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Recent Developments in Risk Management

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Disqualification — Substantially Related Matters — Waiver of Conflict by Lack of Diligence in Seeking Disqualification

***State of Minnesota, et al v. 3M Company*, Hennepin County (Minn.), Court File No. 27-CV-10-28862 (Feb. 5, 2016)**

Risk Management Issue: Does a client waive its former attorney's conflict of interest by failing to promptly seek disqualification after the conflicted attorney undertakes representation of a party adverse to the former client?

The Case: Beginning in 1992 the 3M Company utilized the services of the law firm of Covington & Burling LLP to represent it in connection with various matters, including a regulatory matter before the U.S. Food and Drug Administration involving 3M's production of fluorochemicals and perfluorochemicals (collectively "the FCs"). By 1998 concern had arisen regarding the use of FCs and, in an effort to deal with the litigation risks, 3M assembled a litigation defense team, which included a Covington attorney as well as lawyers from several other law firms.

Although Covington continued to perform legal services for 3M, Covington attorneys ceased working on FC-related matters by 2006. By October 2010 Covington ceased representing 3M in any matters whatsoever.

Approximately two months later, on December 30, 2010, the State of Minnesota sued 3M, alleging, among other things, that the FCs produced by 3M presented a risk of serious harm to human health and the environment. Covington represented the state in the FC lawsuit.

On January 4, 2011, almost immediately after the FC lawsuit was filed, 3M's in-house litigation staff engaged in discussions regarding Covington's representation of the state in the lawsuit and the potential conflict resulting from that representation.

Despite immediate recognition of the potential conflict posed by Covington's representation of the state in the FC lawsuit, 3M took no action to address the issue for over a year, until March 2012, when it informed the court of the conflict issue. Covington refused to voluntarily withdraw from representing the state.

Finally, on April 30, 2012, one month before the discovery cutoff in the FC lawsuit, 3M moved to disqualify Covington based on the alleged conflict of interest.

Following review by the Minnesota Supreme Court, the case was remanded to the trial court for an evidentiary determination as to whether 3M had waived the right to seek Covington's disqualification.

On remand, the trial court first noted that the issues involved in the FC lawsuit were "substantially related" to the issues involved in Covington's prior representation of 3M in the FC regulatory matter and, therefore, Covington's representation of the state in the FC lawsuit constituted a conflict under Rule 1.9 of the Minnesota Rules of Professional Conduct. However, the court held that 3M had waived the right to seek disqualification by delaying in

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filing the motion for disqualification for approximately 16 months, from January 2011 when it first knew of the potential conflict, until April 2012. Accordingly, the motion for disqualification was denied on the basis that 3M had waived the right to seek disqualification.

Risk Management Solution: If there is an actual conflict on the part of an attorney who is representing a party adverse to the former client, it is imperative that the former client immediately — or at least very promptly — seek to disqualify the conflicted attorney as soon as the adverse representation becomes known. Without prompt action, the former client risks waiving the conflict and foregoing the right to seek disqualification of its former attorney — even though the attorney has knowledge of privileged information and attorney work product from a prior matter which is (or may be) substantially related to the current case. However, the law firm would nevertheless continue to be found to preserve the former client's secrets and to not to use them to the detriment of the former client.

Right to Withdraw — Nonpayment of Fees

Sanford v. Maid-Rite Corp., 816 F.3d 546 (8th Cir. 2016)

Risk Management Issue: May a law firm withdraw from representing a client due to the client's failure to pay fees?

The Case: Larkin, Hoffman, Daly & Lindgren, Ltd. (the Firm) was retained by Maid-Rite and other defendants in a class action suit filed by then current and former Maid-Rite franchisees. The allegations were that Maid-Rite made unlawful representations regarding the company's profitability that induced them to purchase franchises and open Maid-Rite restaurants. The complaint alleged losses exceeding $4 million.

Defendants signed an engagement letter with the Firm in September 2014 and agreed that the Firm would send invoices on a regular basis — usually monthly — and that invoices would be payable upon receipt. The Firm also reserved the right to withdraw from representation for good cause, including failure to timely pay amounts billed. The Firm sent invoices to defendants every month from September 2014 through January 2015. Defendants paid the September invoice, but failed to make subsequent payments. The Firm repeatedly advised that it would withdraw unless it was paid. Defendants made many promises that they would pay, but did not. They also failed to provide the Firm with information critical to the defense.

The Firm moved to withdraw in January 2015, six month prior to the close of discovery and more than a year before the earliest possible trial date. The district court denied the motion.

The U.S. Court of Appeals for the 8th Circuit reversed. It cited Minnesota Rule of Professional Conduct 1.16(b), which permits a lawyer to withdraw under certain enumerated circumstances:

> (5) the client fails substantially to fulfill an obligation to the lawyer regarding the lawyer's services and has been given reasonable warning that the lawyer will withdraw unless the obligation is fulfilled;
>
> (6) the representation will result in an unreasonable financial burden on the lawyer or has been rendered unreasonably difficult by the client; or
>
> (7) other good cause for withdrawal exists.

The court found that defendants' refusal to pay was undoubtedly a substantial failure to fulfill an obligation to the lawyer and supplied good cause for withdrawal. In addition, defendants' failure to provide the Firm with important information related to their defense also failed to fulfill an obligation to the Firm. Moreover, the Firm had warned

defendants several times that if the outstanding bills were not paid the Firm would seek to withdraw. Finally, the court found that the record was clear that defendants were notified of the motion to withdraw. Thus, the court concluded that it was presumptively appropriate for the Firm to withdraw.

Comment: This decision is markedly different in tone from the withdrawal case discussed in the March 2016 *Lawyers' Lawyer Newsletter* Vol. 21, Issue 1. In *Caveman Foods, LLC v. Ann Payne's Caveman Foods, LLC*, Civ. No. 2:12-1112 WBS DAD, the court denied a motion to withdraw brought when the client allegedly notified the subject law firm that it had ceased all business operations, and terminated the representation. In that case the law firm did not attempt to withdraw on the basis of nonpayment, but rather alleged that the client terminated the representation and that because the client was no longer operating, the representation would have been "unreasonably difficult." The court could not verify counsel's factual assertions, but noted that a simple internet search indicated that the client was conducting an ongoing business. As a result, the *Caveman Foods* court denied the withdrawal based on its finding that the law firm had not engaged in a diligent attempt to locate its client. In *Sanford*, the Firm only sought to withdraw based upon nonpayment. Comparing the cases, the lesson is that the simplest approach to a withdrawal motion is to keep the basis of the withdrawal to information or facts within the Firm's control.

Risk Management Solution: This case is significant for its lesson on careful drafting of engagement agreements, including detailed billing guidelines and payment expectations, and a reservation of the right to withdraw for nonpayment. Taking care at the outset of the relationship can work to a firm's advantage in a nonpayment situation. Extensive and written notice to the client, including an opportunity to rectify the circumstances on which the withdrawal will be based, is equally important. This case is a powerful precedent as to how to proceed at every stage for firms seeking to limit the potential risks resulting from nonpaying clients.

Conflicts-Checking Systems — What Constitutes a Sufficient Conflicts Check?

New York State Bar Association Committee on Professional Ethics Opinion 1085 (2/16/2016)

Risk Management Issues: What are law firms' obligations in operating conflicts checking systems? What must firms do in order to determine whether their lawyers previously represented an adverse party? What are law firms' continuing obligations to perform new conflict checks if or when new information relating to conflicts becomes available?

The Opinion: The New York State Bar Association Committee on Professional Ethics considered an inquiry from a law student practicing through a law school clinic regarding the sufficiency of the clinic's existing conflicts-checking system, where the legal names of potential adverse parties were unknown. The law student wanted to assist a potential client convicted of a crime in seeking post-conviction relief on the ground that the client was the victim of human trafficking. Viewing the alleged traffickers as adverse parties, the law student believed that the alleged traffickers had to be included in a conflict check. However, the information available on the alleged traffickers was limited to "street names" and general areas of residence. The law student sought guidance to determine: (1) whether it was sufficient to run a conflict check using the "street names" of the alleged traffickers; and (2) whether the conflict check needed to be repeated if the law student discovered more information on the alleged traffickers.

The Committee categorically stated that a "lawyer's duty to avoid conflicts is not limited to the requirement of an adequate conflict-checking system." Having determined that the law school clinic had to abide by the same requirements as law firms, the Committee outlined two affirmative requirements for detecting a conflict pursuant to New York Rule of Professional Conduct 1.10(e). First, a law firm is required to make "a written record of its engagements, at or near the time of each engagement." Second, a law firm is required to "implement and maintain a system by which proposed engagements are checked against current and previous engagements" when any of four triggering events occurs: "(1) the firm agrees to represent a new client; (2) the firm agrees to

represent an existing client in a new matter; (3) the firm hires or associates with another lawyer; or (4) an additional party is named or appears in a pending matter." The Committee further noted that the purpose of such a system is to "render effective assistance to lawyers in the firm in avoiding conflicts of interest," and, thus, the conflict system "must be adequate to detect conflicts that will or reasonably may arise." NYRPC 1.10, Cmt. [9].

Before accepting a new client, a law firm must review current and previous engagements to determine if there is a conflict with a current or previous client, checking the names of all known materially adverse parties. When the legal name of an adverse party is unknown — and a lawyer has reason to believe that the firm may have represented other clients with interests materially adverse to the prospective client — a firm should supplement the usual conflicts check with examining its lawyers' memories as to the available information (e.g., the law school clinic should make reasonable efforts to inquire with its lawyers about the "street names" of potentially adverse parties) "through in-person, telephonic, or electronic communications." NYRPC 1.10, Cmt. [9B]. On the other hand, the Committee recognized that "if there is no reason to believe that the firm has ever represented clients with interests materially adverse to those of the prospective client, then there may be no need to supplement the check of written records." Therefore, the extent to which a conflict check should be supplemented, and the scope thereof, will depend on the particular circumstances.

Moreover, once a firm accepts a new matter, it has a continuing conflicts-checking obligation if any of the above-mentioned four triggering events occurs. Even without a triggering event, the Committee recommends running a new conflict check when a firm acquires new information, stating that such practices help lawyers comply with their ethical duty to avoid conflicts.

Noting steps for minimizing potential conflicts in the scenario raised by the law student, the Committee suggests expanding the information sought and recorded by the law school clinic at the time of new engagements to include more informal identifiers, such as "street names." Essentially, the more information recorded and available, the more effective the conflict-checking system is likely to be.

Risk Management Solution: If alternate identifying information on parties adverse to a potential client exists, the conflicts check should go beyond a check of its written records to include consulting its lawyers who may have represented those adverse parties. Further, when new information about the adverse parties becomes available during the representation, lawyers should perform a new conflict check based on the new information. Depending on a firm's area of practice, more informal identifiers may need to be recorded at the time of new engagements so that the conflicts-checking system is more effective.

In-Firm Attorney-Client Privilege Revisited Under Federal (Ninth Circuit) Law

Loop AI Labs, Inc. v. Gatti, No. 15cv00798HSG (DMR), 2016 BL 53774 (N.D. Cal. Feb. 24, 2016)

Risk Management Issues: Are communications between a law firm's in-house chief legal officer and claims counsel and the firm's attorneys relating to a current client matter covered by the attorney-client privilege?

The Case: The law firm that represented plaintiff Loop from 2012 through March 2015 also represented the defendants for a period of time that overlapped with its representation of plaintiff. Loop served the law firm with a subpoena requesting the production of 30 categories of documents. The law firm claimed attorney-client privilege to defeat the subpoena.

Unlike most of the recently reported cases on this topic decided under various states' privilege rules (see the comment below) the court held that this case was subject to the federal law of privilege. Although accepting that there is an attorney-client privilege for in-firm counsel under governing federal case law, unlike the recent state privilege rulings the court held that "[t]he [U.S. Court of Appeals for the] Ninth Circuit recognizes a fiduciary exception to the attorney client privilege." The court noted that:

> In the context of a law firm's communications with its in-house counsel, one court has held that 'a law firm cannot assert the attorney client privilege against a current outside client when the communications that it seeks to protect arise out of self-representation that creates an impermissible conflicting relationship with that outside client.' *In re SonicBlue, Inc.,* No. 0351775, 2008 Bankr. LEXIS 181, [2008 BL 15488], 2008 WL 170562, at *9 (Bankr. N.D. Cal. Jan. 18, 2008). Where conflicting duties exist, the law firm's right to claim privilege 'must give way to the interest in protecting current clients who may be harmed by the conflict.' *Id*.; *see also In re Sunrise Sec. Litig.,* 130 F.R.D. 560, 597 (E.D. Pa. 1989).

However, after analyzing the assertions of the law firm and the client, and the facts as to what the law firm was doing — or not doing — for Loop during the brief period when it simultaneously represented the defendants, the court concluded that the facts did not actually support the application of the fiduciary exception.

In particular the court accepted the law firm's statement that unlike the lawyers in the earlier federal cases, the firm did not perform any work for Loop after it became aware of the potential conflict, and never simultaneously performed work for its conflicting clients. Instead, the firm took immediate steps to evaluate its ethical obligations, and promptly withdrew from representation within two weeks. Accordingly, the court agreed that the earlier federal cases cited by Loop were distinguishable on their facts, that the firm notified Loop that it was withdrawing from its representation only 12 days after learning of the conflict through an email from Loop's counsel, and that the firm did not perform any work for Loop during that two-week period.

The court also found no evidence that the firm was aware of "impending ethical issues" prior to the email from Loop's counsel and that "it appears that it promptly ceased its representation of all parties with conflicting interests." The court held that it was adopting "the reasoning set forth in *Thelen* and *SonicBlue*, and therefore [found] that the fiduciary exception to attorney-client privilege [did] not apply here. The documents [were] therefore protected from production."

Comment: This case follows earlier cases identified above and others on the same topic, discussed in prior issues of the *Lawyers' Lawyer Newsletter*. *See* September 2014 Volume 19, Issue 4 (discussing *Crimson Trace Corp. v. Davis Wright Tremaine LLP)*; September 2013 Volume 18, Issue 4 (discussing *RFF Family Partnership, LP v. Burns & Levinson, LLP* and *St. Simons, LLC v. Hunter, Maclean, Exley & Dunn*); March 2015 Volume 20, Issue 2 (discussing *Palmer v. Superior Court*), and July 2015 Volume 20, Issue 4, (discussing *Moore v. Grau*). Although state courts have rejected the fiduciary exception, the older federal cases, listed here, affirmed that exception. So the law firm here was left vulnerable to losing the benefit of the privilege that otherwise would apply.

Risk Management Solution: The district court's acceptance in principle of the fiduciary exception to the attorney-client privilege is a notable reversal of the recent trend of rejecting that exception when applying that privilege to an attorney's consultation with in-firm counsel. Nevertheless, by narrowly construing the exception so that it does not apply if the law firm was not actually still advising the client during the period as to which it sought the privilege, the court clearly affirmed the underlying importance of the privilege. Accordingly, at its root, this case represents an affirmation of the guidance we have regularly given in the past, namely that it is advisable for law firms to formally designate an in-house attorney as the firm's general counsel (here designated as "chief legal officer" and "claims counsel"). In order to prevail in asserting the privilege, the designated counsel should not perform work on the particular client matter, and should not bill the client for the time spent on the communications. It is also evident from this case that if federal law may apply, the firm should immediately cease work for the client as to which the internal advice is to be sought if it is going to be successful in avoiding the application of the fiduciary exception to the privilege, which apparently still lives on in federal law, at least in the Ninth Circuit.