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PROFESSIONAL CONDUCT

Regulation of Lawyers: Is the FTC's Red Flags Rule an Omen?

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Special to the Legal

One of the professional responsibility trends we've been thinking about lately is the nationalization, and even globalization, of the practice of law. Many of us work in firms with offices that reach across the nation and even, as the saying goes, across the pond. But no matter how small or big our practices are, sitting at our computers, we have the world at our fingertips. Given these facts, is it possible that someday the practice of law will be regulated on a national or global level?

The Federal Trade Commission's recent (as of yet unsuccessful) attempt to impose regulatory requirements on law firms is an example of what we think may be on the horizon. If the FTC ultimately prevails in its effort, your firm may be required to comply with a set of federal guidelines aimed at preventing identity theft known as the "Red Flags Rule" (72 Fed. Reg. 63,718 (final Rule issued Nov. 9, 2007)). In short, the rule requires certain businesses to develop and implement plans to protect the personal information of their customers by screening for certain identity theft "red flags."

On Aug. 27, 2009, the American Bar Association filed a complaint for declaratory and injunctive relief in federal court in Washington, D.C., to prevent the FTC from applying the Red Flags Rule to attorneys.


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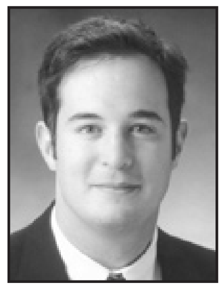
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In support thereof, the ABA contended, inter alia, that the FTC's actions were "in excess of [its] statutory jurisdiction, authority, or limitations," and therefore were in violation of the Administrative Procedures Act (5 U.S.C. §§ 702 et seq.). On Oct. 29, 2009, Judge Reggie Walton (of Scooter Libby fame) entered summary judgment in favor of the ABA and against the FTC on those same grounds.

As the FTC has threatened to appeal the district court's decision, we think it's worthwhile to discuss both the substance and policy of the Red Flags Rule and its potential impact on the practice. First, you should understand that the rule is intended not only to protect your clients from identity theft, but also to ensure that your clients are not impersonators who are committing identity theft.

Driven by a congressional directive in the Fair and Accurate Credit Transactions Act of 2003, 15 U.S.C. §§ 1681 et seq., or FACTA, the FTC promulgated the Red Flags Rule to require "each financial institution and each creditor to establish reasonable policies and procedures" regarding identity theft "with respect to account holders at, or customers of, such entities." To comply with the Red Flags Rule, financial institutions and creditors need to develop written plans for the detection of, and response to, patterns or activities that bear the hallmark of theft of personal consumer information stored in their "covered accounts." Covered accounts are very broadly defined to include "continuing relationship[s]" established by a person with a business that involve multiple transactions or payments, or bear "a reasonably foreseeable risk" of identity theft.

What are the "red flags"? Examples provided by the FTC include inconsistent customer identifying information, dubious contact information or a notice from a victim or law enforcement of suspected identity theft involving a covered account. The FTC's message to businesses is simple: Make sure you know that your client is who he or she purports to be.

OK, so how do we fit into this regulatory scheme? Federal statutes define the term "creditor" as anyone who regularly extends to others the right "to purchase property or services and defer payment therefore." According to an "Extended Enforcement Policy" published by the FTC on April 30, 2009, at 16 C.F.R. 681.1, this includes attorneys who bill their clients after the work is performed instead of demanding immediate, up-front compensation for contracted services. However, this does not include those of us compensated through a retainer or a contingency fee arrangement, since there is no "credit" extended.

In its motion for summary judgment against the FTC, the ABA contended that lawyers are not creditors, and that we do not "'regularly extend' credit by providing services to a client in advance of billing for those services." (In fact, it would be difficult to structure fee collection any other way since state rules of professional conduct typically prohibit the receipt of payment before services are rendered.) The ABA also asserted that the FTC was attempting to intrude upon the traditional state responsibility of policing the legal profession. Finally, the ABA claimed that enforcement of the Red Flags Rule against lawyers would "create a substantial drain on the financial resources of lawyers, particularly those whose support systems are limited and already devoted to serving their clients." According to the ABA's estimation, implementation of the rule could cost law firms billions of dollars in billable time.

In response, the FTC argued that Congress failed to specifically exclude lawyers from the ambit of FACTA and, by extension, the Red Flags Rule. According to the FTC, FACTA's definition of the term "creditor" was drawn from existing statutes that have always been interpreted by courts and agencies to include attorneys who do not request immediate payment for legal services, thereby deferring payment and extending "credit" to their clients. The FTC noted that courts subject lawyers to other federal statutes, such as the Fair Debt Collection Practices Act and the Sherman Antitrust Act, and argued that FACTA and the Red Flags Rule should be no exception.

In its response, the FTC focused on the potential harm to victims of identity theft versus the burden of compliance with the Red Flags Rule on lawyers. In the view of the FTC, any inconvenience or other burden of compliance was "more than offset by the protections afforded to the [potential] victim[s]" of identity theft. At the same time, the FTC conceded that the initiation of an enforcement action against a lawyer who knows his client would be highly unlikely.

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The district court determined that lawyers are not "creditors" for purposes of FACTA, and therefore are not subject to the Red Flags Rule. Specifically, Walton found no evidence that Congress intended to regulate lawyers through FACTA. Ruling from the bench, the judge stated that he had "a real problem with concluding that Congress intended to regulate lawyers when these statutes were enacted." According to the judge, under the FTC's expansive definition of the term, even a plumber who charges a customer after working on a toilet for two days would have to be considered a creditor for purposes of the act.

Of course, we agree with Walton and the ABA on this issue. The application of the Red Flags Rule to the practice of law would be burdensome and, to a large extent, redundant. We already operate under strict rules of professional responsibility, which require us to maintain confidentiality on behalf of our clients. For example, Rule 1.6 of the Pennsylvania Rules of Professional Conduct imposes a duty on us to protect from disclosure information relating to the representation of our clients even after the representation has concluded.

At least for now, we are safe from this attempted federal intrusion into our practices. But we have to wonder: Is this attempt at federal regulation an aberration or is it an omen of things to come?

Litigation associates Sarah P. Bryan and Oleg V. Nudelman contributed to this article. •