Halloween Issue
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# The Lawyers' Lawyer Newsletter

## Recent Developments in Risk Management

TRICK OR TREAT!

The editors of the Halloween Edition of *The Lawyers' Lawyer Newsletter*
bring you recent risk management cases that are truly frightening, or just plain spooky.
We hope you enjoy these grave tales and learn something from them.
We ask your forgiveness for any resulting bad dreams.

## TRICK OR TREAT! Disgorgement – The Scary Consequences of Failing to Conduct a Reasonable Investigation Into the Source of Fees

*F.T.C. v. Network Services Depot, Inc.*, ___F.3d ___, 2010 WL 3211724 (9th Cir. 2010)

*Risk Management Issue:* What are the consequences of a failure to investigate the source of funds needed to pay attorney fees when the lawyer is aware of facts that cast doubt on the client's right to use the funds to pay the fees?

*The Case:* The U.S. Federal Trade Commission (FTC) brought an action against a group of related companies and their principals, including Charles Castro, who had engaged in the business of selling internet kiosk investment opportunities, alleging that defendants' kiosk selling operation was a classic Ponzi scheme. Castro retained an attorney to represent him and paid the lawyer a flat fee of $375,000, which the fee agreement stated to be "earned upon receipt." Castro paid the attorney with funds that had been surreptitiously withdrawn eight days earlier from two accounts, which he told his lawyer contained funds held for his minor children.

The attorney acknowledged that he was aware that his client was in a dispute with the FTC and that he was aware of the draft complaint provided to his client by the FTC. The lawyer stated that he knew the FTC could eventually take action against his client, but denied any knowledge that the FTC intended to seek a freeze on his client's assets. The attorney claimed that, prior to accepting payment, he investigated financial records for Castro and his company and learned of Castro's cooperation with the FBI investigation. At that time, neither the attorney nor Castro reported to the FTC the source of the funds used to pay legal fees.

The trial court determined that the attorney's fees were paid from funds derived from Castro's unlawful activities and imposed a constructive trust over a portion of those fees. The court rejected the lawyer's contention that he had no knowledge of the source of the funds used to pay his fees and that he was a *bona fide* purchaser because he provided legal services for the fee paid.

Disgorgement — The Scary Consequences, continued on page 2

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*Comment:* This case illustrates the potentially heavy cost of taking a "head in the sand" approach to screening and accepting new clients. The court in this case found that the attorney received information sufficient to put him on notice that his retainer had been paid from potentially illicit funds, thus, triggering the attorney's duty to make a good faith inquiry into the source of the fees. The court found that the attorney's reliance on the client's representation about the funds was not objectively reasonable.

*Risk Management Solution:* When a law firm considers a new engagement, its screening process should include some investigation into whether the funds used to pay the firm's legal fees are proper client funds. When a law firm obtains evidence of dishonesty or that the source of its retainer is legally questionable and it decides nonetheless to accept the engagement, the firm takes the risk that its retainer may be subject to confiscation or disgorgement.

## TRICK OR TREAT! Man-Handling a Lateral

*Eggleston v. Bisnar / Chase LLP,* Case No. 30-2010 00404255 (Super. Ct. Orange County, Cal.)

*Risk Management Issue:* While integrating lateral attorneys is important, is it possible to go too far?

*The Case:* After refusing to attend a "New Warrior Training," Steven Eggleston, a former lawyer at the law firm of Bisnar | Chase, claimed that a firm partner harassed him and constructively discharged him.

Eggleston's complaint alleged that he joined the firm in July 2009 and was to receive a draw plus a percentage of the cases he originated at the firm. Shortly thereafter, partner John Bisnar allegedly told Eggleston that Eggleston "need[ed] to go" to a seminar called "New Warrior Training" (NWT) offered by The Mankind Project. Bisnar also suggested that Eggleston might obtain some type of "supervisory capacity" if he attended.

Eggleston asked Bisnar what the NWT seminar was about, but Bisnar was apparently "evasive," claiming in part that "the things that took place at the seminar were secret and that men who attended had to take an oath not to reveal to outsiders what took place." According to the complaint, Eggleston then turned to Google, where he read that men are encouraged to carpool to the NWT seminars, which are held at remote locations, so they cannot readily leave once they arrive. Attendees then have their personal belongings taken away, are subjected to yelling and intimidation, and are asked to participate in strange rituals. On a "trust walk," for example, attendees are stripped naked, blindfolded, and then led through the woods by hand by a supervisor. Attendees are also allegedly asked to sit in a large circle on the floor, hold a large wooden dildo, and describe in graphic detail a sexual experience.

Disturbed by such accounts and fearing that his supervisor Bisnar might accompany him to the training, Eggleston initially avoided the New Warrior Training. Bisnar then allegedly became extremely hostile, bullied Eggleston to attend a later seminar, and reduced Eggleston's pay. When Eggleston instead later decided he would not attend the NWT seminar at all, Bisnar supposedly stopped paying Eggleston any draw. Eggleston left Bisnar | Chase in March 2010, but conflicts continued. Eggleston was required to repay his draws to the firm. He had difficulties negotiating client notice of his departure with Bisnar | Chase and over the firm's liens on cases he took. Eggleston later learned that the firm had avoided letting clients engage him, apparently to avoid paying origination credit. Eggletson filed a 13-count complaint against the firm, asserting claims including for sexual harassment, retaliation, constructive termination, and wage violations.

*Risk Management Solution:* While all firms have odd traits, some are stranger than others. Lateral attorneys should make sure they have done their homework before joining a firm. And firms should take care that their customs do not chase off good employees, or result in claims against the firm.

## TRICK OR TREAT! Conflicts of Interest From Beyond – Inappropriate Relationship With Spirit Leads to Disciplinary Scrutiny

*In Re Johnson, Respondent,* Member of the State Bar of Arizona, No. 09-0717

*Risk Management Issue:* How can a lawyer better recognize and avoid the tangled web of a self-interest conflict?

*The Case:* An attorney responding to a disciplinary complaint (Respondent) was alleged to have had an inappropriate relationship with a client, whom she was originally retained to represent in a divorce. The relationship began after the client's wife died, when Respondent began to "channel" the wife's spirit, purportedly communicating her thoughts and feelings to her former husband. The client testified that shortly after his wife died, in the course of this "channeling," Respondent, acting as his late wife, told him she loved him and pressured him to have sex. He believed his late wife's spirit had come back to try and heal some of the damage caused by her drug use.

Although the death of the wife of the client ended Respondent's representation of the client to obtain a divorce, the client asked Respondent to represent him again in a dispute over the wife's probate estate. The estate matter ended in a settlement that was very beneficial to the client. But the client later claimed that he was unhappy with the settlement and that Respondent's conduct harmed him emotionally and financially.

The hearing officer found that there was not enough evidence to prove that a sexual relationship occurred during Respondent's representation. He noted that the client encouraged Respondent's "channeling" of his late wife, and found that although there was a significant risk that Respondent's representation could have been materially limited by the unique relationship, there was no evidence that the client was harmed financially or emotionally.

*Comment:* These circumstances provided the foundation for a second disciplinary claim wherein the State Bar of Arizona alleged that Respondent provided false information on an unrelated charge. In the later case, Respondent was asked in a hearing whether she had ever "channeled" a person for one of her clients' and whether she did any "channeling" of deceased persons. Respondent answered "no" to both questions. Respondent defended the charge by stating that she did not consider her communications for the former client's deceased wife's spirit to be "channeling." She also claimed that the questions did not bring to mind the former circumstances, because the experience had been so painful that she blocked it out.

*Risk Management Solution:* It is sometimes difficult to recognize a personal interest conflict of interest. This may be especially true for small firms and solo practitioners, who are their own screeners and the only arbiters of whether their personal interests might adversely impact the representation. Those without professional peers to turn to for objective advice should consider adopting a bright line rule: if there is any personal interest, avoid the representation.

## TRICK OR TREAT! No Treat Here – Judge Orders Client Who Engaged in Spoliation to Pay up or Go to Jail

*Victor Stanley, Inc. v. Creative Pipe, Inc.*, 2010 WL 3530097 *"Victor Stanley II"* (D. Md. Sept. 9, 2010)

*Risk Management Issue:* How far must lawyers go to obtain their clients' compliance with the requirements to preserve and produce electronically stored information?

*The Case:* Just when lawyers thought they had their arms around the risks attendant to the failure to comply with the federal discovery rules regarding electronically stored information (ESI), one federal court has recognized jail time as an available discovery sanction

under Fed. R. Civ. P. 37(a). The court in *Victor Stanley II* identified a series of failures to preserve ESI as well as defendant's deliberate deletion of ESI following the entry of several preservation orders.

A forensic investigation of defendant's computer revealed that, on several occasions, defendant willfully destroyed evidence relating to the lawsuit and made several more attempts to destroy additional evidence that was subsequently recovered. The court described defendant's actions as "the single most egregious example of spoliation that I have encountered in any case that I have handled or in any case described in the legion of spoliation cases I have read in nearly fourteen (14) years on the bench." The conduct was so egregious that defendant ultimately admitted that spoliation had occurred, conceded the relevance of the lost information, and consented to the entry of a default judgment on one of plaintiff's claims involving a copyright violation.

Notwithstanding defendant's concessions, the court sanctioned defendant by entering a finding of civil contempt, and by awarding plaintiffs all of their costs and fees allocable to the spoliation. The monetary award was to include all costs relating to uncovering defendant's discovery abuses, the fees incurred for having to bring the various ESI motions to the court, and the cost of retaining an expert. Given the discovery abuses involved, the court also concluded that without the threat of jail time defendant would do all that he could to avoid paying the award of fees and costs. The court therefore ordered that defendant's actions be treated as contempt, and that defendant be imprisoned for a period not to exceed two years "unless and until he pays to plaintiff, the attorney's fees and costs that will be awarded after the plaintiff has submitted an itemized accounting." The court noted that defendant could avoid imprisonment by promptly paying the fees and costs that would be awarded, which would likely be substantial.

*Comment:* This decision is noteworthy for several reasons in addition to use of jail time to enforce an ediscovery sanction. The author of the *Victor Stanley II* opinion is a member of the Judicial Conference Advisory Committee on Civil Rules, and is viewed by those who follow ediscovery decisions as one who is on the cutting edge of developments in this area of the law. Additionally, the opinion surveys the law in various federal circuits on spoliation and sanctions, and makes the case for why there is a need for uniform standards of culpability for different types of ediscovery sanctions.

*Risk Management Solution:* When it comes to the law on discovery and spoliation, the stakes are high both for clients and for their lawyers. There are already examples of cases where clients facing such sanctions have attempted to point the finger at their attorneys, and to allege that their lawyers failed to adequately inform them of what was required of them, or that they were not warned of the consequences for failure to comply with the rules. All law firms should consider developing a policy that requires their attorneys to advise affected clients, in plain language at the outset of each representation which is likely to involve ESI, that they must not tamper with ESI and that the consequences of defalcations are grave.