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Recent Developments in Risk Management

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Application of the Sarbanes-Oxley Whistle Blower Provisions to Law Firms — Federal Preemption of the Ethics Rules Governing Confidentiality

Lawson v. FMR LLC, 134 S. Ct. 1158 (2014)

Risk Management Issue: What internal and client-related risks arise from the application of the whistle-blower provisions of the Sarbanes-Oxley Act to law firms?

The Case: Congress enacted the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "the Act") to safeguard investors in public companies and restore trust in the financial markets following the collapse of Enron Corporation. The Act aims to "prevent and punish corporate and criminal fraud, protect the victims of such fraud, preserve evidence of such fraud, and hold wrongdoers accountable for their actions."

A provision of the Act, 18 U.S.C. § 1514A, specifically protects whistleblowers. It instructs: "No [public] company . . ., or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of [whistleblowing or other protected activity]."

Lawson addressed the following issue: Does Section 1514A shield only those employed by the public company itself, or does it shield employees of privately held contractors — for example, *law firms*, accounting firms, investment advisers — who perform work for the public company?

The U.S. Supreme Court held that Section 1514A shelters employees of private contractors, just as it shelters employees of the public company served by the contractors.

Petitioners Jackie Hosang Lawson and Jonathan M. Zang (plaintiffs) separately initiated proceedings under Section 1514A against their former employers, privately held companies that provided advisory and management services to the Fidelity family of mutual funds. The Fidelity funds were not parties to either case because, as is common in the mutual fund industry, they had no employees. Instead, they contract with investment advisers like respondent FMR to handle their day-to-day operations, which include making investment decisions, preparing reports for shareholders, and filing reports with the U.S. Securities and Exchange Commission (SEC).

Petitioners alleged that they suffered a series of adverse actions and/or were fired in retaliation after raising concerns about certain cost accounting methodologies and inaccuracies in SEC registration statements. FMR moved to dismiss the suits, arguing that neither plaintiff had a claim for relief under Section 1514A. FMR is privately held, and maintained that Section 1514A protects only employees of public companies. The district court rejected FMR's interpretation of Section 1514A and denied the dismissal motions in both suits, but certified a question of law for interlocutory appeal. The U.S. Court of Appeals for the First Circuit reversed and the U.S. Supreme Court granted *certiorari* to resolve the question of whether Section 1514A extends whistleblower protection to employees of privately held contractors who perform work for public companies.

The Supreme Court held that Section 1514A's plain language that no ". . . contractor . . . may discharge . . . an employee" meant that a contractor may not discharge its own employee. Thus, under Section 1514A, a contractor may not retaliate against its own employee for engaging in whistleblowing activity. FMR argued that "an employee" must be read to refer exclusively to public company employees to avoid the absurd result of extending protection to the personal employees of company officers and employees, e.g., their housekeepers or gardeners. The Supreme Court countered that if Congress had intended to limit Section 1514A's protections to employees of public companies, it would have inserted the phrase "of a public company" after "an employee" in the text of the statute.

The Supreme Court also concluded that its textual analysis of Section 1514A was consistent with the provision's purpose. Congress installed whistleblower protection in Sarbanes-Oxley as one means to ward off another Enron debacle. The Supreme Court noted

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Hinshaw & Culbertson LLP
222 North LaSalle Street
Suite 300, Chicago, IL 60601
312-704-3000
www.hinshawlaw.com
www.lawyeringlaw.com
www.lawyersfortheprofession.com

Editors:
Anthony E. Davis and Daniel E. Tranen

Contributors:
Daniel Sanchez-Behar, Garrett D. Lee,
William M. Lopez and Kate G. Schnake

that outside professionals — accountants, law firms, contractors, agents, and the like — were complicit in, if not integral to, the shareholder fraud and subsequent cover-up perpetrated by Enron.

FMR argued that Congress addressed its concerns about the role of outside lawyers and accountants in facilitating Enron's wrongdoing, not in Section 1514A, but exclusively in other provisions of Sarbanes-Oxley "directly regulat[ing] accountants and lawyers." In particular, FMR pointed to sections of the Act requiring accountants and lawyers for public companies to investigate and report misconduct, or risk being banned from further practice before the SEC. These requirements, the Court noted, indicate why Congress would have wanted to extend Section 1514A's coverage to the many lawyers and accountants who perform outside work for public companies. Although lawyers and accountants are subject to extensive regulations and sanctions throughout Sarbanes-Oxley, no provision of the Act other than Section 1514A affords them protection from retaliation by their employers for complying with the Act's reporting requirements. The Court could not countenance the position advanced by FMR (and the dissent) that Congress intended to leave these professionals vulnerable to discharge or other retaliatory action for complying with the law.

Comment: The implications with respect to the rules governing confidentiality under states' rules of professional conduct (Rule 1.6) are profound, and perhaps momentous. Now, notwithstanding whatever those rules say, law firm employees — including lawyers — will have the protection of federal law if they reveal confidential information in the context of a Sarbanes-Oxley whistleblower lawsuit.

Risk Management Solution: To mitigate the risk of liability under the Sarbanes-Oxley Act, law firms should fully understand their obligations under the statute, as well as implement internal whistleblower policies, such as explicit prohibitions of all forms of retaliation. Above all, law firms should review and, as appropriate, enhance complaint and reporting mechanisms and internal controls to enforce whistleblower policies, so as to encourage the identification and resolution of such situations internally, in order to forestall the actual bringing of lawsuits.

Waiver of Conflict of Interest — Attorney Disqualification

Grovick Props., LLC v. 83-10 Astoria Boulevard, LLC, 2014 NY Slip Op 05627 (App. Div., 2d Dep't. Aug. 6, 2014)

Risk Management Issue: What amount of detail must be included in a waiver of a future conflict of interest for it to be binding on the client and enforceable by the attorney?

The case: Plaintiff, Grovick Properties. LLC (Grovic), purchased commercial property from defendant 83-10 Astoria Boulevard, LLC (Astori). The law firm of Ruskin Moscou Faltischek, P.C. (RM), though attorney Jon Schuyler Brooks (Brooks), represented Grovick on the purchase of the property. At the closing, Grovick and Astoria learned that the state of New York wanted to place an environmental lien upon the property resulting from the costs of remedial efforts in abating the discharge of petroleum. The state threatened to seek reimbursement from plaintiff of those costs if the parties closed title prior to the lien being filed. Astoria and Grovick subsequently entered into an escrow agreement, whereby Astoria placed $500,000 in escrow, to protect plaintiff against any action by the state.

Thereafter, Astoria retained Brooks and RMF to represent it in connection with certain claims made by the state for reimbursement of the cleanup and removal costs. Astoria signed a conflict of interest waiver that stated, in part, that Brooks and RMF continued to represent Grovick with regard to the transaction between Astoria and Grovick. The waiver also stated:

> Furthermore, in the event Astoria at any time for any reason elects to discontinue its engagement of this firm, or should an adverse relationship arise between ASTORIA and GROVICK, you acknowledge and agree that we may continue without restriction to represent GROVICK and its principals in any and all matters, including those that arise from or relate to the [property].

The state then filed a cost-recovery action against Astoria seeking clean-up costs. Brooks continued to represent Astoria in the claims by the state. In 2010, Astoria terminated Brooks' representation, and approximately one month later, Brooks sought the release of the escrow funds. Astoria and the state objected to such release, and Grovick commenced the instant action to recover its costs for removing the petroleum contamination. Despite signing the conflict of interest waiver, Astoria moved to disqualify Brooks and his subsequent law firm.

The New York Appellate Division, Second Department, reversed the lower court's ruling, which had granted the motion to disqualify. The appellate court ruled that Astoria had specifically waived any conflict of interest that could have arisen from Brooks' representation of Grovick. The court further ruled, "[t]he waiver fully informed the Astoria defendants of the potential conflict of interest and, by executing the waiver, the Astoria defendants consented to have Brooks represent them notwithstanding that conflict."

Risk Management Solution: Because the conflict of interest waiver at issue in this case was clear and concise and it identified for Astoria, with specificity, the possible future conflict of interest, it was ultimately upheld. When drafting such waivers, it is imperative to thoughtfully articulate the language in the waiver and identify in as much detail as possible any possible future conflicts of interest that will be waived.

Withdrawal of Attorneys — Engagement Letters

Robbins v. Legacy Health Sys., Inc., 177 Wash. App. 299 (2d Div. 2013)

Risk Management Issue: May a lawyer withdraw from a matter when the client is unwilling to pay the costs associated with the engagement?

The Case: In late 2008, plaintiffs hired attorney Mary Schultz (Schultz) to represent them in the prosecution of a medical malpractice case. As part of the engagement, plaintiffs agreed that they would be responsible for the costs associated with the litigation, and authorized Schultz to advance the costs with the express requirement, in the representation agreement, that these costs be reimbursed.

At the start of the litigation, plaintiffs paid $52,000 in costs, and by January 2012, Schultz had advanced them an additional $34,000. However, Schultz advised plaintiffs that the case would not move forward unless they complied with the fee agreement and reimbursed her for those costs. After repeated attempts to collect payment, Schultz filed a notice of withdrawal on April 4, 2012.

Shortly after the notice of withdrawal was filed, two of the medical defendants moved for summary judgment, and plaintiffs filed their objection to Schultz's withdrawal based on that ground. At the hearing on the withdrawal motion, Schultz asked the court for permission to withdraw, but the court denied her request. Instead, the court ordered that Schultz stay in the case at least through summary judgment, even though the medical defendants agreed to strike their motions until the representation issue was resolved. The court added that it would release Schultz after she helped plaintiffs find a new attorney, but refused to address Schultz's concerns about who would pay for the costs of the continued representation. Schultz appealed.

A few months later, plaintiffs retained a new attorney, withdrew their objection to Schultz's motion to withdraw, and subsequently moved to vacate the June 2012 order and to discharge Schultz. Schultz opposed plaintiffs' motion, arguing that the trial court should grant her motion to withdraw as of June 2012 (when she initial made the motion), instead of the March 2013 hearing date on plaintiffs' motion.

The Washington Court of Appeals held that the trial court abused its discretion by refusing Schultz's motion to withdraw. Specifically, the court explained that requiring Schultz to continue representing plaintiffs resulted in an unreasonable financial burden on her, and plaintiffs rendered Schultz's representation unreasonably difficult given their dispute over fees and costs. In addition, the court made it clear that this was not a case where counsel attempted to withdraw at the eleventh hour, but rather gave her clients ample notice and time to find a new attorney as the issue of the costs and the need to find a new lawyer had been ongoing for years prior to the original motion to withdraw. Ultimately, the court decided that Schultz's withdrawal would not have materially affected plaintiffs, especially given that defendants' motions for summary judgment had been withdrawn by their counsel.

Accordingly, the appellate court directed the trial court to enter an order granting Schultz's motion to withdraw as of the original hearing date, as well as an award of costs.

Risk Management Solution: *Robbins* reaffirms an attorney's right to withdraw from a matter when the client fails to reimburse him or her for costs, if that withdrawal will not prejudice the client's case, based upon substantial hardship of the lawyer if forced to continue representation, as provided in most states' versions of the Model Rules of Professional Conduct 1.16.

This case also underscores the need for clearly worded engagement letters that delineate the roles and responsibilities of both the attorney and the client — especially when it comes to payment of fees, costs and other expenses. Engagement letters should also set forth the circumstances permitting the lawyer to withdraw from the representation, consistent with the application of the rules of professional conduct. Confirming the client's ability to pay for these expenses before taking on the engagement is also advisable — especially when the costs are expected to be substantial and to increase as the representation continues.

The Scope of the Work-Product Doctrine — Attorney Sanctions — Failure to Disclose Documents

Cahaly v. Benistar Property Exchange Trust Company, Inc., 85 Mass. App. Ct. 418 (2014)

Risk Management Issue: May attorneys withhold information pursuant to the attorney work-product doctrine where the withheld information concerns a significant fact issue in dispute?

The Case: Real estate investors (plaintiffs) retained a corporation (Corporation) to hold $8 million of their funds in escrow. The Corporation held these funds as an intermediary for clients engaged in Section 1031 property exchanges. The Corporation then began trading plaintiffs' funds through two investment firms, although trading third-party funds was prohibited. plaintiffs initiated a lawsuit against the Corporation and the two investment firms, alleging losses due to the Corporation's wrongful investing of their assets without their knowledge. One of the investment firms (Investment Firm) retained a law firm (Law Firm) to represent it in the lawsuit.

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A central issue concerning the Investment Firm's liability was whether it knew that the Corporation served as an intermediary for third-party funds. After being retained in June 2001, the Law Firm investigated whether employees of the Investment Firm knew that the Corporation was trading third-party assets. The Law Firm was informed that none of the Investment Firm's employees knew that the Corporation's accounts involved third-party funds. The Law Firm also determined that none of the Investment Firm's employees had visited the Corporation's website, which would have revealed that the Corporation served as an intermediary for third-party funds.

On June 19, 2002, the trial judge granted plaintiffs' motion to compel evidence of visits by the Investment Firm employees to the Corporation website. The Investment Firm, though the Law Firm, responded that no non-privileged documents had been found.

On July 15, 2002, the Law Firm received a file from the Investment Firm's in-house lawyer (In-House File). The documents in the file indicated that on September 20, 2000, an Investment Firm employee had become suspicious that the Corporation was embezzling money due to some information on the Corporation's "question and answer page." The employee then visited the Corporation's website and viewed the pages on it indicating that the Corporation acted as intermediary for third-parties for Section 1031 property exchanges. The In-House File also contained a facsimile transmission from that employee to an administrative manager of the Investment Firm attaching the pertinent website pages.

In October 2002, the Law Firm drafted a supplement to the Investment Firm's answers to interrogatories, which would have disclosed the facts found in the In-House File. Before serving the supplement, however, the Law Firm discussed the In-House File with the Investment Firm's in-house lawyers and determined that the employee was working under the umbrella of the office of the general counsel for the Investment Firm, that he acted in anticipation of litigation, and that he was generally under the direction of attorneys. Thus, they determined that the file documents were the in-house lawyers' work product and were protected from disclosure in discovery. As a result, the Law Firm did not to serve the supplemental answers to the interrogatories.

At the trial, which occurred in 2002, the Law Firm argued that the Investment Firm did not know that the funds in the Corporation accounts belonged to third-parties and that there was no reason for the Investment Firm employees to go to the Section 1031 pages on the Corporation website. After the trial, the court granted plaintiffs a new trial for reasons not pertinent to the work product claim.

The Investment Firm retained different counsel for the second trial, which was set to occur in 2009. During preparation for that trial, the Investment Firm produced the In-House File as responsive to the document requests served by plaintiffs in 2001. As a result of this disclosure, plaintiffs moved for sanctions against the Investment Firm and the Law Firm. The trial court held that the Law Firm acted in good faith in deciding not to disclose the In-House File and in presenting a defense at the 2002 trial that the Investment Firm employees had not viewed the Section 1031 pages of the Corporation's website.

The Massachusetts Appeals Court reversed, noting two qualifications to the general protections offered by the attorney work-product doctrine: (1) work product may be subject to disclosure upon a showing of substantial need for the material and if its equivalent cannot be obtained by other means; and (2) there is a distinction between fact work product and opinion work product, and while opinion work product (which consists of an attorney's impressions, conclusions, opinions or legal theories) is not discoverable, fact work product is discoverable if its production is essential to the preparation of the other party's case.

Considering these qualifications, the appeals court held that the Law Firm lacked an adequate basis to withhold the In-House File because it consisted of fact work product, concerned significant points of contention in the parties' dispute, and was important to plaintiffs in making out their claim against the Investment Firm. Of significance to the appeals court's decision was its determination that the contents of the In-House File directly contradicted the Investment Firm's entire defense that it had no knowledge that the Corporation was an intermediary for third-party funds. The appeals court held that when the activities of a party and/or its attorney are at issue in a dispute, the documents that deal with such activities must be produced, even if they are work product. The appeals court concluded that sanctions might be imposed against the Law Firm and remanded the case for further proceedings concerning whether the Law Firm acted in good faith.

Comment: As the court noted, by making the argument that the Investment Firm did not visit the Corporation's website, when the Law Firm knew that this argument was false, the Law Firm violated Rule 3.3 of the Rules of Professional Conduct (a lawyer shall not knowingly make a false statement of fact or law to a tribunal and shall not knowingly offer evidence that the lawyer knows to be false). Under no circumstances does an evidentiary or discovery rule in litigation provide an attorney with license to violate the Rules of Professional Conduct.

Risk Management Solution: There is no sure-fire process for insuring against the improper suppression of discoverable evidence through the overly aggressive and inappropriate use of the attorney-client privilege or the attorney work-product doctrine. However, the use of traditional techniques, such as regular practice group meetings, to discuss active cases is a way that firms can seek to have "sunshine," and to bring into the open for general discussion this kind of situation, and thereby make it more probable that appropriate ethical positions will be adopted that avoid exposing individual lawyers and the firm to sanctions. This kind of review is especially important when lawyers are contemplating aggressive use of the attorney work-product doctrine that may expose a lawyer and the firm to sanctions should a court determine that the documents should have been disclosed.

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