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Recent Developments in Risk Management

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Motion to Withdraw — Meaning of Requirement to "Diligently Attempt" to Locate the Client

Caveman Foods, LLC v. Ann Payne's Caveman Foods, LLC, Civ. No. 2:12-1112 WBS DAD

Risk Management Issue: When a lawyer or law firm wants to withdraw from an engagement in a matter involving litigation, what constitutes a "diligent attempt" to locate a client?

The Case: Caveman Foods, LLC (Caveman) filed a trademark infringement and unfair competition suit against defendant Ann Payne's Caveman Foods, LLC (defendant). Defense counsel renewed a motion to withdraw as counsel for defendant that it had previously made.

Counsel initially filed its motion for withdrawal in February 2014, reporting that defendant had notified the firm that it had ceased all business operations and had no assets available for distribution to creditors. Counsel stated that defendant also terminated counsel's services and consented to counsel's motion for withdrawal. During the hearing on that motion, defendant's corporate representative, George Sampson, and his personal attorney appeared by telephone. Sampson's attorney, however, instructed him not to answer any questions or speak to the court. As such, the court could not verify whether the individual on the phone was a proper representative of defendant, whether defendant had ceased its business operations and terminated counsel, and whether defendant understood and agreed to the consequences of being unrepresented by counsel. As a result, counsel's motion was denied.

A year later, counsel renewed its motion to withdraw. Counsel stated that it had not undertaken any work in this action on behalf of the defendant after its first motion for withdrawal was denied. Counsel further stated in its motion that the defendant was no longer an active company and that it had no office, telephone, email, employees, or forwarding contact information in the United States. Counsel had sent notice of the motion to defendant's registered office in Pennsylvania and to the last-known email address of one of defendant's former representatives.

The court denied counsel's renewed motion to withdraw. The court noted that although Rule 3-700(C)(5) of the California Rules of Professional Conduct permits an attorney to withdraw if the "client knowingly and freely assents to termination of the employment," a client's assent alone does not require the court to grant a motion for withdrawal. The court was unable to verify counsel's representations or assure that defendant fully understood and agreed to the full consequences of counsel's withdrawal.

Counsel also argued that withdrawal was appropriate under Rule 3-700(C)(1)(d), which permits withdrawal if the client "renders it unreasonably difficult for the [attorney] to carry out the employment effectively." Counsel argued that defendant has ceased all business operations, was no longer an active company, had no assets that can be distributed to creditors, and had no office, telephone, email, employees, or forwarding contact information in the United States. The court, however, did not find this a compelling argument either. The court noted that a simple internet search for "Ann Payne's Caveman Foods" revealed that the defendant was actually an active company that was headquartered in Toronto, Ontario, Canada. The defendant also had an actively maintained website and recent press releases. Additionally, the website listed its current mailing address, phone numbers, email addresses, the names and contact information of its representatives, the

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addresses of eight retailers that sold the defendant's product, and upcoming events that defendant's agents were going to attend in the near future. Based on the foregoing, the court found that counsel's contentions that defendant was unresponsive and "unwilling or unable to communicate" were unfounded.

Furthermore, the court noted that granting counsel's motion to withdraw would effectively place defendant in immediate violation of the Local Rules since it would no longer have counsel to represent it. E.D. Cal. L.R. 180(a) ("A corporation or other entity may appear only by an attorney.").

The motion was denied, and the court noted that counsel could withdraw only if it located replacement counsel for defendant.

Risk Management Solution: When filing a motion to withdraw on these grounds, it is first necessary to undertake a diligent attempt to locate the client. If it proves impossible to contact him or her through a telephone call or email or by fax, it is still necessary to make enquiries, including internet research and possibly even by engaging an investigator in order to demonstrate that the client has actually disappeared.

Scope of Duty to Protect Client and Trust Accounts from Hacking

North Carolina State Bar 2015 Formal Ethics Opinion 6 (October 23, 2015)

Risk Management Issue: What are lawyers' ethical obligations to protect client funds from misappropriation resulting from a third party hacking into the lawyer's system, and under what circumstances do lawyers have a duty to replace those funds?

The Opinion: In its opinion, the Council of the North Carolina State Bar considered a lawyer's ethical obligations in the event that client funds are stolen by a third party from a trust account maintained by a lawyer. The opinion was limited to addressing the lawyer's ethical obligations, not any potential legal liability. In the context of online banking, the Council opined that when a third party illegally accesses the lawyer's computer network and electronically steals funds from a client trust account, the lawyer does not have an ethical obligation to replace the stolen funds, provided that the lawyer has taken reasonable security measures to protect the client funds in compliance with prior ethics opinions.

However, according to the opinion, the lawyer has a duty to take certain steps after the theft in order to minimize the damage. The lawyer should notify the clients of the theft, and advise them of the consequences for the representation. The lawyer should also help the clients identify a means to cover their losses, identify and pursue any bank liability, and work with law enforcement. In an ongoing matter, the lawyer should defer a client's matter and provide an explanation to third or opposing parties if necessary. Finally, the lawyer must report the theft to the appropriate client trust fund authorities.

Comment: Several other state bar ethics opinions have found that the use of online systems for preservation of client information and online banking are permissible, provided that lawyers use reasonable security measures to minimize the risk of third-party access or misappropriation. For instance, NY State Bar Association Ethics Opinion 842 (Sep. 10, 2010) found that a lawyer may use an online data storage system to store confidential client information provided the lawyer takes reasonable care to ensure the maintenance of confidentiality by staying informed of technological security measures, and employing the available technology to safeguard against a security breach. Other opinions include FL Bar Ethics Opinion 12-3 (Jan. 25, 2013), finding that a lawyer may use cloud data storage for client information, provided that the service provider maintains adequate security; and NC State Bar 2011 Formal Ethics Opinion 7 (Jan. 27, 2012), finding that a lawyer may use online baking to manage a client trust account, provided that the lawyer uses reasonable care to minimize the risk of loss or theft, including thorough education of managing lawyers about ever-changing security risks and active maintenance of end-user security.

Risk Management Solution: In order to fulfill the ethical obligation to maintain client funds and to avoid any professional responsibility consequences of a security breach, lawyers are required to take reasonable security measures in light of current technology. Lawyers should review their state's ethics opinions outlining certain standards or best practices for maintaining online security and ensure that the security measures protecting client funds comply. For example, North Carolina State Bar 2011 Formal Ethics Opinion 7 outlined a lawyer's affirmative duty to keep apprised of the security risks present in online banking, to maintain end-user security through use of strong password policies and encryption and security software, to employ an information technology consultant, and to ensure training on firm security measures by all firm staff who assist in the management of the trust account. Additionally, due to the ever-advancing nature of technology and hacking threats, the reasonableness of a given security measure will change over time. Lawyers should regularly revisit the security issue and ensure that the measures employed to preserve client funds are sufficiently current and able to protect against ongoing security risks.

Finally, even if lawyers employ reasonable security measures and avoid breaching the Rules of Professional Conduct, in the event of a security breach, lawyers have a duty to inform clients of the breach, take necessary steps to help recover the funds, and protect the client's interests with respect to any consequences of a theft.

Enforceability of Restraints on the Practice of Law in Attorney Employment Contracts — Penalties for Competition — Application of the Rules of Professional Conduct and Public Policy

Moskowitz v. Jacobson Holman, PLLC, 2015 WL 4255100 (E.D. Va.)

Risk Management Issue: How do ethical rules prohibiting agreements that directly or indirectly restrict an attorney's right to practice law affect the enforceability of contracts between partners and associates and their law firms that violate these rules?

The Case: In this case, the U.S. District Court for the Eastern District of Virginia held that a violation of Rule 5.6 of the District of Columbia's (D.C.) Rules of Professional Conduct renders a contract provision between a partner and his former firm *per se* void and unenforceable. A former equity partner of a law firm retained the firm's clients when he left the firm. Under the firm's partnership agreement, the firm was required to pay the withdrawing equity partner the equity balance in its Accrual Basis Account (Account). The firm's operating agreement, however, contained a clause requiring withdrawing equity partners to forfeit 50% of their Account if they took firm clients with them when leaving the firm.

Citing the 50% forfeiture cause, the firm only paid the partner 50% of his Account following his departure. The partner sued for the remaining Account balance. In response to the partner's claim, the firm filed a counterclaim seeking to enforce the 50% forfeiture clause. The partner asserted an affirmative defense to the counterclaims arguing that the forfeiture clause was void and unenforceable because it violated D.C. Rule of Professional Conduct 5.6 which prohibits law firms and other employers from restricting the "rights of a lawyer to practice after termination of the relationship." The firm filed a motion for judgment on the pleadings pursuant to Federal Rule of Civil Procedure 12(c) requesting the court to find as a matter of law that a violation of the attorney ethical rules, without more, does not render a contract provision unenforceable.

After a lengthy and ultimately inconclusive debate as to whether the forfeiture provision actually violated Rule 5.6, the Court held that a Rule 5.6 violation, as determined by a trier of fact, is a sufficient basis to render the forfeiture provision unenforceable as contrary to public policy. In coming to its conclusion, the Court rejected the firm's arguments that (1) a violation of a rule of professional conduct cannot serve as the basis for civil liability, and (2) a contract provision that violates a rule of professional conduct is not *per se* void and unenforceable.

In rejecting the firm's first argument, the Court noted that ethical violations have been given effect outside the disciplinary context by D.C. courts in civil actions concerning fee disputes, attorney disqualifications, and fiduciary duty claims. The court also found guidance from the Restatement (Third) of the Law of Governing Lawyers § 13 cmt. a (2000) and other jurisdictions' use of Rule 5.6 in actions involving restrictive covenants in attorney agreements to

support the notion that courts have generally accepted the restrictions found in lawyer codes for purposes of assessing the enforceability of such provisions.

In rejecting the firm's second argument, the Court disagreed with the firm's interpretation of D.C. case law regarding the interplay between a violation of an ethical rule and a breach of fiduciary duty against an attorney. Contrary to the firm's assertion, the Court noted a violation of an ethical rule alone in certain circumstances can constitute a breach of an attorney's common law fiduciary duty under D.C. precedent.

The Court also referenced other D.C. courts decisions which held as unenforceable certain contract provisions that violated specific ethical rules, citing *Jacobsen v. Oliver*, 555 F. Supp. 2d 72 (D.D.C. 2008) and *Hickey v. Scott*, 738 F. Supp. 2d 55 (D.D.C. 2010).

Lastly, the court rejected the firm's argument that the court must engage in additional public policy analysis before determining that a provision that violates Rule 5.6 is void. The Court found that because Rule 5.6 inherently balances public policy concerns of limiting both the attorney's right to practice after leaving a firm and the client's freedom to choose counsel, there is no need for an additional balancing test.

Ultimately, the Court held that a finding by the trier of fact that the firm's forfeiture provision violated Rule 5.6 would render the provision unenforceable as a matter of law.

Risk Management Solution: Since this decision is consistent with similar case law in other states, it is incumbent on firms to ensure that their employment and partnership or other business agreements are not only legally sound, but also comply with the Rules of Professional Conduct. A fresh review should be undertaken if a firm's agreements have not been evaluated with these situations in mind. Notably, there is extensive case law as to what constitutes an improper penalty.