follows sets forth some of the considerations and rules that we need to keep in mind if we are to develop such an analysis. It does not address liability or duties that arise in rendering opinions in transactions subject to federal securities laws. That topic will be addressed in other materials.
I. Context in which opinions questioned is critical.
   A. Most opinion case law arises on motions for summary judgment.
      1. View factual allegations in light most favorable to non-moving party taken as true (Matsushita Elec. Indus. Co. v. Zenith Radio Corp, 475 U.S. 574, 587 (1986)).
      2. Granted only if appears beyond a doubt that plaintiff can prove no set of facts in support of claim (Kline v. First Western Government Securities, 24 F. 3d 480, 485 citing Fed. R. Civ. P. 56(c)).
      3. Cases settle leaving overbroad and untested statements of relevant legal principles.
   B. Posture of Batson report.
      1. Identify potential recoveries for Enron bankruptcy estate.
      2. Standard used in examination: whether there was sufficient evidence for a fact finder to conclude that the elements of a claim were satisfied.
      3. Examiner not ultimate decision maker.
      4. In bankruptcy, trustee waives corporation’s privilege and all attorney generated material in corporation’s custody, possession and control is produced.

II. What must be proved to establish negligence in rendering an opinion.
   A. Elements of malpractice action based on negligence (Restatement (Third) of the Law Governing Lawyers (“Restatement”) § 48).
      1. Lawyer owes a duty of care.
      2. Lawyer fails to exercise duty of care.
      3. Failure is a legal cause of injury.
      4. Lawyer has no defense.
   B. Duty is to exercise competence and diligence normally exercised by lawyers in similar circumstances (Restatement § 52).
      1. Competence is the skill and knowledge normally possessed by other lawyers in good standing (Restatement § 52, comment b.)
a. Generally judged against lawyers undertaking similar matters in the relevant jurisdiction, which is generally a state and not a narrower locality.

b. In certain areas where the practice is national, the standards will be national.

2. Diligence must be reasonable for the representation, including, where appropriate, “inquiry into facts, analysis of law, exercise of professional judgment, communication with client, rendering of practical and ethical advice, and drafting of documents.” (Restatement § 52, comment c.)

C. To whom is duty owed:

1. Client

a. Client-lawyer relationship arises when client and lawyer consent or when lawyer fails to manifest consent and lawyer knows or reasonably should know that the person is relying on the lawyer (Restatement §14).

b. Exercise duty in pursuing client’s lawful objectives in matters covered by the representation (Restatement § 50).

c. Client defines objective after consultation (Restatement § 50).

2. Nonclient:

a. Duty of competence and diligence is owed to a nonclient when lawyer or lawyer’s client (with lawyer’s acquiescence) invites the nonclient to rely on the lawyer’s opinion and the nonclient is not too remote (Restatement § 51(2); see also Vereins-und Westbank v. Carter, 691 F. Supp 704 (S.D.N.Y. 1988).

b. Duty of candor (Restatement § 98; Model Rules of Professional Conduct 4.1). Covers both false statements and material omissions.

III. Duties where lawyer provides an opinion.

A. In providing an evaluation or opinion to a nonclient in furtherance of the objectives of a client, lawyer must exercise care as provided in Restatement § 51(2) and not make false statements prohibited under Restatement § 98 (Restatement § 95 and comment c.).

1. Lawyer does not function as an advocate for nonclient.

2. Third party does not become a client.
3. Lawyer does not undertake broader advising duties that may be owed to own client when preparing an opinion for a third party. Only advises with respect to questions actually covered in opinion (four corners doctrine).

4. Lawyer can rely on customary practice in rendering opinion, including customary diligence and customary usage as articulated in bar association reports, treatises and articles (Restatement § 95, comment a.).

B. Customary practice when rendering an opinion to one’s own client is not well articulated (for the description and a discussion of issues that are discussed below, see Chapter 15 of Legal Opinions in Business Transactions by Arthur Norman Field (Practicing Law Institute)).

1. Advice generally not limited to a formal opinion, but will also advise client informally. Such informal advice may be far more comprehensive than what is covered within four corners of any opinion.

2. Duties to client are dependent upon context of entire relationship or engagement.

3. Unless relationship is terminated, lawyer may have responsibility to client after delivery of any opinion.

4. Explanation of customary practice in rendering an opinion may need to come from lawyer rendering opinion (as compared to recipient’s counsel in third-party opinion context), especially where no in house counsel is involved.
I. GOALS OF BANKRUPTCY

A. Reorganization – Goal of a Chapter 11 proceeding is for a debtor to restructure its business so as to preserve its value as a going concern and to satisfy pre-petition claims through a plan of reorganization.

B. Equality of Treatment – Bankruptcy theory requires that equally situated creditors be dealt with equally.


D. Equitable Powers – Equitable powers of the court include the power to equitably subordinate claims (11 U.S.C. § 510(c)) and the power to substantively consolidate (general power of Court under § 105(a)).

II. BANKRUPTCY-RELATED GOALS OF STRUCTURED FINANCING

A. Ability to have property supporting the transaction be subject to realization notwithstanding the bankruptcy or reorganization of sponsor company.

B. Need to obtain comfort that assets will not be property of the estate (11 U.S.C. § 541) or subject to the automatic stay (as set forth in 11 U.S.C. § 362).

III. CUSTOMARY OPINIONS IN THE BANKRUPTCY CONTEXT

A. “True Sale” Opinions

1. Definition

A “true sale” is a transfer of an interest in assets (frequently accounts receivable or other financial assets) which results in the assets being removed from the estate of the transferor in the event of the bankruptcy of the transferor.

May also be a “true contribution” of assets from one entity to another (i.e., a transfer of the assets in exchange for equity in the transferee).
2. Source of Law

Although the issue of whether a transfer is a “true sale” or a secured financing is generally raised in a bankruptcy proceeding, the issue is actually a question of state law although the law does not vary materially between states.

3. Importance of Determination

If a transfer is a “true sale” the transferred assets will not be part of the transferor’s bankruptcy estate and, most importantly, the “automatic stay” will not impede enforcing rights against the assets.

4. Principal Factors in the Sale vs. Loan Analysis

1. *Typically an issue with financial assets.*

2. *Recourse is the single most important factor.* Some recourse, e.g., with respect to breaches of representations and warranties and dilutions would not be inconsistent with a true sale. Issue is “nature of the recourse” and “true nature of the transaction”. *Major’s Furniture Mart, Inc. v. Castle Credit Corp., Inc.*, 602 F.2d 538, 544 (3d Cir. 1979).

3. *Retained Rights and Rights to Surplus.* If an obligation is a secured loan, the transferor (debtor) is entitled to any surplus. If the transfer is a “true sale” any upside belongs to transferee. See Uniform Commercial Code (Official Text), §§ 9-608(b) and 9-615(e).

4. *Intent of the Parties.* Terms such as “security” or “collateral” indicate a loan, and terms such as “sale” or “absolutely convey” support sale treatment. See *In re Golden Plan of Cal., Inc.*, 829 F.2d 705, 709-11 (9th Cir. 1986). Nevertheless parties generally take a “protective security interest” and perfect even where a true sale is intended.

5. *Administration and Collection of Receivables.* Collection by transferee is significant indication of sale. Nevertheless, it is common for the transferor to be designated as “servicer” or “collection agent”. If transferee can designate replacement servicer at any time, this is positive. At a minimum, right should accrue after Event of Default (or similar event). Similarly, if account debtors are notified of transfer, this would be a favorable fact.

6. *Right to Repurchase.* If transferor is given right to repurchase, the transaction looks less like a sale except that “administrative convenience” repurchases (e.g., when receivables are less than 10% of original amount) are generally acceptable.
B. Substantive Consolidation Opinions

1. Definition

"Substantive Consolidation" means the effective merger in a bankruptcy proceeding of two or more legally distinct (albeit affiliated) entities into a single debtor with a common pool of assets and a common body of liabilities.

2. Factors

One frequently cited case (In Re Vecco Construction Industries, Inc., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980)) listed the following factors:

   a. The degree of difficulty in segregating and ascertaining individual assets and liability;
   b. The presence or absence of consolidated financial statements;
   c. The profitability of consolidation at a single physical location;
   d. The commingling of assets and business functions;
   e. The unity of interests and ownership between the various corporate entities;
   f. The existence of parent and inter-corporate guarantees on loans;
   g. The transfer of assets without formal observance of corporate formalities.

3. Balancing Tests

There are at least four different standards established by different U.S. Courts of Appeals


      Factors to consider when deciding whether substantive consolidation is appropriate include (1) the necessity of consolidation due to the interrelationship among the debtors; (2) whether the benefit of consolidation outweigh the harm to creditors; and (3) prejudice resulting from not consolidating the debtors.

    b. Eastgroup Properties v. Southern Motel Assoc. Ltd., 935 F.2d 245,
The proponent of substantive consolidation must show that (1) there is substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid some harm or to realize some benefit...When this showing is made, a presumption arises “that creditors have not relied solely on the credit of one of the entities involved.”...Once the proponent has made this prima facie case for consolidation, the burden shifts to an objecting creditor to show that (1) it has relied on the separate credit of one of the entities to be consolidated; and (2) it will be prejudiced by substantive consolidation...Finally, if an objection creditor has made this showing, “the court may order consolidation only if it determines that the demonstrated benefits of consolidation ‘heavily’ outweigh the harm.”

c. **In re Augie/Restivo Baking Co., Ltd.,** 860 F.2d 515, 518 (2d Cir. 1988).

   (1) Whether creditors dealt with the entities as a single economic unit and “did not rely on their separate identity in extending credit.”...or (2) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.

d. **In re Auto-train Corp.,** 810 F.2d 270, 276 (D.C.Cir. 1987).

Before ordering consolidation, a court must conduct a searching inquiry to ensure that consolidation yields benefits offsetting the harm it inflicts on objecting parties...The proponent must show not only a substantial identity between the entities to be consolidated, but also that consolidation is necessary to avoid some harm or to realize some benefit...At this point, a creditor may object on the grounds that it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation...If a creditor makes such a showing, the court may order consolidation only if it determines that the demonstrated benefits of consolidation “heavily” outweigh the harm.

4. Other relevant cases include **In re Bonham,** 229 F.3d 750 (9th Cir. 2000) (ordering substantive consolidation to further an equitable distribution of assets by treating corporate shells as a single economic unit) and **FDIC v. Colonial Realty Co.,** 966 F.2d 57 (2d Cir. 1992) (determining that neither the Bankruptcy Code nor principles of equity prohibit a court’s use of substantive consolidation).

C. Historical Approach Taken By Opining Lawyers

1. True Sale and Nonconsolidation Opinions are almost always “reasoned” or “explained.” See TriBar Opinion Committee, Third Party “Closing”
Opinions, 53 Bus. Law. 592, 607 (1998). It is not unusual for opinions given by some firms to run 30 pages or longer.

2. Such opinions will generally refer to the inherent uncertainty involved in predicting what action a Bankruptcy Court will take in a particular complicated structured transaction. They typically cite, directly or indirectly, the goal of promoting reorganizations and the pervasive equity powers of the Bankruptcy Court. See TriBar Opinion Committee, Opinions in the Bankruptcy Context: Rating Agency, Structured Financing and Chapter 11 Transactions, 46 Bus. Law. 717, 722 (1991) (the “TriBar Bankruptcy Report”). Many opinion recipients will accept opinions which refer specifically to the TriBar Bankruptcy Report as contemplated therein. 46 Bus. Law. at 737.

D. “Reliance” By Accountants

It generally is not appropriate to permit accountants to rely on an opinion. In structured transactions (particularly securitizations) it is appropriate to make available to the auditors a copy of an opinion pursuant to a separate letter (addressed to the client, not the auditors) that contains substantially the following limitations:

“Notwithstanding any language to the contrary in our opinion of even date relating to the above-referenced transaction, you are authorized to make available to your auditors such opinion solely as evidential matter in support of their evaluation of management’s assertion that the transfer of the receivables meets the isolation criteria of SFAS 140, provided a copy of this letter is furnished to them in connection therewith. In authorizing you to make copies of such opinion available to your auditors for such purpose, we are not undertaking or assuming any duty or obligation to your auditors or establishing any lawyer-client relationship with them. Further, we do not undertake or assume any responsibility with respect to financial statements of you or your affiliates.”