AMERICAN BAR ASSOCIATION

ADOPTED BY THE BOARD OF GOVERNORS

JUNE 13, 2009

RECOMMENDATION[*]

RESOLVED that the American Bar Association urges the Federal Trade Commission and Congress to clarify that the Commission's Red Flags Rule imposing requirements on creditors relating to identity theft is not applicable to lawyers while they are providing legal services to clients.

[*] Please note that the recommendation but not the report constitutes official ABA policy.

REPORT

Background

Congress enacted the Fair and Accurate Credit Transactions Act of 2003 (FACTA) in part to combat the growing problem of identity theft. Section 114 of FACTA directed the federal banking agencies, the National Credit Union Administration, and the Federal Trade Commission (FTC) to issue joint "Red Flags" regulations and guidelines for the detection, prevention, and response to identity theft.

The Red Flags Rule applies to "financial institutions" and "creditors." The definition of "creditor" in the Fair Credit Reporting Act (FCRA) refers directly to the definition of "creditor" in the Equal Credit Opportunity Act (ECOA): "any person who regularly extends, renews, or continues credit; any person who regularly arranges for the extension, renewal, or continuation of credit; or any assignee of an original creditor who participates in the decision to extend, renew or continue credit." "Credit," in turn, is defined by the ECOA as "the right granted by a creditor to a debtor to defer payment of debt or to incur debts and defer its payment or to purchase property or services and defer payment therefor." The FTC has stated that professionals who regularly bill their clients for their services after those services are rendered are "creditors" under the ECOA; therefore, according to this interpretation, lawyers are "creditors" and subject to the Red Flags Rule.

The agencies issuing the Red Flags Rule have concluded that the plain language of the statute covers all entities engaged in the provision of credit and does not permit industry-based exclusions. The agencies have recognized that, because some creditors engage in transactions where the risk of identity theft is low, the Rule should be risk-based and require the use of reasonable processes and procedures to detect, prevent, and mitigate against identity theft. Based on the FTC template created to assist low-risk entities to comply with the Rule, most if not all lawyers engaged in the customary practice of law would be considered low-risk.

The Red Flags Rule was to go into effect May 1, 2009. The ABA Governmental Affairs Office (GAO) was notified by Commission staff on April 23, 2009, that the Red Flags Rule would apply to lawyers. GAO met with FTC staff the next day to confirm this assertion, and that afternoon ABA President H. Thomas Wells Jr. sent a letter to FTC Chairman Jonathan D. Leibowitz requesting a delay of the effective date of the Rule so that the ABA would have time to assess the Rule and its impact on lawyers. On April 30, 2009, the FTC postponed the Rule's enforcement date to August 1, 2009.

GAO assembled a working group of ABA entities to assess the Red Flags Rule and its potential impact on lawyers. Upon further examination and consideration of the Rule, the sponsoring

entities of the recommendation proposed that the Red Flags Rule should not apply to lawyers engaged in the practice of law. This recommendation advocating exemption for lawyers from the Red Flags Rule was first proposed by the working group and thereafter adopted by the sponsoring entities.

Why the Red Flags Rule Should Not Apply to Lawyers

FACTA was not intended to cover lawyers, nor does it require the FTC to cover lawyers under the Red Flags Rule.

Under FACTA, Congress instructed the FTC to make rules for "each financial institution and each creditor regarding identity theft with respect to account holders at, or customers of, such entities." Nowhere in the legislation did Congress state that it intended to regulate lawyers with respect to their client relationships; Congress was concerned primarily with lenders and banks. Prior legislative versions of FACTA applied only to insured depository institutions or users of consumer reports; the final version included "creditors" as well as "financial institutions." Nonetheless, some Members of Congress and congressional staff have acknowledged that the FTC's definition of creditor "adds classes of businesses not specified in the regulation."[1]

The U.S. Court of Appeals for the Third Circuit has held that the "hallmark of 'credit' under the ECOA is the right of one party to make deferred payment," but lawyers do not routinely grant such a "unilateral right to defer payments" and that "express terms of [lawyers'] fee agreements plainly manifest their right to prompt and full payments."[2] The Court, citing the District Court's analysis, held that "it is insufficient to trigger ECOA coverage to show that a debtor failed to pay a debt or that a creditor voluntarily chose to delay collection," but rather that the "key element … is whether, under the agreement between the debtor and the creditor, the debtor has a right to defer payment of existing debt or to incur future debt and defer payment at its sole discretion."[3] Lawyers should not be considered "creditors" for purposes of the Red Flags Rule simply because, in accordance with state rules of professional conduct, they must provide the client with the basis or rate of the fee and expenses for which the client will be responsible.

The FTC previously attempted to regulate lawyers under the Gramm-Leach-Bliley Act (GLBA), another general financial regulatory statute. The U.S. Court of Appeals for the D.C. Circuit considered the FTC's foray into the regulation of lawyers under GLBA, concluding: "[i]t is undisputed that the regulation of the practice of law is traditionally the province of the states."[4] Federal law "may not be interpreted to reach into areas of State sovereignty unless the language of the federal law compels the intrusion,"[5] and "if Congress intends to alter the 'usual constitutional balance between the States and the Federal Government,' it must make its intention to do so 'unmistakably clear in the language of the statute.'"[6] The D.C. Circuit, in

[1] Letter from Nydia Velazquez, Chair of the House Small Business Committee, to Jonathan D. Leibowitz, Chairman of the Federal Trade Commission, April 8, 2009.
[2] *Reithman v. Berry*, 287 F.3d 274 (3rd Cir. 2002).
[3] *Id*. at 287 F.3d 277.
[4] *Am. Bar Ass'n v. Federal Trade Commission*, 430 F.3d 457, 471 (D.C. Cir. 2005)
[5] *City of Abilene v. FCC*, 164 F.3d 49, 52 (D.C. Cir. 1999)
[6] *Citing Will v. Michigan Dep't of State Police*, 491 U.S. 58, 65 (1989) (quoting *Atascadero State Hospital v. Scanlon*, 473 U.S. 234, 242 (1985)).

deciding the GLBA case, ruled that "[Congress] does not ... hide elephants in mouseholes"; to regulate lawyers based only on the very general grant of authority in GLBA over "financial institutions" would require the court "to conclude that Congress not only had hidden a rather large elephant in a rather obscure mousehole, but had buried the ambiguity in which the pachyderm lurks beneath an incredibly deep mound of specificity, none of which bears the footprints of the beast or any indication that Congress even suspected its presence."[7] Beyond the D.C. Circuit's holding that the FTC lacked jurisdiction over lawyers under GLBA, the U.S. Supreme Court has held that "[s]ince the founding of the Republic, the licensing and regulation of lawyers has been left exclusively to the States and the District of Columbia within their respective jurisdictions."[8]

The manner in which lawyers customarily bill is not an extension of credit.

The customary billing for legal services should not fairly be considered to be a "deferral" of payment. The FTC's position on the Red Flags Rule is that the mere fact of billing for services after they have been rendered amounts to a "deferral" of a debt and therefore an extension of credit. However, lawyers do not extend credit in the manner envisioned by FACTA.

Lawyers practice under an unusual, if not unique, stringent ethical system in which legal fees are subject to sanction if they are deemed excessive under established standards. The charging of excessive fees is in and of itself an ethical violation. Therefore, regardless of the specifics of billing arrangements used in client-lawyer relationships, it is logically impossible to charge for legal services until they are rendered; a fee cannot be charged unless and until services are rendered because, until that point, there is no basis by which to calculate the fees. The earliest a client may be charged for services is the period during which services are rendered or after the services are completed. Since that is the earliest time a client could be billed, the fact that the service precedes the billing does not make the billing "deferred" and thus is not the extenuation of credit.

To the extent that a retainer or other prepayment mechanism is used, lawyers are required to hold these funds in trust. While the lawyer may have possession of the funds, the funds are held for the benefit of client; the lawyer may not charge against those amounts and withdraw funds until and unless services are administered and an appropriate bill can be rendered. Therefore, even when a lawyer holds funds in connection with not yet delivered services, he or she has not actually been paid. The concept of "deferral" is inapplicable because payment is not tendered until after services are performed. When lawyers perform services against a set periodic retainer, the lawyer is obligated to provide the contracted services contemporaneously with or in connection with the payment of those regular amounts; there is no "deferral."

Even under alternative fee arrangements, there is no "deferral." In common contingency, partial contingency, or success fee arrangements, a lawyer does not receive payment or fees until a specified event or result occurs. Only upon the occurrence of that triggering event does the lawyer become entitled to payment; even though payment follows performance of the services,

[7] *Am. Bar Ass'n*, 430 F.3d 457 at 467.
[8] *Leis v. Flynt*, 439 U.S. 438 (1979).

again, there is no "deferral." When a third party pays lawyers' fees, the lawyers submit their statements for services upon completion of the engagement; their entitlement to the fees cannot be determined until the services (or at least a substantial portion of them) are rendered. In none of these circumstances is there "deferral," and therefore there is necessarily no extension of "credit."

The U.S. Court of Appeals for the Second Circuit has also determined that lawyer billing arrangements fall outside the ECOA. The court determined that lawyer billing practices could not fairly be considered to be a "credit transaction" because lawyers regularly bill for their services while they are being performed or upon their completion. The court ruled that progressive payments made contemporaneously with work performed were not a deferral of payments that could be classified as credit.[9]

Failure to apply the Red Flags Rule to lawyers would not increase the risk of identity theft.

The burden of lawyer compliance with the Red Flags Rule far outweighs any perceived benefit a client might receive. The FTC's template for low-risk entities refers to approval of the identity theft program by a Board of Directors or committee of the Board; many solo practitioners and small law firms do not have such formal bodies. Further, the additional language that would need to be inserted into clients' engagement agreements could make relatively simple transactions more cumbersome. Each entity must also devote time to developing an identity theft program even though the client's identity is already protected by rules of confidentiality and the attorney-client privilege.

Developing a program under the Red Flags Rule is a resource-intensive task even for a low-risk entity like a law firm. The FTC's estimate that a low-risk entity would only be obliged under the rule to spend one hour to comply initially, with a recurring maintenance burden of 15 minutes each year, is manifestly unreasonable. In a representative law firm with approximately 300 lawyers, the cost of compliance is estimated conservatively to be $50,000, representing 120 hours in lawyer time. A firm of fewer than 15 lawyers estimated that initial compliance would require 10-15 hours on the part of a lawyer, plus time for approval, training, and maintenance. The point is not that the Red Flags Rule compliance costs may be small – or even relatively small. Rather, it is that of development and implementation of the entity's identity theft program are far from trivial and, most important, are far greater than any benefit that clients would receive from such a program. Multiplied by the number of lawyers and firms subject to the Rule, the total cost far exceeds any potential benefits to clients or the public.

The FTC staff, when asked, could identify not a single incident of identity theft arising from the law practice context. That should not be surprising: the likelihood of identity theft arising from a client-lawyer relationship for purposes of the Red Flags Rule is remote in the extreme, and lawyers are already required to protect client identity. The identity theft risk addressed by FACTA and the Red Flags Rule is the fraudulent obtaining of credit, or access to existing credit, by a person pretending to be someone else through the theft of the victim's identifying information. The type of identity theft addressed by the Rule would be present only if an

[9] *Shaumyan v. Sidetex Co*., 900 F.2d 16 (2nd Cir. 1990).

individual pretended to be someone else, either to fraudulently initiate a client-lawyer relationship or to obtain legal services on the pretext that the person is another individual who is already a client of a lawyer. Therefore, a person would not only have to assume another person's identity, but his or her legal needs as well. Moreover, identity theft incidents (IT system hacking, dumpster diving, laptop theft, etc.) are covered by other laws specifically tailored to information security and are not covered by the Red Flags Rule.

Further, there are other provisions in place to protect a client's identity in his or her relationship with a lawyer. Principles of agency law, the law of fiduciaries, and the existing law governing lawyers all require lawyers to represent their clients with loyalty, competence, and diligence. Under each of these bodies of law, a fundamental precept of lawyers' professional responsibility is the appropriate safeguarding of client information, documents, property, and confidences (including identity).[10] Moreover, the precept of competent representation of clients is embodied in ABA Model Rule of Professional Conduct 1.1 ("Competence"). (The Model Rules are the basis for most state professional conduct codes that directly govern lawyers.) Comment [5] to Rule 1.1 instructs lawyers to inquire into and analyze "the factual and legal elements" of their clients' problems. Thus, lawyers need to inquire into and verify questions of client identity.

Conclusion

Lawyers are not engaged in the type of commercial activity that Congress was attempting to regulate with FACTA and should not be considered "creditors" under the Red Flags Rule. Identity theft in connection with legal services does not present the type of harm Congress was seeking to remedy. Further, the client-lawyer relationship has been in the province of judicial branch state regulation, and federal statutes must be explicit in order to change that responsibility from state to federal government. The inability of the FTC to point to any instances of identity theft of the type that the Red Flags Rule is designed to prevent under a client-lawyer relationship demonstrates the lack of basis or need for the Red Flags Rule to apply to lawyers.

Congress and the Federal Trade Commission should take steps to ensure that, when the final Red Flags Rule goes into effect, that rule will not apply to lawyers engaged in the practice of providing legal services to clients.

Respectfully submitted,
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[10] ABA Model Rules of Professional Conduct 1.15, "Safekeeping Property"; *The Restatement (Third) of the Law Governing Lawyers,* Section 46(1), Comment 17.

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