PRESS RELEASE

Federal Deposit Insurance Corporation

February 17, 1994

FDIC ISSUES REPORT ON THE REVIEW OF THE ROSE LAW FIRM

FOR IMMEDIATE RELEASE

Attached is the report of a review conducted by the FDIC's Legal Division into questions relating to the FDIC's retention of The Rose Law Firm in litigation stemming from the failure of Madison Guaranty Savings and Loan.

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February 17, 1994

LEGAL DIVISION REPORT ON THE RETENTION OF THE ROSE LAW FIRM FOR THE MADISON GUARANTY SAVINGS AND LOAN CONSERVATORSHIP

The purpose of this report is to review the facts and circumstances surrounding the retention of the Rose Law Firm (the "Firm") for the representation of the conservatorship of Madison Guaranty Savings & Loan (the "Conservatorship" and the "S&L", respectively) in litigation against the Frost & Co. ("Frost") accounting firm. It explores (1) whether the Firm's prior representation of the S&L before the Arkansas Securities Commissioner constituted a conflict of interest; (2) whether the litigation against the Conservatorship by the father-in-law of the Firm partner in charge of the Frost litigation was a conflict of interest; and (3) whether any action against the Firm is warranted.

Assertions have been made that the Firm had conflicts of interest that should have prohibited it from representing the Conservatorship and the FDIC in the Frost litigation. We have reviewed the time period in which the FDIC was responsible for managing the Conservatorship (from February 28, 1989, through August 9, 1989, when the Resolution Trust Corporation was established) to determine the facts related to the Firm's retention. As a part of our review, we looked at all relevant materials identified by the Firm, and interviewed each of the participants and others who were involved with the Conservatorship.

As detailed below, based on the information available to us, we have found no basis to conclude that under the then applicable rules either situation involved a conflict of interest. Accordingly, we recommend no sanctions against the Firm.

Background

On February 7, 1989, the FDIC entered into an agreement with the Federal Savings and Loan Insurance Corporation ("FSLIC") to act as agent for the FSLIC in any receivership or conservatorship appointed for an insured savings association after January 1, 1989. On February 28, 1989, FSLIC was appointed Conservator for the Madison Guaranty Savings & Loan. Pursuant to the agreement with the FSLIC, the FDIC was appointed the managing agent for the Conservatorship. In that role, the FDIC was required to marshal the institution's assets and pursue all claims by and defend those agains the S&L. Among the litigation existing at the S&L at that time was a suit against the institution's former auditor, Frost & Co. As managing agent, it was the FDIC's responsibility to determine whether that suit had any value and, if so, to continue the pursuit of the action. The FDIC's formal role ended on August 9, 1989, with the creation of the RTC, whose function as receiver or conservator for any S&L closed after January 1, 1989.*

The Firm's Prior Representation

In 1985, the Firm represented the S&L before the Arkansas Securities Commissioner on two matters: a plan to issue a $3 million private placement of preferred stock in the S&L, on which the Commissioner was asked to issue an opinion; and an application by which the S&L, assuming it raised the capital, sought to set up a service corporation that would become a wholly-owned broker dealer of securities. The opinion was issued on May 14, 1985, and the Commissioner approved the service corporation on September 20, 1985, although placing a condition on the approval that the S&L must raise the capital by December 31, 1985. The capital was never raised and the plan was not implemented. There were no communications between the Commissioner's staff and the Firm after 1985 with respect to the securities placement or the plan.

Part of the submission in support of these two applications was an audit of the financial statements of the S&L performed by Frost for calendar year 1984. Certain adjustments to these financial statements were questioned by the Commissioner's office. The records of the Commissioner's office show that the effect of those adjustments was explained in letters from Frost and John Latham, the S&L's chief executive officer, attached to a letter from the Firm on July 25, 1985. There is no indication that the Firm retained the auditor, assisted in any way in the audit or took any position as to the quality of the audit.

In 1988, the S&L initiated litigation against Frost charging that the auditor had been negligent, reckless and breached its contract by failing 5o fairly represent the S&L's financial condition in the 1984 and 1985 audits. The S&L was represented in the litigation by the law firm of Gerrish and McCreary.

The Gerrish firm also was involved in defending directors and officers of failed banks in actions instituted by the FDIC. After FDIC was appointed managing agent of the Conservatorship, the FDIC staff attorney responsible for the Frost litigation concluded that, pursuant to FDIC policy, the firm had a conflict of interest with the FDIC and had to be replaced. The staff attorney also concluded that few firms in Arkansas had the experience and capacity to do accounting malpractice work, which is considered to be complex in nature. The staff attorney first considered the Arkansas law firm of Wright, Lindsey & Jennings, which had represented FDIC in other matters, but it too had a conflict of interest. The staff

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*The FDIC's Legal Division continued to provide legal support to the RTC with staff dedicated to RTC legal matters until September 1991, when all RTC legal matters were assumed by a newly created Legal Division within the RTC comprised of the FDIC staff formerly dedicated to RTC work.

attorney then contacted the Rose firm based on previous work done by the Firm on behalf of the FDIC in connection with the Corning Bank failure.**

The staff attorney contacted a partner of the Firm (based on the staff attorney's recollection, probably Webster Hubbell) and asked the Firm to take over representation. The staff attorney is sure the Firm would have been asked about any conflicts of interest, but due to the passage of time has no specific recollection of making that request or any response that may have been made. Richard Donovan, a partner with the Firm who worked on the case, states that he recalls Mr. Hubbell having advised the staff attorney of prior representation of the S&L on a matter involving the Arkansas Securities Commissioner. Mr. Hubbell's recollection differs. He recalls advising the staff attorney very generally the Firm had done a small amount of work for the S&L years earlier, but that he did not view that as amounting to a conflict. He believes the work he was aware of was lending and collection work. He says he does not believe he was aware of the of the earlier securities work at that time, so he does not believe he discussed it with the staff attorney then. The FDIC staff attorney has no recollection of the issue being raised and says that if it had been it would have been discussed with the attorney's supervisor. The supervisor has no recollection of the issue being raised.

** While the Firm had sent a letter to the FDIC dated February 28, 1989, soliciting work relating to any S&L failures, it does not appear the staff attorney was aware of that letter or that it influenced her decision to ask the Firm to represent the FDIC. Also, assertions have been made that the letter may have been deceptive and misled the FDIC regarding prior representation because it stated "the FIrm does not represent any savings and loan association in state or federal regulatory matters." However, the letter also states "(f)rom time to time we ahve provided special ized service to some savings and loan associations in such areas as employment discrimination, work-out of participation loans and bankruptcy." The firm also acknowledged in the letter that there may be individual transactions or situations where a conflict of interest could arise.

The Existence of a Suit Involving Mr. Hubbell's Family

At the time the conservator was appointed (and when the Firm was retained), Mr Hubbell's father-in-law, Seth Ward, Sr., was involved in litigation with the S&L. Mr. Hubbell's father-in-law had obtained a judgment of roughly $470,000 for commissions alledgedly owed him by the S&L for the sale of real estate on behalf of Madison Financial Corporation, a subsidiary of the S&L. That case was then on appeal.

Mr. Hubbell says he was aware of the Ward litigation but he did not view it as a conflict. He says he believes he did advise the staff attorney about it, but he cannot be certain. The staff attorney does not recall whether the Ward relationship was raised at the time of the Firm's retention in March of 1989. However, another FDIC staff attorney became

aware of the relationship and informed the staff attorney on the case, in a letter dated June 8, 1989. At that time, the second staff attorney expressed concern that Mr. Hubbell would have access to information through his representation that could be damaging to the litigation involving Mr. Ward. After reviewing the facts, the staff attorney responsible for the Frost litigation concluded that the facts did not pose a conflict. On June 23, 1989, the staff attorney wrote to the FDIC's Managing Agent for the Conservatorship concerning the Hubble/Ward relationship, stating that Mr. Hubbell had not represented Mr. Ward in the past and he would not do so in the future.*** Mr. Hubbell then sent a letter to the FDIC Managing Agent, dated June 28, 1989, in which he affirmed that he had not and would not in the future represent Mr. Ward in the dispute with the S&L.**** Mr. Hubbell also confirmed in an interview that he had not drafted any documents that were involved in the Ward litigation.

*** The staff attorney's letter also noted that the primary attorney in the case was Richard Donovan, not Mr. Hubbell, and stated that Mr. Hubbell was involved only in an indirect way. Based on discussions with the staff attorney, this was meant to indicate that Mr. Donovan, as the junior partner on the case, would do most of the day-to-day work. Based on fee bills for the case, Mr. Hubbell performed a significant amount of work.

**** The issue was raised again after Mr. Hubbell's letter when an FDIC credit specialist sent a memorandum in his supervisor expressing concern about the relationship and seeking senior level review of the situation. This memorandum also was called to the attention of the FDIC's Regional Counsel indicating that this should be "a Washington issue" because the staff attorney responsible for the Frost litigation was based in Washington, D>C> No further action appears to have resulted from these subsequent memoranda.

As an added precaution, according to Mr. Hubbell, Mr. Donovan and Gary Speed, another partner at the Firm who worked on the Frost case, the Firm imposed an informal, unwritten procedure in connection with the Frost litigation that kept Mr. Hubbell from having access to information about his father-in-law. According to Messrs. Donovan and Hubbell, Mr. Hubbell was not allowed access to material such as an investigative report done by the S&L's prior attorneys, and he was kept out of several depositions when information concerning Mr. Ward's loans was expected to be involved. Mr. Speed states that Mr. Hubbell would leave the room if Mr. Ward's name came up during discussions, and that he and Mr. Donovan would not discuss Mr. Ward in the presence of Mr. Hubbell.

Analysis

Criteria for Determining Whether a Conflict Exists

The standards governing the professional conduct of attorneys, including issues relating to actual and potential conflicts of interest, are set forth in codes or rules of professional responsibility and conduct adopted by the various states. Many states have adopted, or have patterned their rules on, the American Bar Association'Model Rules of Professional Conduct ("the Model Rules"). Arkansas adopted the Model Rules as its rules of conduct for attorneys in 1985. The Model Rules generally prohibit an attorney from representing a client where the attorney also represents or previously represented another client whose interests are adverse to the first client. The Model Rules provide that a client may waive a conflict of interest by consenting to the representation after consultation with the attorney and provided the attorney reasonably believes the representation will not adversely affect the relationship with the other client. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7. Under the Model Rules, and all state rules of which we are aware, it is the attorney, not the client, who has the primary responsibility to identify conflicts of interest when approached with a request to represent a client with respect to a new matter.*****

***** Notwithstanding that the responsibility to identify any potential conflicts rests principally with the attorney, in 1990 the FDIC Legal Division adopted comprehensive policies and procedures governing the retention of law firms and the waiver of actual or potential conflicts of interest. In 1989, the FDIC's conflicts procedures, however, were less formal. Prior to their retention, firms generally were required to respond to a series of questions regarding past and current representations. Unfortunately, in early 1989, due to the tremendous increase in workload as a result of the FDIC's added FSLIC responsibilities, such inquiries were not always documented. In this instance, there are no documents show what inquiry was made of the Firm.

The relevant provisions under the Arkansas rules of professional conduct provide that:

"A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless: (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and (2) each client consents after consultation"; and
"A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless: (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation."

The Firm's Prior Representation

The information regarding whether the Firm disclosed that it had represented the S&L on the prior securities matter is unclear. The more important question, however, is whether a conflict of interest existed that should have been disclosed before the firem agreed to represent the conservator.

In essence, the Firm represented the S7L's interests before the Securities Commissioner in 1985 and it was representing the S&L's interests (on behalf of the S&L's conservator) in 1989. Previous representation of an institution by itself does not create a conflict when a subsequent conservator is appointed for the institution. There is no indication in the records, or based on our review, that the Firm did anything more with respect to the audit in question than take it at face value in its representation in 1985. There did not appear to be any divergence of interest between their representation in 1985 and 1989. As a consequence, the Firm's representation in 1985 was not "directly adverse" to its representation of the Conservatorship in 1989.

In addition, we have found no evidence that the Firm had a close relationship with the SD&L which might call into question its independence. The Firm did not serve as general counsel or exclusive of frequent counsel for the S&L. In addition, no member of the Firm served in any senior managerial or directorial relationship with the S&L prior to its failure.

Under the Model Rules, disclosure of prior representation such as involved here may not be required. However, where a firm is aware of such a prior relationship, we would expect it to convey that information to our staff to assist in determining whether to retain the firm. It is not clear whether the information was conveyed to the FDIC staff at the time. However, based on our review, we do not believe the prior representation represented a conflict of interest.

The Existence of a Suit Involving Mr. Hubbell's Family

It is uncertain whether the Hubbell/Ward relationship was disclosed at the time of retention. Nevertheless, it was clearly discussed within three months after retention and the staff attorney concluded there was no conflict. The assessment appears to be correct.

Mr. Hubbell had not represented Mr. Ward so there was no conflict of representation directly adverse to the Converservatorship. Also, Mr. Hubbell's representation of the FDIC did not appear to have any effect on Mr. Ward. Under Arkansas rules, unless Mr. Hubbell's representation of the Conservatorship would be "materially limited" by his "responsibilities to" his father-in-law or his own personal interests, no disclosure was required. Also, FDIC procedures, at that time, would not have required the disclosure of the relationship.

While concern was expressed by some FDIC staff shortly after the Firm's retention that Mr. Hubbell would have access to information that could benefit his father-in-law, there is no indication any such information was transferred. Moreover, Arkansas rules of professional conduct (as do all State rules of conduct) prohibit an attorney from revealing information relating to representation of a client, unless the client consents after consultation. As a precaution, the firm apparently imposed its own informal "firewall" to prevent information regarding Mr. Ward from being passed on to Mr. Hubbell. Also, the FDIC's procedures at that time did not require disclosure of a relationship such as existed with respect to Mr. Hubbell and his father-in-law.

Therefore, no actual conflict appears to have existed. While in this case it is unclear whether advance disclosure was made and there was no requirement that Mr. Hubbell's relationship be disclosed, we want to emphasize that on an issue as subjective as this, we believe the better course would have been for the attorney to make clear and full disclosure in writing to the FDIC and let the FDIC as client determine whether in its judgement the representation at issue was likely to affect its interests adversely.

****** Nevertheless, that was not specifically required at the time and, when disclosure was made, the FDIC determined the representation was not adverse.

Conclusion

In 1989, the Legal Division lacked formal procedures regarding the determination of conflicts of interest and, at the same time, the Division's staff was experiencing an enormous increase in workload due to the rapidly expanding duties of the FDIC. As a consequence, in hindsight documentation regarding the retention of the Firm is more limited than would be ideally hoped for. However, based on our review, we have found no basis to determine that either of the alleged instances involved a conflict of interest.

Therefore, we see no basis to recommend any sanctions against the Firm.

****** In 1990, the FDIC adopted formal procedures to deal with conflicts which emphasized that waivers must be sought even where there is only the "appearance" of a conflict. Also, in 1990, the Supreme Copurt of Arkansas recognized that although the "appearance of impropriety" is no longer specifically a part of the state's rules of professional conduct the principle is still a part of the rules. First American Carriers, Inc. v. Kroger Co., 302 Ark. 86, 787 S.W. 2d 669 (1990)