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Claims Trends in ALAS’s 2011-2019 Case Reserves

Jason A. Burlingame
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I. BACKGROUND

This is our annual analysis of the case reserves that ALAS has posted since 2011, with a particular focus on reserves in the preceding year. Below we explore the 83 claims on which we posted more than a de minimis reserve in 2019. The tab for 2019 was $299 million, our third highest total since 2013.

Though we have much to learn from our losses, ALAS’s overall claims experience continued to be good. Our modest 2019 underwriting loss was far smaller than our beginning of the year projection, making 2019 the fourth consecutive year in which underwriting performance materially exceeded projections. Claims frequency in 2019 tied our lowest annual frequency mark in the last 25 years. Claims severity was stable, as the 10-year rolling average cost per incurred claim continued to hover within the narrow band that has contained this metric for the last six years.

A. 2019 Headlines

The Great Recession: With the COVID-19 recession looming over us, why hearken back to an event that is over 10 years old? Because we continue to pay for it. Several of our 2019 reserves, including two of our four worst, have their roots in the real estate and financial collapse at the end of the last decade.

Recessions cause claims against transactional lawyers. Parties scrabble through documents searching for escape routes from deals that have become financial losers due to market changes. When they find a route that works, the disadvantaged party sues its lawyers for malpractice, arguing that competent lawyers would have closed the exploited loophole. Some of those claims are baseless, and we defend them vigorously. Yet many claims identify an inarguable mistake. Significantly, the mistake typically was committed amid a booming economy, not a broken one. The loss prevention lesson is to adhere to processes that promote quality work product regardless of the state of the economy.

Impaired Lawyers: We never stop worrying about impaired lawyers. Although their direct financial impact on ALAS is difficult to quantify, as was the case in 2011–17, the loss prevention inquiries we receive demonstrate that our firms continue to encounter mental health and substance abuse challenges. See also ALAS Loss Prevention Manual, Tab III.D. The 2020 health crisis has only increased the threat to the well-being of law firm personnel. In addition, over the past two years, impaired lawyers have caused or aggravated claims resulting in a loss to ALAS. Although the dollar impact is minimal—about 1% of our 2011–19 reserves—the human costs are incalculable. Mental health issues and substance abuse are problems in the profession, and we all need to look out for our colleagues and speak up when we fear someone may be struggling.
Ethical Lapses by Firm Leaders: As we discuss below, losses arising out of lawyer misconduct remained at a disturbingly high level for the second straight year. We were particularly troubled by expensive claims arising out of reckless behavior by firm leaders. In 2018–19, we paid a steep price when firm management (i) pursued questionable business deals with firm clients, or (ii) ignored known conflicts when recruiting and hiring laterals. Lawyers respond to what management does more closely than what management says—misbehaving firm leaders set a poor example for others at the firm.

Cause of Loss: For the second year in a row, losses driven at least in part by lawyer misconduct and conflicts of interest spiked well above their long-term averages. Mistakes also were significantly elevated in 2019. Client misconduct remained consistent with prior years.

This chart places each case reserve into all applicable categories, and several reserves fit within multiple categories. (For example, if we set a $5 million reserve on a claim where both a mistake and a conflict were material to our decision, we put all $5 million in both columns.) We unpack all four causes of loss in Section II below.

Practice Area: In the good news category, claims involving legal opinions chalked up just $3 million in reserves last year, matching a similarly good performance in 2018. Those two years are a happy contrast to 2011–17, when opinion letter claims averaged nearly $22 million annually. We also offer half a cheer for relatively benign years in real estate and estate planning. These practices collectively accounted for under 8% of our 2019 reserves, appreciably less than our typical recent experience. The intellectual property (IP) practices, excluding litigation, also had a quiet year, including zero dollars for missed patent filings.
After pitching a shutout in 2018—zero dollars in loss—the securities practice is making noise again. One of 2019’s largest reserves is due to a firm’s alleged lulling of state and federal securities regulators who were investigating the client’s Ponzi scheme. Moreover, history teaches that securities is our highest severity practice: each securities claim on which we incurred a loss during the 10 years preceding 2019 cost ALAS an average of $9.1 million, almost two and a half times more than the average claim.

In other bad news, the negative litigation practice trend that began in 2012 worsened in 2019: 40% of ALAS’s 2019 reserves came from litigation, the highest percentage we have seen during this bad streak. For perspective, consider that litigation created only 15% of ALAS’s loss from 1979–2011. From 2012–19, however, that percentage more than doubled to 31%—with no increase in litigation as a percentage of our firms’ practices. What is driving this trend? Mistakes, predominantly. Consistent with our prior experience, mistakes were present in over 90% of our 2019 litigation reserves. But conflicts, client misconduct, and misbehaving lawyers also are causing expensive claims in this practice. We also continue to see severe claims arise out of contingent fee matters.

Corporate posted its highest loss since 2012. 2019’s elevated results were driven by mistakes, conflicts, client misconduct, and bad-acting lawyers. We address these issues throughout Section II below.

The ERISA practice was active, as our firms were variously accused of making their own mistakes or not catching and correcting the mistakes or misconduct of their clients and other professionals, especially actuaries. Given the often huge sums involved in pension work, we strongly encourage ERISA lawyers to document the limited scope of their legal services, and then adhere to that scope limitation as the matter proceeds. If the client requests additional services, firms should make a conscious decision on whether to expand the representation’s scope and then document that too. When a pension fund stumbles, a lawyer who had been asked only to do discrete tasks does not want a paper trail incorrectly indicating that they played a broader role, including making investment decisions, formulating actuarial assumptions, or performing other functions.

Finally, representations in which lawyers counseled clients on antitrust issues or handled administrative matters caused ALAS higher-than-normal loss in those practices.

**EB-5:** ALAS has not previously written about this immigration practice, but it is starting to impact our claims. In 2019, one of our worst claims arose out of an EB-5 Ponzi scheme.

In brief, the EB-5 program provides that in exchange for investing several hundred thousand dollars or more in an approved capital project in the United States, a
foreign individual and that individual’s immediate family are eligible for permanent U.S. residence. The EB-5 program had little activity until the Great Recession made project financing scarce. That created a boom in both this program and related legal work that continued post-recession. Unfortunately, the EB-5 program has a history of fraud and abuse. This may be unsurprising to some as the program involves many hallmarks of “unworthy client” claims that ALAS has experienced, including non-U.S. investors, pooled accounts of relatively small individual investments, and various middlemen involved in (i) the solicitation or recruitment of non-U.S. individuals interested in emigrating, and (ii) the connecting of projects needing capital to potential investors. For a general overview of this “golden green card” program that was created by statute in 1992, see https://www.uscis.gov/eb-5.

We encourage our firms’ EB-5 practitioners and loss prevention partners (LPPs) to discuss this practice. Its risk profile may be more akin to the high-severity securities practice, see above, than typical immigration work.

Other Trends: Lawyer failures to document key client communications exacerbated 11 claims comprising 26% of our 2019 loss. On the plus side, however, we noted 14 matters in which our exposure was reduced thanks to thoughtful documentation.

In addition to the actuaries who bore fault in ERISA claims, we also identified other professionals—e.g., accountants, financial advisers, and law firms (including, heaven forfend, some ALAS firms)—who were culpably involved in the problem that created the claim. All told, these other professionals were present in 25% of our 2019 reserves.

Other noteworthy problems in 2019 were:

- As in 2018, lateral hires were involved in a quarter of our 2019 losses. This is well above the longer-term average of 15%.

- Long-standing firm clients and clients that were family groups or businesses accounted for 20% of last year’s reserves. Lawyers should not have a false sense of security just because they are working with a client that has years or even decades of positive history with the firm: those clients are suing their lawyers. We supply some loss prevention

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1 See, e.g., SEC Investor Alert, Investor Alert: Investment Scams Exploit Immigrant Investor Program (Oct. 1, 2013) (warning individual investors about fraudulent investment scams that exploit the EB-5 program); see also SEC Press Release, SEC Charges Lawyer and Her Husband in EB-5 Fraud (Oct. 18, 2018) (immigration lawyer and husband charged in fraudulent scheme allegedly generating millions of dollars of undisclosed compensation from foreign investors through EB-5 program); SEC Press Release, SEC Charges EB-5 Operator With Securities Fraud (Apr. 28, 2017) (noting that accused had agreed to repay several million dollars siphoned away for personal use rather than investing it as promised through the EB-5 program).
recommendations on working with these clients in Section II.B below. Most urgently, we encourage lawyers who serve as a consigliere—an all-around troubleshooter and problem-solver for a family or its business—to reconsider that role.

- Imprudent emails and texts undermined the defensibility of several claims receiving $52 million in total reserves. Some of these emails criticized clients or firm lawyers. Other messages debated—in the context of an alleged conflict—whose clients were most lucrative. Emotive and humorous emails may be cathartic when pressing the “Send” button, but they bring no joy to the lawyer who wrote them when produced to the claimant in a legal malpractice case.

- Clients with unpaid legal fees factored into 13% of our reserves. In one egregious example, an argument over $400,000 in outstanding fees translated into a multimillion-dollar loss to ALAS and our firm. We urge our firms to watch accounts receivable (A/R) and work-in-process carefully. Many firms, with ALAS’s support, assign responsibility for pursuing overdue A/R to someone in the firm’s finance or accounting department. That person often is more effective in reaching a business resolution of fee issues than the billing or relationship partner.

- Botched business intake procedures were present in 18% of our reserves. Examples include missing or defective engagement letters and conflict waivers; taking on a client who had fired its previous two law firms; representing a legal malpractice plaintiff that did not pay its bill before suing the firm; and accepting a case seeking to expand lender liability on a theory that the firm was arguing against on behalf of some banking clients in several other matters.

Although there is no shortage of problems to address, we are pleased to work with our firms to confront these challenges.

II. THE “BIG FOUR” CAUSES OF LOSS

A. Mistakes Jumped

Quality remains “Job 1” as mistakes not only continued to dominate our losses, but jumped up from the 65% long-term average to reach 78%, the second-highest level since 2011.
We categorize mistakes as nonlitigation (transactional, primarily) and litigation. We typically see nonlitigation errors outweigh litigation mistakes by a nearly 2:1 ratio. 2019’s mistakes were anomalous in that litigation errors, $118 million, cost us slightly more than nonlitigation, $116 million. Over the 2011–19 time frame, however, the imbalance persists with litigation mistakes totaling $704 million versus nonlitigation mistakes at $1.2 billion.

1. Nonlitigation Mistakes

In 2019, we posted $116 million in reserves due to alleged lawyer mistakes in nonlitigation matters, primarily in the corporate, real estate, and estate planning practices.

<table>
<thead>
<tr>
<th>Type of Nonlitigation Mistake (Dollars in millions unless otherwise noted)</th>
<th>2011–19</th>
<th>2019 Only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simple mistake</td>
<td>$661</td>
<td>$103</td>
</tr>
<tr>
<td>Bad result/Client’s judgment “mistake”</td>
<td>$354</td>
<td>$11</td>
</tr>
<tr>
<td>Missed deadlines (nonpatent)</td>
<td>$79</td>
<td>$2</td>
</tr>
<tr>
<td>Internal investigation</td>
<td>$28</td>
<td>--</td>
</tr>
<tr>
<td>Missed deadlines (patent)</td>
<td>$33</td>
<td>--</td>
</tr>
<tr>
<td>Other mistakes</td>
<td>$31</td>
<td>--</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1.2 Billion</strong></td>
<td><strong>$116</strong></td>
</tr>
</tbody>
</table>

2011–19 Mistakes Average = 65%
From 2011–19, the largest contributor to the $1.2 billion lost due to nonlitigation errors was simple mistakes—drafting errors, wrong advice, failures to advise, and other errors. As the foregoing table shows, this was the overwhelming cause of loss in 2019. Here are some common themes in 2019’s transactional errors:

**Missed Tax Issues:** Most of these claims arose in the corporate, real estate, and estate planning practices. Lawyers handling projects within those disciplines were accused of creating unnecessary tax liabilities for their clients. Especially in the corporate and real estate claims, tax issues often were not the lawyer’s responsibility; rather the client was working with an accountant, financial advisor, or other professional who was advising the client on tax matters. Unfortunately, the lawyers sometimes failed to limit the scope of their engagement to exclude tax advice. In a few instances, the engagement letter did exclude tax advice, but the lawyers commented on limited aspects of tax liability without noting the limited nature of their advice. The estate planning tax errors we saw were within the scope of the lawyer’s work.

**Rushed Work:** Lawyers made errors in transactions that had to be completed on a rush basis. Sometimes the time crunch was due to the client’s delay in retaining the law firm; other times, the deal changed when a party withdrew shortly before the closing. These timing issues are outside of the lawyers’ control, but lawyers can document when short turnaround times are thrust upon them.

**Formulas in Long-Term Contracts:** Formulas and long-term contracts are breeding grounds for transactional mistake claims. Formulas that are incorporated into long-term contracts multiply that exposure because even a small error times 20 or 50 or 60 years can equal a lot of money. We saw multiple instances of this problem in 2019.

**Lack of Critical Proofreading:** There were many examples of this in 2019. Two illustrative ones were sloppily drafted deal documents that fomented an ownership dispute among business partners, and lawsuits that were incorrectly listed as contingent liabilities on a schedule (thereby triggering the client’s indemnification obligations to the buyer).

We attribute $11 million to “bad result” claims that, in our view, arose when a client accused its lawyers of not protecting the client from its own risky, improper, or unwise decisions. Examples for 2019 include a pension fund that mismanaged its own assets, a landowner that proceeded with a construction project despite its real estate lawyer’s warnings against doing so, and allegedly defective WARN Act advice. Two matters involved licenses; in one, the client erred when it prepared and submitted the initial application on its own; in the other, a client failed to maintain a license that it needed to conduct its business.
2. Litigation Mistakes

As noted above, litigation is mired in an enduring funk. Its bad run began in 2012 and hit a high water mark of 40% in 2019. The overriding cause of litigation losses in 2019 was, as usual, mistakes: over 90% of our loss was an actual or alleged mistake. We divide litigation mistakes into missed deadlines, other mistakes (discrete error, bad result, and all-around-bad-job), and sanctions.

Our 2019 litigation mistake reserves comprised roughly equal parts missed deadlines ($36 million), bad results ($33.5 million), and discrete errors ($31.5 million). Happily, sanctions were down from their longer-term average and from their 2018 high, but we were troubled by the lawyer conduct in some of these claims.

**Missed Deadlines:** Consistent with longer-term trends, missed deadlines accounted for about one-third of litigation mistake losses in 2019. One missed deadline arose out of a failure to timely identify a liability expert. A few claims arose out of untimely notice to the client’s insurer. One of these was unusual: the client’s insurer received timely notice of a lawsuit, but denied coverage based on a failure to report U.S. Securities and Exchange Commission (SEC) subpoenas that were served on the client a few years earlier. That D&O insurance policy defined “claim” to include the service of SEC subpoenas. ALAS recommends that litigators exclude insurance-related issues from the scope of engagement. But if a lawyer agrees to handle the insurance aspects of a matter, including advising the client on notice obligations, then the lawyer should review the policy language.
Bad Results: Claims in this category are driven more by a bad litigation result or the client’s poor decision-making—and not lawyer error. In 2019, we had multiple bad result claims based on unfavorable, admissible evidence that emerged during the litigation or the absence of facts that the client wished existed. Other claims arose when clients rejected their lawyers’ advice on settlement and experts. In the latter category, a client unwisely decided to stick with its own lowball-damages expert instead of following the firm’s recommendation. Finally, in 2019 we again encountered a claim that we believe was driven by the client’s (specifically, the in-house lawyer’s) failure to budget for the bad result that our firm advised was likely coming.

Discrete Error: Perhaps the biggest takeaway from 2019’s “discrete error” litigation reserves is that very few were caused by simple mistakes, such as losing physical evidence or failing to advise a client that its claim lacked merit. More complex problems caused most of these claims.

Two matters were repeats of expensive problems that we have seen before. The first involved releases in settlement agreements. A law firm represented the client in multiple cases. In settling a relatively minor case, the law firm included an overbroad release that a court subsequently found released the adversaries from all litigation with the client. This is why ALAS recommends second partner review of releases in settlements. In the second scenario, the lawyer addressed a narrow issue in big dollar litigation being handled primarily by another law firm. The other law firm mucked up the case in areas outside the ALAS firm’s narrow scope, but the client sued the ALAS firm for its entire claimed loss.

Another firm also was blamed for an error committed by its co-counsel: an international non-ALAS firm inadvertently produced privileged client documents from its own files. The client accused the ALAS firm of (i) not adequately supervising the other, much larger firm, and (ii) not timely seeking to claw back those documents.

Complicated procedural questions with sometimes unsettled law generated several alleged mistakes. Some examples: In negotiating a common-interest agreement, one firm failed to preserve the client’s right to apportion blame to other defendants who were not parties to that agreement. Another firm, when confronted with an adverse nonfinal judgment that effectively gutted its client’s suit, dismissed its client’s remaining claim to make the judgment appealable. Unfortunately, the appellate court decided that the firm should have asked the trial court for entry of judgment in its adversary’s favor instead of seeking a voluntary dismissal. Three claims turned on liability for accrued interest. In one, a firm’s conditional tender was held inadequate to stop interest from accruing on attorneys’ fees that the court previously had awarded. In the second claim, the firm failed to advise the client, after prevailing at trial, that the client would be liable for interest on the funds that its adversary tendered if the appellate court reversed. A third firm was accused of not filing a motion for prejudgment interest, though it is not clear that the law required such a motion.
Sanctions: Although these were down in 2019, we saw bad lawyer conduct in multiple claims. We found this noteworthy because the sanctions category often includes lawyers (as opposed to clients, co-counsel, or the court) who either did nothing wrong or made missteps falling well within the pale of mistakes or misplaced trust as opposed to misconduct. Not so for most of 2019’s sanctions, as we saw lawyers who disobeyed court orders, misappropriated an adversary’s privileged information, continued to use evidence after its falsity became apparent, and played games in discovery. These claims also figure in the lawyer misconduct column.

B. Conflicts of Interest Remained at Their Highest Recent Levels

An optimist would say that 2019 answered our prayers with respect to conflicts. Last year’s article expressed the hope that 2018’s high water mark of 52% would prove to be a peak. And it still might be ... or a plateau, at least. Conflicts as a percentage of ALAS’s reserves have risen precipitously over the past three years, with the long-term average edging up to 38%.

LOSS PREVENTION SUGGESTIONS

To address 2019’s mistake problems, we encourage lawyers to document the limited scope of their engagements, especially as to tax issues in transactional matters. Lawyers should then adhere to that scope limitation, or expand it intentionally, being diligent to include tax or other specialists from their firm when they do so. Particular care also is needed when lawyers work on agreements that include complex formulas, a lengthy term, or both. Sometimes circumstances beyond the lawyer’s control require firms to work on complicated matters in a limited time frame. But please document shortened turnaround times when they occur.

Documentation also is the best defense against bad result claims regardless of practice area. In litigation, for example, a client may decide to retain its own expert against the lawyer’s recommendation. If the lawyer does not document the client’s rejection of this advice, then as far as the legal malpractice jury is concerned, you chose the expert, not the client.

As always, ALAS is pleased to provide programming for major practice groups. In addition, ALAS plans to publish a revised edition of “Preventing Mistakes,” ALAS Law Firm Management Guide (2016), which will update our advice about project management, proofreading, checklists, and other techniques to avoid mistakes.
As in 2018, no category was grossly disproportionate to its long-term average, but there were noticeable upticks in multiple representations and being adverse to another firm client.

### Conflicts of Interest Categories

<table>
<thead>
<tr>
<th>Category</th>
<th>2011–19</th>
<th>2019 Only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multiple representations (joint, concurrent)</td>
<td>$430</td>
<td>$79</td>
</tr>
<tr>
<td>Adverse party also a (former) client</td>
<td>$209</td>
<td>$46</td>
</tr>
<tr>
<td>Prior work</td>
<td>$156</td>
<td>$14</td>
</tr>
<tr>
<td>Doing business with a client</td>
<td>$122</td>
<td>$8</td>
</tr>
<tr>
<td>&quot;I thought you were my lawyer&quot; (ITYWML)</td>
<td>$94</td>
<td>$4</td>
</tr>
<tr>
<td>Other</td>
<td>$83</td>
<td>$4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1.1 Billion</strong></td>
<td><strong>$155</strong></td>
</tr>
</tbody>
</table>

**Multiple Representation/ITYWML:** We combine the multiple representations category (which includes joint and concurrent representations) with the ITYWML (or unintentional joint representations) category. Together, they account for about half of our conflicts-related loss. Transactional matters usually generate most of the harm in both categories. In 2018–19, however, several claimants alleged that litigators representing joint clients favored one of those clients over the other. In one dangerous claim, a firm represented a CEO in litigation adverse to his company while also representing the company in corporate matters; there were no conflict waivers. These litigation claims contributed significantly to the loss in this category.
Lawyers representing families and family businesses in transactional or estate planning matters created several claims, as various clients within those groups accused the lawyer of betraying their interests. In one claim, a firm worked on a series of deals by which a trustee allegedly looted the client-family’s trusts. The family alleged that the firm impermissibly represented both sides in some deals. Other claim scenarios that we saw again in 2019 included:

- A law firm with a long history of representing a family and its business worked on the sale of the family’s stake in the company to an employee stock ownership plan (ESOP). Claimants allege that the firm favored the family over the company in that sale. In that scenario, it is not helpful if a firm lawyer also served as the company’s outside general counsel.

- A law firm that had a long-standing relationship with a private equity (P/E) client also represented one of the P/E client’s portfolio companies. The portfolio company client sued the firm, arguing that the lawyers disadvantaged the company for the ultimate benefit of the P/E client.

- The firm concurrently represented a company and management. In one claim, the firm represented only the company, but when potential criminal liability came to light, the firm advised both its client and corrupt management on their exposure without obtaining a waiver. (In this situation, the better course often is not to seek a waiver; rather, the lawyer should reiterate that he or she only represents the company, and then advise members of management to retain their own independent lawyers.)

**Adverse to (Former) Client:** Litigators generated some of these claims. One firm represented the plaintiff in a case with multiple potential defendants. In strategizing with the client as to which of these parties the client should sue, the firm allegedly failed to disclose that some parties on the do-not-sue list were firm clients. Another claim involved a client using a litigation funder that also was a firm client. The law firm correctly directed its litigation client to a different lawyer to advise the client on its dealings with the litigation funder. According to the claimant, however, that lawyer—a close relative of a firm partner—was not truly independent; instead, she merely served as a conduit through which the firm could be adverse to its litigation client. One claim arose in a white collar criminal case when the firm issued fiercely contested third-party subpoenas to potential witnesses who were firm clients in unrelated matters.

In the nonlitigation context, a firm’s new hire supplied advice and confidential information to one of “his” clients on the same matter in which his new colleagues already were advising the other side. Another firm allegedly did not tell its client that an adverse party in a complex deal also was a law firm client on other matters.
**Prior Work:** This is the conflict that arises between a lawyer and the client when alleged defects in the law firm’s work product become relevant to an ongoing representation such that it could color the lawyer’s advice to the client. We are pleased to report that our losses here were down from prior years. Moreover, in several claims the firm timely detected a potential prior work conflict and then withdrew. In other claims, the firm continued to represent the client, but only after (i) the client consulted with independent counsel, and (ii) the firm sent the client a good waiver letter. One year does not make a trend, but our sense is that firms are doing better here.

**Other—Material Limitation Conflicts:** We typically use the “other” category for the (mostly defense) reserves that we post on claims that include vague or ill-formed conflict allegations. In 2019, however, plaintiffs flagged some subtle but potentially dangerous material limitation conflicts. (What is a material limitation conflict? Think of it as anything that undermines a lawyer’s ability to be an objective legal advisor. See ABA Model Rules of Prof’l Conduct, Rule 1.7(a)(2).) Examples of this conflict in our 2019 reserves include a claim where the client’s financial advisor made a mistake while working on a deal on which the law firm represented the client. The lawyers allegedly stayed mum about the financial firm’s error because the financial advisor was a client of the law firm on unrelated matters. In another claim, estate planning lawyers allegedly favored certain beneficiaries over others because those beneficiaries were social friends with the person who referred the work to the law firm.

**LOSS PREVENTION SUGGESTIONS**

The table at the top of this section demonstrates that joint and concurrent representations are dangerous. These dangers become more pronounced when the firm has represented a family group and its businesses for years, or when the firm represents both a company and individual members of management on related or unrelated matters. When a law firm has a convoluted history of current and former client relationships with a client group, there is not always a neat solution when new work knocks on the door or a conflict arises amid an ongoing representation. Sometimes, a firm may need to decline work or withdraw. Often, however, lawyers can control risk by working with their LPP on each new engagement to:

- Identify which party(-ies) the firm will represent in that matter, and which party(-ies) it will not represent;
- Confirm client identity, along with the scope of engagement, in writing; and
C. Client Misconduct Persisted in 2019

Consistent with its long-term average, client misconduct was present in 39% of the reserves we posted in 2019.

In these "unworthy client" claims, the lawyers are accused of aiding and abetting their clients’ misconduct. In 2019, we again saw a variety of fraudster-clients...
misappropriate investor funds, and we again saw some of these clients indicted or jailed for this conduct. The health-care field, as it often does, provided a lot of activity last year, including one client who was forcibly exited from his business by government regulators, another who charged excessive commissions to pharmacies, and yet another who sought illicit payments from referring physicians. One non-health-care bad actor took funds to which he was not entitled; the law firm’s only connection to this activity was that the funds flowed through the law firm’s trust account.

But 2019’s unworthy clients wore many hats, including a Fortune 50 company that intentionally fed its lawyer misinformation regarding a license application, pension fund managers who allegedly mismanaged their government fund, a longtime client accused of breaching duties to his business partner, and finally, a spouse who looted the testator’s assets while acting as his attorney-in-fact. The lawyers in each claim were alleged to be complicit in their client’s misconduct.

2019 also continued the recent trend of client misconduct showing up in litigation matters. In one claim, a lawyer was defending the client from government investigations, and his client ignored the lawyer’s written advice to stop commingling certain funds; claimants subsequently accused the lawyer of lulling the authorities. Multiple clients provided their lawyers with falsified evidence, destroyed evidence, or failed to produce responsive documents.

**LOSS PREVENTION SUGGESTIONS**

A firm’s best defense against bad-acting clients continues to be its proverbial front door. Firms should perform a routinized background search on all prospective clients. Pandemics permitting, some firms encourage lawyers to meet prospective clients in person before agreeing to provide legal services, especially in the transactional setting. We do too.

Happily, we are seeing fewer unworthy client claims where the firm unwittingly took on a bad actor despite the client having a negative history in the public record. The bigger challenge is watching clients post-intake. Lawyers who provide remedial advice to clients need to ensure that the clients are executing that advice. If the client is dragging its heels, the lawyer should consider withdrawing—loudly, if necessary.

Please consult the firm’s LPP with any concerns regarding client quality. Even long-term clients that are household names are misbehaving, and lawyers can pay the price when clients stray.
D. Lawyer Misconduct Continued Its Spike

After a promising decline in mid-decade, bad lawyer behavior increased significantly over 2018–19. Unlike in 2018, however, the majority of this year’s losses—$66 million of the $119 million total—was due to serious misconduct, i.e., claims in which lawyers committed crimes, serious frauds, or comparably bad conduct.

Serious Misconduct: In addition to the increased dollars, a significant change was the broadened swath of law firm actors who engaged in scurrilous conduct. Prior to 2019, a partner or similarly experienced lawyer committed virtually all of the serious misconduct. Although those lawyers certainly made their mark last year, they were joined by a nonlawyer lobbyist, a staff lawyer, and a paralegal. Here is the catalogue of 2019’s serious misconduct: aiding and abetting a client’s Ponzi scheme, intentionally disclosing a client’s privileged and confidential information to others, receiving and misusing an adversary’s privileged material, disregarding court orders, knowingly making false statements to a court, threatening a client because of the client’s refusal to join the lawyer’s attempt to defraud a third party, and mouthing instructions to a witness who was under oath and on the stand at trial. And no, we are not making these up.

Other Bad Behavior: We also track bad behavior that falls short of the severe standard described above. We posted reserves totaling over $50 million in this category. Some of these claims avoided the “serious misconduct” designation only because we do not yet know enough facts. Here is 2019’s tally of bad behavior: standing pat while possibly knowing about a client fraud or theft; doing business with a client, including purchasing a client’s share of a multimillion-dollar business for $100 without a Rule 1.8(a) letter; gaming discovery such that the court struck the client’s damages expert; evading the firm’s business intake procedures so as to work on a client’s fishy contract; attacking a firm client in a public statement; making
misrepresentations in a deal document; continuing to pursue an argument after its factual basis was put in serious doubt; ignoring known conflict issues while pursuing a lateral; and overbilling. Some claims landed in this bucket due to a lawyer’s failure to timely report events to the client and/or the firm’s LPP, including a missed deadline, the receipt of a sanctions motion, and USPTO’s rejection of the client’s trademark application.

We learned a lot from our 2019 reserves, but we paid for that knowledge. We share the lessons here so that we can reduce losses going forward. We always are pleased to discuss this with our firms.

LOSS PREVENTION SUGGESTIONS

A favorite managing partner, now retired, liked to good-naturedly quiz one of us, “Which lawyer should worry me more, the fool or the knave?” We never were able to answer to his satisfaction, but 2019 certainly confirmed his well-founded fear of the knave. Until someone perfects a truth serum, a firm’s best defense against the scourge of bad behavior is a healthy firm culture that features positive behavior by law firm leaders. Regrettably, we saw several counterexamples to this in 2018 and 2019. Firms also should encourage all personnel to share concerns about bad or unusual behavior with their LPP. Equally important is treating whistleblowers who act in good faith fairly.

III. CONCLUSION

We learned a lot from our 2019 reserves, but we paid for that knowledge. We share the lessons here so that we can reduce losses going forward. We always are pleased to discuss this with our firms.
When Lawyers Engage in Insider Trading

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I. INTRODUCTION

Confidentiality is a pillar on which our system of legal representation is built. The ability of clients to communicate sensitive information to their lawyers without hesitation and to trust that it will be held in strict confidence borders on the sacrosanct. One might argue that without the assurance of confidentiality, there can be no meaningful lawyer-client relationship.

When a lawyer engages in insider trading, abuses confidentiality, and misuses the information entrusted to him, he not only risks great harm to the client whose information he has exploited, it is potentially injurious—reputationally, financially, and ethically—to the law firm where the lawyer works. The negative publicity and professional embarrassment can cause "enormous consequences for a law firm."¹

Indeed, the potential harm goes beyond the client and the law firm. Insider trading by lawyers can undermine confidence in the system of legal representation as a whole. If clients cannot trust that the information they share will be protected from misuse or misappropriation, they may feel that they cannot be candid with their lawyer. Clients must have complete confidence that when they provide confidential information to a lawyer, the lawyer (and those who work with and for the lawyer) will safeguard that information and do nothing to take personal advantage of it or to misuse the information at the client’s expense. This article will provide some historical context on lawyer insider trading cases, discuss recent cases, and offer loss prevention suggestions to help prevent insider trading.

II. BACKGROUND

The issue of lawyers and law firm employees engaging in insider trading has been a concern for at least 40 years. In 1977, the U.S. Securities and Exchange Commission (SEC) issued an unusual public statement noting that it had come to the SEC’s attention that “in certain instances law firm personnel may have abused their position of trust and confidence by trading in securities while in possession of material nonpublic information obtained in the course of their employment, or by revealing such information to others who have engaged in securities transactions on the basis of such information.”² The SEC urged firms to establish policies and procedures to prevent the misuse of confidential information and cautioned that "[l]aw firms, like others which have confidential


information in their possession that may affect securities trading markets, have an affirmative obligation to safeguard such information."³

In 1980, in perhaps the only case of an insider trading enforcement action against a law firm, the SEC charged a New Jersey patent law firm, all of its partners, and one associate with insider trading when they purchased common stock of Refac Technology Development Corporation "while in possession of material, non-public information concerning the allowance by the U.S. Patent Office of certain principal claims in an application for the basic patent on a laser, being prosecuted by [the law firm] under a joint royalty arrangement with Refac and the inventor of the laser."⁴ In announcing the enforcement action, the SEC reiterated the alarm expressed in its 1977 release and stated that it "wishes again to emphasize its concern with respect to the use of material nonpublic information by partners, associates and employees of law firms."⁵ Despite the SEC’s concerns, over the course of the 1980s, insider trading by lawyers and law firm employees proliferated. It has been estimated that during the 1980s and early 1990s, the SEC brought roughly "sixteen separate insider trading cases involving 23 lawyers and at least five other cases against law firm employees."⁶

The 1990s marked an escalation of the government’s concerns about a lawyer’s legal obligation not to tip or trade securities based upon a client’s confidential information. At that time, a corporate insider could be held liable under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder when the insider trades in the securities of his corporation on the basis of material nonpublic information. Known as the “classical theory” of insider trading liability, it applied not only to the officers, directors, and other permanent insiders of a corporation, but also to lawyers, accountants, consultants, and other others who temporarily become fiduciaries of a corporation.⁷ Under the “classical theory,” the insider’s duty is to the corporation’s shareholders.

In U.S. v. O’Hagan, a case involving a partner in a law firm who misused client information to trade stock and call options before the public announcement of an impending tender offer, the Supreme Court recognized the “misappropriation theory” of insider trading liability.⁸ Observing that a company’s confidential information qualifies as property to which the company has a right of exclusive use, the O’Hagan Court recognized that where a fiduciary duty exists to keep such information confidential, the undisclosed misappropriation of such information “constitutes a fraud akin to embezzlement—the

³ Id.
⁵ Id.
‘fraudulent appropriation to one’s own use of the money or goods entrusted to one’s care by another.’”9 To this end, “[a] fiduciary who ’[pretends] loyalty to the principal while secretly converting the principal’s information for personal gain,’ dupes or defrauds the principal.”10 A “misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public.”11 Thus, the misappropriation theory is premised on the legal duty that an outsider owes, not to the shareholders of the corporation, but to the source of the confidential information entrusted to him.

III. A RESURGENCE OF LAWYERS ENGAGING IN INSIDER TRADING

Over the past decade, the SEC has witnessed a resurgence of insider trading by lawyers. Although it is difficult to estimate how much unlawful insider trading is occurring at any given time, the number and nature of cases the SEC has brought against lawyers in recent years suggests that insider trading by lawyers may be increasing. Indeed, in 2019 alone, the SEC brought two major enforcement actions against in-house lawyers at well-known public companies.12 These cases garnered significant public attention insofar as the lawyers were seemingly undeterred by the career-ending consequences a charge of insider trading can bring and were apparently unaware of the substantial risk they were taking. Insider trading cases against lawyers generally fall into one of two categories—system access cases or opportunity cases.

A. Law Firm Systems Access Cases

Systems access cases occur when law firm personnel obtain and tip or trade upon material nonpublic information from a law firm’s computer network. These cases often arise where firms allow lawyers and staff to have unrestricted or unauthorized access to client file folders in network directories via an “open” document management system. Because of the ease of access and lack of technological

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9 Id. (citing Carpenter v. U.S., 484 U.S. 19 (1987)).
10 Id. at 653–54.
11 Id. at 656.
restriction on obtaining the information, systems access cases typically result in repeat or serial insider trading.

For example, in SEC v. Walter C. Little et al., the SEC charged a partner in a prominent law firm with accessing his firm’s computer network to obtain nonpublic client information, trading on that information, and often tipping his neighbor, who also traded. Similarly, in SEC v. Eydelman et al., the SEC charged a law clerk at a major New York law firm after he accessed files containing information about 13 pending transactions and gave the information to a middleman, who conveyed it to a trader. SEC v. Temple and Pastro involved a law firm network IT manager who used his position to access information about 22 merger and acquisition deals and provided information to his brother-in-law. In SEC v. Cutillo et al., a lawyer at a major international law firm conspired with others outside the firm to tip them in advance of four deals involving his law firm’s clients. And, in SEC v. Matthew Kluger et al., perhaps the longest running insider trading scheme in history, the SEC charged a law firm associate who had worked at four well-known law firms over a 17-year period, with tipping on at least eight deals that generated more than $30 million in profits to the lawyer and his co-conspirators.

B. Opportunity Cases

In an opportunity case, a person who otherwise does not plan to trade securities obtains material nonpublic information from a friend, family member, colleague, or acquaintance and seizes the moment to trade. Unlike in a systems access case,

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18 Kluger received a 12-year sentence, the longest prison term ever in an insider trading case. In reviewing the reasonableness of Kluger’s sentence, the Third Circuit wrote, “we cannot overlook the circumstance that Kluger served as a source of the scheme to function. Furthermore, Kluger was an attorney who took an oath to uphold the law ....” U.S. v. Kluger, 722 F.3d 549, 568 (3d Cir. July 9, 2013). In considering the substantive reasonableness of Kluger’s sentence, the court found that “Kluger’s argument does not give adequate attention to the circumstance that he received a two-level sentencing enhancement for abusing his position of trust as an attorney ....” Id. at 571.
opportunity cases don’t involve a person deliberately seeking to gain access to this information.

Lawyers and law firm personnel often come into possession of market moving information involving clients’ businesses. When they decide to trade securities based on that information, they are “secretly convert[ing] the principal’s information for personal gain.”19 For example, in SEC v. Sudfeld, a real estate partner overheard a colleague and their shared assistant discussing a client’s upcoming merger.20 He later traded on the information. Similarly, in SEC v. Schwinger, the managing partner of the Washington, D.C. office of a large law firm traded in advance of a public announcement that a client company was about to be acquired.21 The partner learned of the impending merger while interviewing the company’s chief counsel, who was seeking a lateral partner position at the law firm.

C. Friends and Family Member Cases

The SEC has investigated a number of cases in recent years in which friends and family members of lawyers have traded stocks based on material nonpublic information they learned about by virtue of their proximity and access to the lawyers. What makes these cases particularly concerning is that the lawyers were unwitting victims. In some cases, the lawyers did not learn about the friend or family member’s conduct until after they received an inquiry from the SEC.

For example, one lawyer learned the hard way to be wary of houseguests. In SEC v. Brian Fettner, the SEC charged the life-long friend, and houseguest of a corporate general counsel with trading on material nonpublic information about an impending transaction the lawyer’s company was negotiating.23 The friend, who was in town for a charity golf tournament, allegedly viewed the information while changing into his golf shoes in the lawyer’s study. Friends are not the only potential bad actors. In SEC v. Fei Yan, an associate’s husband purchased stock and options in advance of two corporate transactions on which his wife was then working.22 Similarly, the father of a law firm associate used a holiday visit to misappropriate information about an impending deal involving a large health-care company.23 Unbeknownst to his daughter, the father, who was also a lawyer, misappropriated information about the transaction from his daughter’s papers and traded the target company’s stock.

23 SEC v. Dean A. Goetz, Lit Rel. No. 21990 (June 6, 2011).
When clients provide their lawyers with material nonpublic information, they expect the lawyers will hold that information in confidence and do nothing to misappropriate or misuse it. Lawyers who breach this trust and misuse a client’s information for their own personal benefit expose themselves and their law firms to potential embarrassment, reputational damage, and negative publicity, in addition to the obvious legal consequences. The SEC has a long history of bringing enforcement actions against lawyers for insider trading. Law firms can mitigate their exposure to unlawful trading by adopting robust insider trading policies, conducting regular training, and taking steps to minimize access to sensitive, market moving information.

**LOSS PREVENTION SUGGESTIONS**

Law firms are warehouses of valuable confidential information, and, thus, they are at particular risk that individuals will abuse their positions of trust and confidence. Indeed, in the SEC’s view, “[l]aw firms … have an affirmative obligation” to safeguard confidential information that may affect the securities markets. Accordingly, the SEC has “encouraged” law firms “to establish policies and procedures regarding confidential information and take steps to ensure that all firm personnel are familiar with those policies, including the serious consequences” of violating them. Although even the most robust policies and procedures cannot guarantee that individuals will not misuse the information entrusted to them, they may provide some protection for firms. Significantly, in several cases where the SEC brought insider trading charges against lawyers but not their firms, the commission made a point of noting that the firms had taken precautions to protect confidential information, restricted lawyers and staff from trading in securities of certain issuers, or adopted other policies intended to prevent insider trading. To prevent and protect against insider trading, firms should:

- **Review and update the firm’s insider trading policy.** Most law firms have adopted written policies and procedures prohibiting insider trading. Firms should review and update those policies to ensure that they are consistent with current law and best practice. Firms should also ensure that the policy has been circulated to its lawyers and employees and require that they certify their receipt and agreement to be bound by the policy on an annual basis. See ALAS Prototype Lawyers’ Manual, Policy 3.2 and Appendix 1.2.

- ** Adopt a securities trading policy.** Most law firms allow securities trading by their employees but limit or restrict trading in client securities. In many cases, firms maintain restricted lists that prevent securities trading in securities for which the firm possesses material nonpublic information. Firms also may adopt preapproval procedures
which require employees to obtain firm approval of securities transactions before being allowed to trade.

Although there is no consensus about the most effective type of trading restrictions, those firms that impose restrictions typically take one or more of the following approaches:

- Banning all trading in client securities;
- Banning all trading in securities on a restricted list;
- Requiring preclearance for trading of client or restricted list securities;
- Banning trading in options of client or restricted list securities;
- Banning short selling of client or restricted list securities;
- Requiring preclearance before acquiring any security constituting more than 5% of an outstanding class of securities; or
- Requiring periodic reporting of trades.

Regardless of the types of restrictions imposed, firms should ensure that their securities trading policies are reasonably designed to prevent the misuse of material nonpublic information when employees trade securities.

- **Conduct training on the consequences of insider trading and regulatory surveillance risk.** In recent years, the SEC has adopted new technology and approaches to detecting and investigating insider trading in real time and has become extremely proficient in connecting suspicious trades to sources of material nonpublic information. Law firms should educate their lawyers and employees about the severe consequences for insider trading. Indeed, even just an investigation into alleged insider trading can cause disruption and reputational harm to a firm.

  Firms also should provide periodic training to lawyers and staff concerning the handling of material nonpublic information and how to protect against its misuse. In addition, firms should educate lawyers and staff about the ease with which regulators can now identify suspicious patterns of trading activity and the relationships between traders and sources of material nonpublic information. Insider trading is more easily deterred when individuals come to understand the significant likelihood that their trading activity will be detected and connected to the law firm’s client as the source of the information.
• **Assess and create controls for material nonpublic information.** The key to mitigating insider trading risk is determining what types of material nonpublic information a firm generally possesses and establishing reasonably designed controls to prevent the misuse of such information. In many law firms, lawyers come into possession of a wide range of material facts. Firms that advise clients on mergers and acquisitions, financial reporting and disclosure issues, and government regulatory approvals are particularly susceptible to insider trading risk. Assessing the nature and extent of material nonpublic information in a law firm provides the foundation for deciding whether or to what extent additional controls are needed. Once a firm has done so, then it should determine which internal controls it should establish to address how material nonpublic information is handled. For example, using project code words for transactional matters may help. The risk of disclosure, however, increases if members of the deal team are inconsistent in their use of code words. Similarly, where law firm lawyers and legal personnel share client information in connection with running conflict of interest checks, there is an increased risk of such information being misused. Adopting procedures to shield incoming public company transactional matters from firm-wide disclosure also can reduce the number of lawyers and employees exposed to material nonpublic information. Firms should also consider having dedicated secure office space for particular matters; locking desk and cabinet drawers; and limiting access to various areas of the firm’s computer network, word processing department, and copy facilities. Some firms that use software to erect screens for conflicts purposes also have found it useful in safeguarding information that could be used for insider trading.

• **Provide file access on a need-to-know basis.** When new project files or client file directories are established, law firms and legal departments should consider restricting access to persons on a need-to-know basis. Establishing restrictions on access and adopting a permissions process will prevent employees who are outside the deal team or earnings process from being able to access file folders containing material nonpublic information.
Are You on the High Ground of the Hemp Industry?

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I. BACKGROUND

In the waning days of 2018, President Trump signed into law the Agriculture Improvement Act of 2018 (Farm Bill). Among other things, the Farm Bill amended certain federal laws relating to the production and marketing of hemp, as well as derivatives of the plant. As a result of these changes, the law now distinguishes between hemp and marijuana, and hemp is no longer an illegal substance under federal criminal law. This change has opened the doors wider to allow for the production of numerous products derived from hemp, including pharmaceutical products containing cannabidiol (CBD).

Beyond the obvious economic benefits for companies in the cannabis industry, the enactment of the Farm Bill essentially created a new practice area for attorneys across the country. The Farm Bill and its regulatory scheme are subject-matter intensive, constantly changing, and fraught with pitfalls that can create serious liability and exposure for unwary lawyers. Additionally, lawyers must navigate a complex system of frequently changing and often inconsistent state rules and regulations.

The first step to giving informed legal advice is understanding the hemp plant itself and, in particular, knowing the differences between hemp and marijuana. Practitioners must then become familiar with the nuances of the Farm Bill and the regulatory environment governing hemp. This article will explain each of those topics, as well as the key ethical considerations when counseling clients in the space.

II. HEMP, MARIJUANA, AND CBD

Botanically, hemp and marijuana come from the same genus of plant, *Cannabis sativa* L., but are different species or varieties that have been grown for different use.¹

In fact, hemp and marijuana are genetically distinct forms of cannabis that differ by their use, chemical makeup, and cultivation practices.² Whereas marijuana generally refers to the psychotropic drug, growers cultivate hemp for use in production of many products, including foods and beverages, personal care products, nutritional supplements, fabrics, textiles, paper, construction materials, and other manufactured goods. Indeed, the growth of hemp dates back to ancient

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¹ See, e.g., Purdue University Industrial Hemp Initiative, NC-FAR Capitol Hill Seminar (Apr. 29, 2016), available at https://www.ncfar.org/HSS_20160429_Presentation.pdf.
times and is now occurring all over the world. In other words, despite sharing similar botanical characteristics, hemp and marijuana are completely different plants with completely different uses and markets.

There are about 500 natural components found within the Cannabis sativa L. plant, of which over 100 have been classified as "cannabinoids" (another word for chemicals unique to the plant). The two most well-known cannabinoids are delta-9-tetrahydrocannabinol (THC) and cannabidiol (CBD). THC is the main psychoactive cannabinoid that gives users the "high" feeling, while CBD is the main nonpsychoactive cannabinoid in cannabis and constitutes up to 40% of the plant’s extracts. CBD can derive from both marijuana and hemp.

From a pharmaceutical perspective, CBD is the most valuable nonpsychoactive compound derived from cannabis plants, because it has been found to possess a high level of antioxidants and anti-inflammatory activity, together with antibiotic, neuroprotective, anxiolytic, and anticonvulsant properties. Although the data is mixed, CBD may have potential clinical effects on anxiety disorders, movement disorders, cognition, and pain. CBD can be ingested in multiple ways, including by inhalation of smoke or vapor and as an aerosol spray into the cheek, or by mouth. It may also be supplied as tinctures (essentially CBD-infused alcohol), CBD oil containing only CBD as the active ingredient, capsules, or as a liquid solution.

As a result of the changes in federal law described below, hemp can be produced legally, which makes CBD more available for companies seeking to develop and sell products that include that compound.

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4 The scientific term is "phytocannabinoid," though it is commonly called "cannabinoid."


III. HOW IS CBD REGULATED?

A. Federal Law

1. The Controlled Substances Act

The Controlled Substances Act (CSA or the Act) establishes a comprehensive federal scheme to regulate controlled substances and makes it unlawful to “manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense any controlled substance.”8 The CSA also makes it a crime to possess any controlled substance except as authorized by the Act.9 Restrictions on the manufacture, distribution, and possession of a controlled substance depend on the “schedule” in which Congress has placed the drug.10

From its inception, the CSA classified both “marijuana” and THC as Schedule I controlled substances.11 Before Congress passed the Farm Bill, the CSA defined “marijuana” in relevant part as “all parts of the plant Cannabis sativa L., whether growing or not; the seeds thereof; the resin extracted from any part of such plant; and every compound, manufacture, salt, derivative, mixture, or preparation of such plant, its seeds or resin.”12 Under this definition, hemp was a controlled substance and, thus, could not be legally manufactured, possessed, or distributed.13

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8 See 21 U.S.C. § 801 et seq. § 841(a)(1).
9 See id.
10 See id. §§ 821–29.
11 Id. § 812(c) (Schedule I(c)(10)).
12 The definition of marijuana under the CSA excluded “the mature stalk of such plant, fiber produced from such stalks, oil or cake made from the seeds of such plant, any other compound, manufacture salt, derivative, mixture, or preparation of such mature stalks (except the resin extracted therefrom), fiber, oil, or cake, or the sterilized seed of such plant which is incapable of germination.” 21 U.S.C. § 802(16).
13 Despite the CSA, the Agriculture Improvement Act of 2014 (the 2014 Farm Bill) permitted qualifying individuals and entities, through state agricultural pilot programs, to grow, cultivate, and market industrial hemp for research purposes. The 2014 Farm Bill definition of “industrial hemp” is similar to the definition of “hemp” in the 2018 Farm Bill. Because the 2014 Farm Bill offered little detail about the limitations and restrictions of its applicability, however, the U.S. Department of Agriculture (USDA), U.S. Department of Justice (DOJ), U.S. Drug Enforcement Administration (DEA), U.S. Food and Drug Administration (FDA), and U.S. Department of Health and Human Services (HHS) filed a “Statement of Principles” on industrial hemp to clarify some ambiguities. 81 Fed. Reg. 53395. Among other things, the statement explained that the 2014 Farm Bill permits the sale of industrial hemp in states with an agricultural pilot program for the purpose of market research, but prohibits general commercial activity, as well as the interstate transportation of hemp plants and seeds. Id.
2. The Farm Bill

The Farm Bill expressly removed hemp from the CSA’s definition of “marijuana.” It also carved out an exception for the low levels of THC found in hemp. This means that hemp is no longer an illegal substance under federal criminal law. Further, the production, sale, and distribution of hemp is no longer subject to the enforcement or regulatory oversight of the DEA. Instead, the Farm Bill delegates those responsibilities to the USDA.

The following five key provisions of the Farm Bill address the production and sale of hemp:

(1) In order to be certain that plants are classified as “hemp” under the Farm Bill, businesses must ensure that the plants contain a THC concentration of not more than 0.3 percent on a dry weight basis.

(2) The primary regulatory authority over the production of hemp is left to each state. States can choose to establish their own “plan” to monitor and regulate the production of hemp or the federal plan will apply. At a minimum, state plans must include the following, although states can enact laws (i.e. “plans”) that are more stringent:
   (a) a practice to maintain relevant land information where hemp is produced;
   (b) a procedure for testing THC levels of hemp;
   (c) a procedure for disposing of noncompliant hemp plants;
   (d) enforcement procedures for violations;
   (e) a procedure for annual, random sample testing to ensure compliance;
   (f) a procedure for sharing information with the federal government; and
   (g) a certification that the state has the resources to carry out its plan.14

(3) the Secretary has sole authority to promulgate federal regulations and guidelines that relate to the production of hemp under a federal plan.

(4) the Farm Bill expressly provides that it does not prohibit interstate commerce of hemp. In fact, it forbids states from outlawing the transportation or shipment of hemp or hemp products through the state if produced in accordance with the Farm Bill.15

(5) the Farm Bill provides that it does not, among other things, affect the authority of the Commissioner of Food and Drugs to promulgate regulations and guidelines under the Food Drug & Cosmetic Act (the FD&C Act).16 In other words, Congress explicitly preserved the FDA current authority to regulate

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14 7 U.S.C. §§ 1639o-1639s.
15 The Farm Bill itself does not address the procedure for how states may verify whether transported hemp is produced in accordance with the Farm Bill.
16 7 U.S.C. § 1639r(c).
products, including those derived from hemp, containing cannabis or cannabis-derived compounds under the FD&C Act.

If a producer cultivates hemp plants exceeding the acceptable hemp THC level, meaning that the reported distribution range does not include a 0.3% or less measurement of delta-9 tetrahydrocannabinol on a dry weight basis, the hemp plant material must be disposed of and cannot be used to manufacture hemp products such as CBD oil.\[17\] Products, such as CBD oil, derived from hemp plant samples that do not include a 0.3% delta-9 tetrahydrocannabinol concentration within the measurement of uncertainty, are considered marijuana products and illegal under federal law.\[18\] They may not be legally manufactured or sold as hemp products pursuant to the Farm Bill. If the hemp plants from which the products are to be derived exceed the acceptable THC level, they must still be disposed of regardless of the cause. As a result, even if the hemp plant material measures at an unacceptable THC level due to factors outside the producer’s control, such as environmental conditions, the plant must still be disposed of and not be processed into hemp products.

The Farm Bill also establishes civil penalties for hemp producers that violate an approved state or federal plan, including producer ineligibility to participate in the program. For violations, the producer must correct the negligent conduct and periodically report to the state on its compliance for a period of at least two years. There are no criminal penalties for negligently violating the plan, even if the violation involves the production of hemp that contains greater than 0.3% THC on a dry weight basis. That said, repeat offenders may be suspended from participating in the program for up to five years, and intentional violations will be reported to the chief law enforcement officer of the state, as well as the U.S. Attorney General.

3. The USDA Regulations

After nearly a one-year delay, the USDA issued interim hemp production regulations (i.e. the federal “plan”) in October 2019. These regulations are essentially a “back stop” for those states that do not have an approved state hemp plan, or otherwise choose not to regulate hemp. Among other topics, the regulations cover the minimum state program requirements, the federal licensing process and application timeline, the transferability of hemp licenses, the interstate transportation of hemp, and THC testing and sampling.

In terms of compliance, the most notable provisions are the THC testing and sampling requirements. First, the regulations clarify the appropriate testing methods of hemp. This was a major issue before the USDA issued its regulations because the Farm Bill

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18 See id.
included vague language that left businesses confused as to the appropriate testing techniques when determining THC levels.

Second, the USDA required that THC testing be performed by a laboratory registered with the DEA to handle controlled substances under the CSA and DEA regulations. This requirement posed significant problems for program participants. There are very few DEA-registered labs. Even worse, some program participants had already developed relationships (and entered into agreements) with laboratories that did not meet this requirement. After receiving backlash from the industry, the USDA suspended this requirement. As a result, "testing can be conducted by labs that are not yet DEA registered until the final rule is published, or Oct. 31, 2021, whichever comes first."20

Third, the regulations introduced a "Measure of Uncertainty" calculation, which is applied to the THC testing results to determine the "Acceptable hemp THC level." The USDA suggests various resources that labs may use to establish an appropriate measurement of uncertainty. The Acceptable hemp THC level is now the standard for determining THC concentration under federal law. However, the measurement of uncertainty now affords producers a small amount of leeway in the range of THC percentage that is permitted in sampled plants for those that test slightly above the 0.3% limit.21 For example, if a plant tests at 0.35% THC (greater than the 0.3% allowed by statute), but the measurement of uncertainty is plus or minus .06% (meaning the THC level for the plant could range between 0.29%–0.41%), the USDA would treat the crop as compliant since 0.3% was included within the measurement of uncertainty.

B. State Law

Because the Farm Bill delegates primary regulatory authority to each individual state regarding the growth and cultivation of hemp, it is critical to understand applicable state law. As of this article, 17 states have USDA-approved state plans.22 If a client is operating in one of those states, then state law and regulations will control, subject to the FDA considerations discussed below. If a client is not operating in one of those states, then the USDA regulations will control. While the USDA regulations govern the actual production and cultivation of hemp plants, the FDA regulations govern hemp-
derived productions. The FDA’s regulatory authority kicks in once the hemp plant has been processed into a hemp-derived product such as CBD oil.

Typically, state hemp laws outline the broad concepts of a state hemp program, including the licensing agency responsible for administering the hemp program, the baseline application requirements to obtain a license, and the penalties for unauthorized conduct. The regulations, on the other hand, is where most of the hemp-specific requirements are found. As with the USDA regulations, the state regulations usually cover a wide range of topics, including sampling and testing procedures, reporting requirements, notice of sale requirements, and the transferability of licenses.

However, each state’s regulatory regime is unique, and compliance with one does not necessarily mean compliance with another. This is particularly true when it comes to hemp-derived finished products. That is, certain states have clearly defined what qualifies as a hemp-derived product, and others have not. And for those that have, hemp-derived products may be regulated by a completely different agency than the agency that regulates the plant itself. For example, Colorado’s Department of Agriculture handles hemp cultivation, while the state’s Department of Health and Environment handles hemp-CBD. Accordingly, firms should ensure they are familiar with all relevant regulations.

IV. THE FDA’S ROLE

The FD&C Act establishes a comprehensive federal scheme to regulate food, drugs, and cosmetics, among other things. The introduction of “new drugs” into interstate commerce without meeting certain regulatory approvals is prohibited. In addition, the FD&C Act proscribes the introduction of adulterated or misbranded drugs into interstate commerce.

Since the Farm Bill was passed, the FDA has generally taken the position that “[c]annabis and cannabis-derived products claiming in their marketing and promotion materials that they are intended for use in the diagnosis, cure, mitigation, treatment, or prevention of diseases (such as cancer, Alzheimer’s disease, psychiatric disorders, and diabetes) are considered new drugs or new animal drugs and must go through the

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23 21 U.S.C § 301 et seq.
24 See id. §§ 331(d), 355(a).
25 Id. § 331(a).
FDA drug approval process for human or animal use before they are marketed in the U.S.26

Similarly, the FDA has stated that “it’s unlawful under the FD&C Act to introduce food containing added CBD or THC into interstate commerce, or to market CBD or THC products as, or in, dietary supplements ... because both CBD and THC are active ingredients in FDA-approved drugs (Epidiolex) and were the subject of substantial clinical investigations before they were marketed as foods or dietary supplements.”27

That said, the FDA has recognized the “growing public interest in cannabis and cannabis-derived products, including [CBD],” as well as the “potential opportunities that cannabis or cannabis-derived products.” It has also promised to “continue to take steps to make the pathways for the marketing of these products more efficient.”28 It has not, however, promulgated any rules regarding CBD products, though it has provided some additional guidance, which is discussed below.

The FDA, however, has issued warning letters to companies that are allegedly operating unlawfully. Most recently, the FDA warned 15 companies for purportedly “illegally selling” various products containing CBD. These 15 warnings represent a significant uptick in the FDA’s enforcement actions against CBD-selling businesses. In comparison, the FDA issued a total of only 18 warning letters between 2015 and 2018. Recently, it seems the FDA has placed an emphasis on warning companies manufacturing and selling CBD products about their alleged health benefits or claims. For example, the FDA has recently issued warnings to companies misrepresenting that their CBD products can assist with the treatment or prevention of COVID-19.29 As a

27 Id.
28 Id.
29 See Warning Letter from Donald Ashley, Director, Office of Compliance, Center for Drug Evaluation Research, FDA, to Dennis Lynch, Project 1600 Inc. (June 18, 2020) (on file with author), available at https://www.fda.gov/inspections-compliance-enforcement-and-criminal-investigations/warning-
result of this more recent round of warnings, industry players have expressed concern about how the FDA will treat CBD products in the future as it continues to learn about the substance and ultimately issues rules in the space. The Federal Trade Commission (FTC) will also be involved in this regulatory environment as evidenced by the fact that it has joined the FDA in sending warning letters to companies advising it is illegal to make claims that their CBD products can prevent, treat, or cure human disease without competent and reliable scientific evidence to support those claims.³⁰

V. KEY ETHICAL ISSUES

A. Lack of Regulatory Guidance

Although the FDA has demonstrated some willingness to take action against entities it believes to be in violation of the FD&C Act, it has not yet taken any steps to regulate products containing or derived from cannabis and its components, including CBD derived from hemp. The combination of an active enforcement effort and the lack of an explicit regulatory framework poses potential problems for both attorneys and their clients.

In the absence of any formal rules, it is difficult to predict and advise upon how the FDA will interpret and react to certain issues involving CBD and other hemp-derived products. Due to this uncertainty, companies involved in the production, manufacture, and/or sale of CBD and other cannabis products have been eagerly waiting for the FDA to come forth with rules to regulate the industry. Unfortunately, it does not appear as though the FDA is going to provide certainty anytime soon. Without the benefit of a regulatory framework, entities operating in the CBD industry are forced to interpret past FDA enforcement actions and public statements as indicators of potential future actions.

This type of analysis often results in more questions than answers. Companies manufacturing, marketing, and selling CBD and other products from hemp are often unsure if their operations, which might be based on nuanced interpretations of the FDA’s past guidance, will be considered by the FDA to be in compliance with the FD&C Act. Additionally, it puts companies focused on operating within the bounds of the FD&C Act at a disadvantage to competitors who are more willing to push the limits of what the FDA has indicated is permissible. Consequently, there is a risk that

attorneys may not provide clients with advice that is within the limits of what the FDA has indicated it will allow. To combat these risks, attorneys should have a firm grasp of the FDA’s guidance.

Although the Congressional Report did not do much in the way of answering outstanding concerns or providing policy updates, it is still informative. In particular, attorneys advising clients in the hemp-derived CBD industry should be familiar with the FDA’s recent report to the House and Senate Committees on Appropriations regarding CBD products (the Congressional Report). Although the Congressional Report did not do much in the way of answering outstanding concerns or providing policy updates, it is still informative. With it, the FDA provided some clarity regarding its foremost concerns and suggested additional steps the FDA is taking or may soon take.

The FDA explained in the Congressional Report that it is still working on how to regulate hemp-derived CBD products, but that it wants more research before it engages in the rulemaking process. The FDA stated that it “is currently evaluating issuance of a risk-based enforcement policy that would provide greater transparency and clarity regarding factors FDA intends to take into account in prioritizing enforcement decisions.” The FDA has also said that “any enforcement policy would need to balance the goals of protecting the public and providing more clarity to industry and the public regarding FDA’s enforcement priorities while FDA takes potential steps to establish a clear regulatory pathway.” At the same time, the FDA reiterated that it would take action to address violations that put the public at risk.

The FDA identified nine key questions it seeks to address as it continues to research and develop regulations of which attorneys should take note to advise their clients:

1. What happens if you use CBD daily for sustained periods of time?
2. What level of intake triggers the known risks associated with CBD?
3. How do different methods of exposure affect intake (e.g., oral consumption, topical, smoking or vaping)?
4. What is the effect of CBD on the developing brain (such as children who take CBD)?
5. What are the effects of CBD on an unborn child or breastfed newborn?

32 Id. at 1.
33 Id. at 13.
34 Id.
35 Id.
6. How does CBD interact with herbs and botanicals?
7. Does CBD cause male reproductive toxicity in humans, as has been reported in studies of animals?
8. Are there differing safety concerns for use in certain animal species, breeds, or classes?
9. Are any residues formed in edible tissues of food-producing animals?  

The FDA also hinted at some potential concessions regarding dietary supplements. Although CBD from hemp is not currently allowed to be marketed as a dietary supplement, the FDA stated that it “has the authority to remove this exclusion through rulemaking.” In doing so, the FDA acknowledged the public’s increased level of interest for CBD products as dietary supplements and the potential pathway for these CBD products. However, the FDA did not provide much guidance beyond this. Instead, the FDA focused on outlining the concerns and challenges with potentially regulating hemp-derived CBD products as dietary supplements and explained that the FDA is working to possibly establish a process for collection of information for its review of these products. As a result, lawyers still do not know what enforcement policy the FDA will issue, and how this will affect companies manufacturing and selling hemp-derived CBD products in the future.

Due to the FDA’s evolving view of CBD products, lawyers working for the CBD industry should pay special attention to enforcement actions taken by the FDA and stay abreast of the FDA’s position to provide the best and most accurate analysis to their clients.

B. Differing State Laws

Practitioners face significant potential exposure if they fail to maintain a thorough understanding of the laws and regulations in which they practice and in where their clients operate. Due to the fluctuating nature of the regulatory environment at the national, state, and local level, ethical pitfalls are a constant concern for those who fail to stay ahead of the curve. The potential issues posed by the lack of a unified federal regulatory framework governing CBD products are further compounded by the variety of, and often contradictory, ways individual states regulate CBD and hemp-derived products. The manner in which each state regulates these products is diverse and often inconsistent. As the examples below demonstrate, a product that meets the federal definition of hemp-derived CBD may not be fully legal under a particular state’s laws.

Despite being delisted as a federally controlled substance under the Farm Bill, CBD derived from hemp is not currently legal in all 50 states. Most states do permit hemp-
derived CBD products to either be manufactured or produced in some form. A small number of states, such as Idaho, continue to all but prohibit CBD derived from hemp. In Idaho, for example, cannabis-derived products must contain zero THC, not the just less than 0.3% as provided for under the Farm Bill.\(^\text{39}\) As a result, any CBD products in Idaho containing any trace amounts of THC, no matter how small, are classified as a controlled substance and illegal.\(^\text{40}\)

Even in states where CBD products are “legal,” there is a wide variety of opinions on what exactly “legal” means. Some states, such as New Jersey and New Mexico, impose only minor restrictions on CBD products, and so, as a result, operators in those states are offered wide latitude on how they wish to market, sell, and manufacture CBD products. Lawyers advising those clients have the luxury of operating in a fairly clear regulatory environment.

However, many states are not as permissive and place at least some restrictions on hemp-derived CBD products. For example, in states such as Michigan, certain CBD products are legal, but CBD cannot be sold as a food or drink additive.\(^\text{41}\) States taking this approach may be indicating an intention to follow the FDA’s position, which may end up being more restrictive.

Due to the wide range of hemp-derived CBD laws from state to state, it is crucial for attorneys to be intimately familiar with the laws and regulations of the state in which they practice. Attorneys whose clients are seeking guidance regarding a jurisdiction in which the attorney does not regularly practice should strongly consider retaining appropriate local counsel in that state. Serious legal pitfalls and potential liability await attorneys that do not tailor their practice and advice regarding hemp-derived CBD products to the specific jurisdiction and locality in which their clients operate. It is critical for attorneys practicing in this industry to stay well informed of, and attuned to, any changes in the law, which remains in a constant state of flux. Some of these changes impose additional restrictions on CBD products, and other changes loosen requirements. Attorneys must be prepared to assist their clients in navigating a challenging path that ensures compliance with the laws of all applicable jurisdictions but also that the clients are not put at a competitive disadvantage because of a failure to identify a change in the law.

\(^{39}\) Idaho Code §37-2705(a), (d)(19) and (27).

\(^{40}\) Under Idaho Code §37-2701(t), the only legal parts of the cannabis plant, whether hemp or marijuana, are (a) mature stalks of the plant; (b) fiber produced from the stalks; (c) oil or cake made from the seeds or the achene of such plant; (d) any other compound, manufacture, salt, derivative, mixture, or preparation of the mature stalks; or (e) the sterilized seed of such plant which is incapable of germination. As a result, the CBD product must both contain zero THC and be derived from one of the five identified parts of the cannabis plant; otherwise it is illegal in Idaho under current law.

C. Implications under the Rules of Professional Conduct

Due to the lack of FDA regulations and the variance of individual state CBD product and marketing laws, lawyers face potential ethical concerns when advising clients engaged in manufacturing, distributing, and producing hemp-derived CBD products. In particular, depending on the jurisdiction in which the client wishes to engage in its business, an attorney could be held responsible for assisting a client in committing an illegal act.

Illegal acts are a particular concern in this industry and practitioners must be on the constant lookout for unworthy current or potential clients willing to commit them, so as to avoid aiding and abetting liability. Competition amongst manufacturers and sellers of CBD products is fierce. Competitors are constantly battling for market share and attempting to find an edge over one another. This can lead to less scrupulous companies cutting corners. Although many entities participating in the CBD marketplace strive to provide their customers with safe and compliant CBD products, there are those that essentially peddle “snake oil.” The companies and individuals that do this have no problem disregarding or violating manufacturing, packaging, processing, or sale requirements under the law. There are numerous examples of entities lying about the amount of CBD in their products, ingredients in the products other than CBD, and the benefits or potential effects of their products. Attorneys must be prepared to guard against unworthy clients willing to take these actions.

Rule 1.2(d) of the ABA Model Rules of Professional Conduct states that

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.42

The commentary advises that the rule “prohibits a lawyer from knowingly counseling or assisting a client to commit a crime or fraud.”43 It further states that a lawyer is not prohibited from giving an honest opinion of the likely consequences resulting from a client’s conduct.44 In addition, “the fact that a client uses advice in a course of action that is criminal or fraudulent” does not by itself make a lawyer a party to the course of action.45 As a result, there is a critical distinction between advising on and providing a

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42 Model Rule of Prof’l Conduct 1.2(d).
43 Model Rule of Prof’l Conduct 1.2, cmt. [9].
44 ld.
45 ld.
legal analysis of potentially questionable conduct as opposed to guiding a client on how to commit an illegal act with impunity.\textsuperscript{46}

With most states and the FDA speaking on the regulation of hemp-derived CBD products, at least to some extent, Model Rule 1.2(d) is particularly instructive for attorneys practicing in jurisdictions where the production, sale, or distribution of CBD products is currently illegal, in whole or part. Pursuant to Model Rule 1.2(d), a lawyer is ethically permitted to advise a client on the consequences of an action that the attorney knows to be illegal in that jurisdiction. However, according to Model Rule 1.2(d), it would be unethical for an attorney to specifically advise a client on how to intentionally circumvent a law or regulation forbidding certain conduct related to the manufacture, sale, or marketing of hemp-derived CBD products.

Fortunately, the rule provides a safe harbor for attorneys advising clients on areas of the law that are open for interpretation, which is the case with regard to the law governing hemp-derived CBD products in many jurisdictions. Under the rule, it would be acceptable for an attorney to advise a client on how to best comply with a law or regulation if the attorney, after a good faith determination, does not believe that the law or regulation poses a complete bar to the activity in which the client wishes to engage. Model Rule 1.2(d) and its commentary further contemplate that an attorney can advise a client on what the attorney believes the scope of a law or regulation to be and what conduct would be acceptable under the scope of the law.

However, an attorney cannot consciously avoid facts evidencing a client’s illegal activities. If an attorney should reasonably be able to infer that a client seeks his or her services to advance a criminal activity, the attorney has a “duty to inquire” further into the client’s actions pursuant to Model Rule 1.2(d) to avoid advising or assisting the client in an illegal activity.\textsuperscript{47} This duty under Model Rule 1.2(d) has particular importance in relation to attorneys advising clients involved in hemp and CBD production. Clients could easily obtain advice for illegal marijuana production under the guise of seeking guidance for lawful hemp cultivation. An attorney must be aware of the potential for this abuse and be prepared to inquire further if it becomes apparent. For example, should it become apparent that a client is seeking a lawyers services to obtain a state hemp cultivation license so that the client could have a cover for an illegal marijuana grow operation, the attorney would have an obligation to make further inquiry as to the circumstances and true motivations for obtaining a hemp cultivation license in order to avoid assisting the client with committing a crime.

Importantly, though, Model Rule 1.2(d) would not offer protection to an attorney that, after making a good faith determination, gives advice they believe to be clearly impermissible under the applicable law of the jurisdiction. For example, it would not be

\textsuperscript{46} Id.

\textsuperscript{47} See ABA Opinion 491 (2020).
ethically permissible for a lawyer to advise a client on how to sell hemp-derived CBD-infused food in a jurisdiction that specifically bars the production or sale of such products. At the same time, it would be permissible for that attorney to counsel their client on whether a certain type of product falls within the definition of “food” and whether that product is actually subject to the jurisdiction’s prohibition on CBD food products.

As a result, attorneys should pay close attention to the rules of professional conduct in their applicable jurisdiction. Although many local rules of professional conduct are modeled after the ABA Model Rules, there may be important nuances that affect the type of guidance an attorney is ethically permitted to give to clients manufacturing, producing, or selling hemp-derived CBD products.

**LOSS PREVENTION SUGGESTIONS**

**Understand the Client’s Business and Manage Client Expectations.** It is crucial for attorneys to be intimately familiar with the client’s business and the specific activity the client wishes to engage in. A failure to fully understand the client’s objectives, and how they wish to achieve them, can lead to analysis or advice that does not take into consideration all the nuances of applicable law. That in turn can result in state-equivalent Model Rule 1.2(d) violations. Finally, attorneys should explicitly inform clients of both the type of conduct related to CBD products in which the client may legally engage in as well as any ethical limitations on the advice the lawyer can provide.

**Know Your Jurisdiction.** As discussed above, permissible conduct related to the marketing, manufacture, and sale of hemp-derived CBD products varies widely from state to state. Furthermore, due to the absence of a comprehensive federal regulatory framework, there are many issues related to CBD products that are open to interpretation. Attorneys working with, and advising clients on, matters related to the production, marketing, and sale of hemp-derived CBD products must be intimately familiar with the applicable laws and regulations of their relevant jurisdictions, the relevant state rules of professional conduct, and prior guidance provided by the FDA. Also, they must not advise on, or assist their clients to engage in, conduct that they know to be either illegal at the federal or state level. Attorneys advising clients in this area might be required to provide the same client a different analysis depending on jurisdictions in which that client operates. Moreover, that advice may vary depending on the particular activity of the client in each jurisdiction in which it operates. In the alternative, the attorney should limit the scope of representation under Model Rule 1.2(c) to only the jurisdiction where the lawyer is licensed and competent. Indeed, an attorney who advises a client in
VI. CONCLUSION

The legal framework governing the hemp and hemp-derived products industry is in a perpetual state of flux as the federal government implements the Farm Bill and states enact their own legislative and regulatory schemes. Although this is a fertile area for legal services, lawyers cannot dabble in this legal environment without putting themselves at substantial peril of committing malpractice and/or ethics violations. An intimate knowledge of the law and its limits, together with a specifically tailored fee agreement, are the best practices to protect oneself from unfounded claims.

Clear Communication with Clients. An attorney advising clients involved in the production, manufacture, or sale of hemp-derived CBD products should clearly communicate key aspects of the relationship with clients—and do so in writing. First, a lawyer should strongly consider a carefully tailored engagement letter that highlights and details the potential issues with operating in the industry and that specifically lays out the services to be provided by the attorney to the client. This specialized engagement letter should specifically outline the conduct the client wishes to engage in and any potential ethical barriers that might prevent the attorney from assisting them. Although it is important for attorneys to zealously advocate for and represent their clients, attorneys must be aware of the legal and ethical limits of their practice and be prepared to inform their clients of such limits. In the end, the specifically tailored fee agreement will be the first line of defense to claims of malpractice or violations of the applicable rules of professional conduct. Second, key advice to the client should be confirmed in writing, and this confirmation should emphasize that the advice is current as of that particular day (noting that with laws applicable to the industry regularly changing, this advice could subsequently change). Third, attorneys must be willing to inform clients of the limits of their representation and inform the client if that boundary is ever reached (at that point, the lawyer may have to withdraw, depending upon the reaction of the client). If the lawyer must withdraw, an appropriate disengagement letter must be issued.
The Fault Lies Not in the StaRs, but in Ourselves: The Updated SRA Conduct Rules

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I. BACKGROUND

On November 25, 2019, the Solicitors Regulation Authority (SRA) Standards and Regulations1 (StaRs) became effective. The StaRs revised the professional rules for all solicitors admitted in Wales and England and constitute a significant change in the regulatory regime for most law firms. For example, there are now two Codes of Conduct: (1) the SRA Code of Conduct for Solicitors, Registered European Lawyers (RELs) and the Registered Foreign Lawyers (RFLs) (Code for Solicitors); and (2) the SRA Code of Conduct for Firms (Code for Firms). This article identifies some of the key changes and ethical traps created by the StaRs.

II. SRA PRINCIPLES

The StaRs begin with the SRA Principles. They require, among other things, upholding the rule of law; maintaining public trust; being independent and honest; having integrity; encouraging equality, diversity, and inclusion; and acting in the best interests of clients.

It is important to understand that these principles also extend to conduct outside of the workplace. For example, a lawyer was recently sanctioned after an unemployment tribunal deemed that he engaged in discrimination when he discharged his pregnant nanny.2 In addition, there have been a number of disciplinary cases against prominent lawyers at major law firms based on allegations of sexual harassment and misconduct.3 We expect to see the SRA continue exercising its disciplinary authority in this manner.

III. THE CODES OF CONDUCT

Although there are now two new codes of conduct, combined they are still shorter than their predecessor, the SRA Code of Conduct 2011 (the 2011 Code). They do, however, come with hundreds of pages of guidance, which is subject to change.4 Furthermore, changes to the guidance are not always publicized, and the SRA does not track the changes. This is particularly problematic because the SRA may contend in disciplinary investigations that the guidance, unlike the rules, operates

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3 See, for example, the case of Freshfields Bruckhaus Deringer partner Ryan Beckwith, fined £35,000 and ordered to pay £200,000 in costs by the Solicitors Disciplinary Tribunal (SDT) (appeal pending), https://www.solicitorstrIBunal.org.uk/sites/default/files-sdt/11887.2018.Beckwith_0.pdf.
retrospectively. It is necessary, therefore, for lawyers to keep abreast of changes to the Codes of Conduct, while being particularly sensitive to revisions to the guidance. Firms should regularly review their policies and internal procedures to ensure that they comply with the new Codes of Conduct and the guidance. Further, where the Codes do not provide the necessary detail, firms may have to revise their policies and procedures to fill the gaps.

In addition, the Introduction to the Accounts Rules states, “Firms will need to have systems and controls in place to ensure compliance with these rules and the nature of those systems must be appropriate to the nature and volumes of client transactions dealt with and the amount of client money held or received.” It follows that if systems and controls are not written down, it may be hard to control fee-earners. In the past, the accounts manager simply could hit fee-earners over the head with the rule book. Now, firms need to have a compliance manual—in order to fill gaps left by the new Codes of Conduct—and clearly communicate that the manual must be followed.

IV. ANTI-MONEY LAUNDERING (AML)

SRA Chief Executive Paul Philip opened the SRA’s October 30, 2019 Compliance Officers Conference with a telling statement regarding anti-money laundering (AML), “There will be many, many more prosecutions in relation to AML.” Since then, one solicitor was fined £45,000 and ordered to pay an additional £40,000 in costs for failing to carry out adequate client due diligence, following the data leak from former Panamanian law firm Mossack Fonseca. The SRA also recently published its Draft Business Plan and Budget, November 2020 to October 2021, which proposes a 20 percent increase in expenditure on AML supervision with visits to all high-risk firms on a three-year rolling basis, along with visiting a sample of lower risk firms.5 Every month the SRA will call in and analyze a sample of firms’ AML policies, procedures, and controls, or their risk assessments. In addition, the SRA is planning to undertake a thematic review into tax advice. Clearly, in this environment, firms need to understand the regulatory requirements related to anti-money laundering and be mindful of certain key compliance points in order to avoid becoming the subject of such a prosecution.

Although not expressly part of the rule changes, the SRA has created a team focused specifically on AML compliance. That team audits firms for compliance and has repeatedly exercised its statutory power to review client files. This power overrides the duties of confidentiality and the legal professional/attorney-client privilege. The SRA Risk Outlook 2019/2020 reported that 172 firms were under review because of AML compliance issues.\(^6\)

Several key AML compliance issues have emerged for firms: (1) gaps in relation to matter risk assessments and risk ratings; (2) controls on work done between inception and completion of customer due diligence (CDD); (3) refreshing CDD at appropriate intervals when new matters are taken on for existing clients; and (4) procedures for high-risk matters, particularly those involving politically exposed persons (PEPs). Firms also need to take steps to ensure that CDD and other AML record retention complies with applicable privacy law, such as the General Data Protection Regulation (GDPR). Compliance on this front is attracting increased regulatory attention. U.S. firms should carefully evaluate the process by which a U.K. office accepts clients from, and undertakes work for, other offices.

V. REPORTING (AND SELF-REPORTING) OBLIGATIONS UNDER THE CODES

The Codes impose reporting obligations on individuals and firms and separate obligations on Compliance Officers for Legal Practice (COLP) and Compliance Officers for Finance and Administration (COFA). As detailed below, however, there are some notable differences in the reporting obligations.

A. Reporting by Individuals and Firms

There are two provisions in the Codes of Conduct that address lawyer and law firm reporting requirements. The first of these requirements can be found at Paragraphs 7.7 of the Code for Solicitors and 3.9 of the Code for Firms. Those paragraphs require prompt reporting “to the SRA or another approved regulator, as appropriate, any facts or matters that you reasonably believe are capable of amounting to a serious breach of their regulatory arrangements by any person regulated by them (including you).”

A number of points arise from this. First, the prior reporting requirements mandated reporting of “serious misconduct.” The Codes, however, broaden the definition of reportable conduct to “serious breaches.” The SRA’s Enforcement Strategy gives examples of DUI, sexual misconduct, and dishonesty.\(^7\) The inclusion of dishonesty is

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not surprising. The test, however, has been applied harshly: In one case, a solicitor who bluff ed to his opposing lawyers that he had instructed a barrister to represent his client at a mediation, when he had not, was "struck off the roll."  

Additionally, the words "capable of amounting to" mean that the facts need not be proven before reporting is required. However, the SRA has clarified that reports should contain more than bare allegations.

The second reporting requirement is located in Paragraph 7.8 of the Code for Solicitors and 3.10 of the Code for Firms. Those paragraphs require that lawyers and firms "report promptly to us any facts or matters that you reasonably believe should be brought to our attention in order that we may (i) investigate whether a serious breach of our regulatory arrangements has occurred or (ii) exercise our relevant regulatory powers."

It is understandable that lawyers would be concerned about setting an SRA investigation in motion—the SRA has wide-ranging powers, investigations commonly run for months or years, and the consequences for noncompliance can be severe. Failing to self-report can also lead to serious repercussions. One global U.S.-based firm has recently been before the SDT facing allegations that it failed to self-report a case alleging sexual misconduct by a firm lawyer in 2012. On June 12, 2020, the SDT dismissed the case against the firm, but fined the former London managing partner £55,000 and ordered him to pay £40,000 in costs. The SDT found that he had attempted to embrace and kiss a junior fee earner against her wishes in a hotel room and had sought to improperly influence the subsequent investigation.  

Both reporting provisions combine subjective and objective elements with the "reasonably believe" standard. The subjective component is triggered when a lawyer believes that there are facts capable of amounting to a serious breach. The objective aspect turns on whether that belief is reasonable, in light of the information available to the lawyer.

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B. Reporting by COLPs and COFAs

There are specific reporting obligations for firm compliance officers under the Code for Firms:

9.1 If you are a COLP you must take all reasonable steps to:

... (d) ensure that a prompt report is made to the SRA of any serious breach of the terms and conditions of your firm’s authorisation, or the SRA’s regulatory arrangements which apply to your firm, managers or employees; save in relation to matters which are the responsibility of the COFA.

9.2 If you are a COFA you must take all reasonable steps to: ... (b) ensure that a prompt report is made to the SRA of any serious breach of the SRA Accounts Rules which apply to them.

Unlike the 2011 Code, there is no mention of any obligation to maintain an internal record of minor breaches. However, COLPs and COFAs should still do so in order to satisfy their respective obligations to monitor the firm’s compliance.

C. SRA Guidance

The SRA has issued guidance on this subject, titled Reporting and notification obligations. There is also guidance on Reporting duties under the SRA Overseas Rules, which highlights the breadth of the SRA’s authority. The guidance refers to the SRA Enforcement Strategy\(^\text{10}\) which identifies several factors for assessing the seriousness of reportable offenses:

- The nature of the allegation;
- Intent/motivation;
- Harm and impact;
- Vulnerability;
- Role, experience, and seniority;
- Regulatory history and patterns of behavior;
- Remediation;
- Overlap with other regulators;
- Private life;
- Criminal convictions;
- Inter-relationship between factors.

Legal Risk LLP has had many more firms seeking advice on reporting obligations under the current Codes than under the 2011 Code. What constitutes a serious breach is a

matter for professional judgment. A key consideration for making a report is the need to address the SRA’s guidance and keep a record of the decision-making process. Paragraph 2.2 of the Code for Solicitors requires that, “You keep and maintain records to demonstrate [our emphasis] compliance with your obligations under the SRA’s regulatory arrangements.”

### VI. CONFLICTS OF INTEREST AND CONFIDENTIALITY

The new Codes have resulted in two significant changes to U.K. rules regarding conflicts of interest. The first change relates to the conflict checking process, and the second pertains to own interest conflicts (generally called “prior work conflicts” in the United States) when the firm may have made a mistake.

The provisions are in paragraph 6 of both the Code for Solicitors and the Code for Firms.

#### A. Conflict Checking

Paragraph 6.3 of each Code requires that lawyers and firms “keep the affairs of current and former clients confidential unless disclosure is required or permitted by law or the client consents.” This language gives rise to two important considerations.

There is also no exception comparable to the provisions of ABA Model Rule 1.6 (b) (7) for conflict checking of laterals and no separate provisions or guidance relating to laterals.

First, there is no exception for checking conflicts in relation to lateral hires. In fact, the guidance says, “The Courts have stated that the duty to preserve confidentiality is unqualified, in that it is a duty to keep the information confidential, not merely to take all reasonable steps to do so.” There is also no exception comparable to the provisions of ABA Model Rule 1.6 (b) (7) for conflict checking of laterals and no separate provisions or guidance relating to laterals.

Second, there are only a few exceptions where disclosure is permitted by law, for example in relation to reporting suspicions of money laundering. This is consistent with the SRA’s increasingly strict approach to maintaining the confidentiality of client information.

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11 See Paragraph 2.2 of the Code for Solicitors.
12 See Paragraph 6.3 of the Code for Solicitors.
On November 25, 2019, the SRA updated its 2014 guidance regarding confidentiality of client information. The guidance requires that a firm must seek client consent before having its overseas office conduct a conflicts check.\(^{13}\) Needless to say, this guidance continues to cause consternation, particularly for larger multinational firms, which may use a non-U.K. office for conflicts checks.

It is possible to do some preliminary screening based on publicly available information, such as legal directories, the press, and matters that the firm has a knowledge of from being on the other side. In light of the SRA’s clear and strict position, firms should exercise caution when attempting to check conflicts on lateral hires.

B. Own Interest Conflicts Following a Mistake

Paragraph 6.1 of both Codes instructs lawyers not to act if there is an own interest conflict, the U.S. equivalent of a material limitations conflict. Waivers are not permitted as a means of clearing these conflicts.

However, paragraph 7.9 creates an apparent tension with this because it requires that lawyers be "honest and open with clients if things go wrong, and if a client suffers loss or harm as a result [that the lawyer] put matters right (if possible) and explain fully and promptly what has happened and the likely impact...." (emphasis added). This gives rise to difficult questions as to whether one can comply with either provision without being in breach of the other.

For example, in Howell Jones LLP in the SDT, the firm made a mistake handling a divorce client's financial settlement.\(^{14}\) The firm advised the client of the mistake, informed him that he could seek separate advice, and received consent from the client to proceed with the representation.\(^{15}\) The firm also consulted a barrister, who advised that it might be possible for the firm to remedy the mistake. The firm proceeded with the representation and tried to remedy the problem but was unsuccessful. The SDT prosecuted Howell Jones, fined the firm £5,000, and ordered it to pay £26,850 in costs.\(^{16}\) The SDT imposed the fine despite the fact that Howell Jones (a) exercised professional judgment (which may be a defense to a rule breach) and (b) secured independent legal advice from the barrister, whose own code of conduct provided that separate duties were owed to the solicitor and lay client.

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\(^{14}\) See SRA v. Howell Jones, Case No. 11846-2018 (Nov. 14, 2018). Legal Risk LLP provides a link to this and other Conflicts resources on its website, www.legalrisk.co.uk/conflicts. The relevant events occurred before STaRs came into force and were addressed under the previous rules.

\(^{15}\) Id.

\(^{16}\) The firm and SDT agreed to this amount, most likely because the firm had limited financial resources to contest the case and the SDT was satisfied that the firm properly admitted to breaching the rules.
The decision is hard to understand because it ignores the fact that the firm advised the client to obtain independent legal advice. The SRA’s guidance, “putting matters right when things go wrong, and own interest conflicts,” is also not helpful on this issue. The guidance suggests that there may be limited circumstances where the firm can continue acting when there is an own interest conflict, but they are fact-specific. Even the examples in the guidance appear, at least to this writer, that they could create potential issues for lawyers. One example is the suggestion that a real estate title defect may be cured by purchasing title indemnity insurance, which may then eliminate the need for the client to receive separate legal advice. There may be, however, significant points on which the client should receive such advice, including the adequacy of the policy limit that takes into account future property inflation and the financial strength of the selected insurer. In light of this, the only truly safe solution is to advise the client to seek separate counsel and to refuse to continue to represent them.

VII. SRA ACCOUNTS RULES

The rules dealing with trust accounts have been significantly shortened. There are now only 13 rules, but these rules are accompanied by 55 pages of guidance. As with the other rules, there are many gaps in the requirements, and firms must now create their own internal procedures to fill those gaps.

The previous rules were very prescriptive, for example requiring that client money be deposited by the next working day. The new rule now simply indicates that the money should be promptly deposited. It is likely that additional guidance will be issued as time goes on, and based on past experience, it is likely to be lengthy.

Firms should pay particular attention to Rule 3.3, which provides:

You must not use a client account to provide banking facilities to clients or third parties. Payments into, and transfers or withdrawals from a client account must be in respect of the delivery by you of regulated services.

“Regulated services” are defined as “… the legal and other professional services that you provide that are regulated by the SRA ….” Breaches of this provision are heavily penalized because they expose the firm to the risk of money laundering.

VIII. NEW FORMS OF PRACTICE

The U.K. does not have an “unauthorized practice of law” restriction, although there are certain “reserved legal activities,” such as advocacy, conduct of litigation, and certain aspects of real estate. Lawyers must obtain permission from the SRA or another approved regulator to practice in these areas. In addition, until the November
2019 reforms, it was generally not permissible for an employed solicitor to provide advice to clients of a non-SRA-authorized law firm.

As a result of the recent changes, it will now be possible for a U.S. law firm to open in London without seeking SRA authorization, and to employ an associate solicitor to offer certain legal services to clients, provided they do not engage in the reserved legal activities. The rules require status disclosures and the usual compulsory insurance, and SRA Compensation Fund provisions do not apply. Although this reform is unlikely to appeal to the larger U.S. law firms, it may entice some smaller firms to open a London office.

LOSS PREVENTION SUGGESTIONS

Law firm leaders and members of the profession must be aware of the heightened regulatory focus provided under the new conduct rules, particularly on the subjects of AML compliance and reporting obligations. To help avoid breaching the rules and the severe sanctions that can flow from such breaches, firms should:

- Conduct the compulsory anti-money laundering firm-wide risk assessments and individual matter risk assessments.
- Ensure the required written anti-money laundering policies, controls, and procedures are up to date and comply with the statutory requirements.\(^{17}\)
- Train firm staff regarding the required reporting obligations.
- Keep adequate records to demonstrate compliance (for example, the decision-making process in relation to conflicts).

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Managing the Signature Line: Avoiding Document Execution Claims

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I. BACKGROUND

It’s a crowded, hot Philadelphia assembly room. Everyone is anxiously waiting for the man at the front of the room to sign the document. With a flourish and an emphatic hand gesture, John Hancock looks up from his keyboard. He announces to all the other delegates that he’s completed his e-signature to the Declaration of Independence in 40-point type so that the king will be able to read it from the transmitted .pdf image without his spectacles.

Told that way, the story doesn’t have quite the same panache as the traditional tale. Yet, in modern times, the document likely would have been executed in this manner, as the use of idiosyncratic manual signatures is rapidly eroding. The cashier does not seem to care that your scrawl on the credit card processing box bears little or no resemblance to your “wet” signature on paper. Some Americans don’t even have a traditional signature: they’ve never mastered the art of script writing. Indeed, the law in many states continues to accommodate signature “by mark,” which is typically an X placed below the final verbiage in the document.

Regardless of how it is done, the ability to bind a person or an entity to a written commitment remains central to law practice. Not surprisingly, it has also been an area for malpractice claims. Although e-signatures draw most of the attention these days, ALAS claims history suggests that there are other, equally important liability issues. This article summarizes five issues that lawyers should consider when a client’s signature is required on a document:

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3 Rule 11 and representations of truthfulness or diligence made by act of signing a document are not the subject of this article. Neither is forgery, though these areas are undoubtedly causes of claims involving signatures.
A. Follow Up

There have been a number of malpractice claims that have centered on the failure to get a document signed in a timely manner, rather than on technical issues regarding signature validity. Typical scenario: clients ask their lawyers to draft a trust agreement, deed, or commercial contract. The lawyers draft the document and send it to the client for signature, but the clients never get around to signing it. The lawyers fail to follow up and to advise the clients of the risk of failing to execute the document in a timely manner. The other parties eventually withdraw their offer, or the clients die or become incompetent. The result? The clients—or the clients’ heirs—blame the lawyers for the delay and for failing to follow up, and they sue the law firm.

We’re not saying that all of these claims are valid. Clients have the right to sign or to delay signing. Nevertheless, claims do arise. To help prevent and defend them, it is advisable to have documentation advising the client of the risks associated with delaying or failing to sign documents that require timely execution. In addition, it is prudent for lawyers to follow up with clients when they have not received the executed documents. Doing so may go a long way to convince a judge or a jury that failure to execute a document was not the lawyer’s fault, but rather a client’s choice.

B. Oversee the Execution of Key Documents

Wills, deeds, powers of attorney, statutory forms, and other legal documents can be tricky to execute properly. Does the will have to be signed in the presence of the witnesses? Or is it enough that the testator affirms his already-affixed signature in front of the witnesses? Same for notaries. It is critical to address these issues contemporaneously because execution errors may not be raised until years after the event, when corrective measures are impossible.

All these issues—and many others—can be better monitored and addressed if a lawyer is present when important documents are executed. Lawyers can arrange for document execution to take place in the firm’s offices or by traveling to the client and personally overseeing the execution process. The problem is, though, that the current trend is actually in the opposite direction: towards remote execution.

Lawyers need to sometimes resist “advances” of this type and insist on directly overseeing the execution of key documents. For example, lack of oversight may permit a spouse or child to “help” an infirm or incompetent client sign an agreement, or just to do it “for” them. Instances like these are repeated scenes in ALAS claims experience—sometimes even to the point where the person “helping”
has impersonated the client on a telephone call. In contrast, if a lawyer is present during the execution process and personally explains the document to the client, the lawyer can ensure that the client has the capacity to sign the document and understands it.

The good news is that technology may now ease the practical difficulties sometimes experienced by both lawyers and clients in assembling at a physical location for document execution. Some ALAS firm lawyers have successfully used videoconferencing to establish a supervisory "presence."4 If done right, the lawyer may be able to observe execution by the purported signatory with all the required formalities. The accompanying video interaction with the signatory may also provide some assurance as to competence and volition. Just as in the case of in-person executions, there may be an ability to record the execution to provide future evidence of its propriety.5 Lawyers who record an execution should, of course, also ensure they have obtained consent of all participants to the extent required by applicable law and coordinate with the firm’s records department on the best means to preserve any recording.

C. Use E-Signatures Appropriately

From instances of lawyers not supervising wet signature of documents, we move to obviating the need for a wet signature altogether. The advent of the Electronic Signatures in Global and National Commerce Act (ESIGN Act)6 and the Uniform Electronic Transactions Act (UETA)7 has fundamentally changed contract execution practices in some commercial fields. The ESIGN Act broadly validates the use of electronic records as a matter of federal law. Under the Act—and assuming some

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4 We are addressing remote supervision by a nonsignatory lawyer. We are not addressing whether execution witnesses may fulfill their function by videoconference, though some remote notary services will allow witnesses to join and observe a document’s signing. As a result of the COVID-19 crisis, ALAS firm lawyers have sometimes let witnesses who were physically present at the location of a document signing observe the document’s execution through windows, from doorways, and at greater distances than was previously customary. Check state law before adopting any of these methods.

5 Whether a firm wants to create such evidence may vary by situation and by state. Some believe that if recording is done only for some executions, a plaintiff might try to use this as evidence of concerns (typically claimed incompetency or undue influence) that the lawyer should have taken more steps to investigate or address.


7 The UETA is in effect in all American jurisdictions, except Illinois, New York, and Washington. These states, however, have roughly equivalent laws. See Electronic Commerce Security Act, 5 ILCS 175/1; Electronic Signatures & Records Act, N.Y. Tech. L. 301-309; Electronic Authentication Act, Wash. Rev. Code 19.34. For a current compilation of cases interpreting the UETA, see Construction and Application of Uniform Electronic Transactions Act, 4 A.L.R. 7th 2.
tie to interstate or foreign commerce—"a signature, contract, or other record ... may not be denied legal effect, validity, or enforceability solely because it is in electronic form." The UETA likewise gives legal recognition to electronic signatures, records, and contracts.\

Although certain deals and documents may merit enhanced signature assurance, an ordinary electronic signature may be acceptable much of the time. However, lawyers should keep in mind the following considerations:

**Consent.** Parties do not have to agree to the use of e-signatures. You can “opt out” of most electronic signature requests. With the exception of certain governmental agency transactions, the ESIGN Act does not “require any person to agree to use or accept electronic records or electronic signatures.” Likewise, the UETA applies only “to transactions between parties each of which has agreed to conduct transactions by electronic means.”

The commentary to the UETA makes clear that there doesn’t have to be an explicit agreement to use electronic means. “[S]uch a requirement would itself be an unreasonable barrier to electronic commerce, at odds with the fundamental purpose of this Act.” Instead, “[w]hether the parties agree to conduct a transaction by electronic means is determined from the context and surrounding circumstances, including the parties’ conduct.”

“Context” is a pretty vague standard. In *Clean Properties, Inc. v. Riselli*, for example, a property owner sought to hire a company to remediate an oil spill. The

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9 UETA § 7.
10 15 U.S.C. § 7001(b)(2). The ESIGN Act also has specific protective provisions on when and how consumers give consent to electronic records. See id. § 7001(c).
11 UETA § 5.
12 UETA § 5, cmt. 3.
13 UETA § 5(b).
14 To review instances where contracts were created by simple exchange of email without signing of a separate agreement, see 4 A.L.R.7th 2, § 5. Under the ESIGN Act, the analysis centers on whether “an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record.” 15 U.S.C. § 7006(5) (emphasis added). If there’s no intent to “seal the deal,” the electronic record ostensibly isn’t a signature. Cf. Buckles Mgmt., LLC v. InvestorDigs, LLC, 728 F. Supp. 2d 1145 (D. Colo. 2010); Pepco Energy Servs. v. Geiringer, 2010 U.S. Dist. LEXIS 4651 (E.D.N.Y. Jan. 21, 2010) (noting intent is crucial).
15 2014 Mass Super. LEXIS 106, WL 4082266 (June 18, 2014). Other cases reach the opposite result—even with an explicit “okay with me” response—where the predicate agreement to conduct the transaction by electronic means was not established. See 4 A.L.R.7th 2, § 6. The ESIGN Act can similarly legitimize exchanged emails as a “writing” sufficient to meet statutory requirements. See *In re Cafeteria Operators, L.P.*, 299 B.R. 411 (Bankr. N.D. Tex. 2003). There are multiple cases finding that a typed
company emailed terms and asked the owner to send a reply agreeing to the terms. The owner did so, concluding the responsive email with a “Thank You” signature block. The court held that was sufficient to create an enforceable contract.

As the *Riselli* case illustrates, a collection of typed emails with no traditional signature by any of the parties may nonetheless collectively form a “signed” written agreement. This raises the risk of inadvertent, premature consent, so lawyers and clients should beware of the contractual impact of their “agreeing” email responses. If parties do not want to form an agreement until it is signed in the traditional sense, they—and their lawyers—should explicitly memorialize this intention. Failure to do so may result in a court finding a “meeting of the minds” when one party or the other still anticipate negotiating additional terms.

**Actual Review and Adoption.** E-signing can provide convenience but be wary of using it when the client hasn’t actually had an opportunity to review the document. Consider this situation. You’re in a rush and need to get a declaration from your client. You explain to your client what the declaration says, but never actually send her the text. The client says she’s fine with it. Is it okay to e-sign the declaration on her behalf and submit it as part of a filing? Better not, at least according to the court in *Valiavicharska v. Celaya*. Citing a local order, the court held that a

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16 Illustrating the old maxim that “there’s nothing new under the sun,” email agreements without a traditional signature are comparable to contracts made through the exchange of telegraph messages. These were upheld, at least sometimes, as early as 1869. See *Howley v. Whipple*, 48 N.H. 487 (1869). The main obstacle in that case was compliance with the statute of frauds, but the ESIGN and UETA, if applicable, were meant to obviate that issue at least as to the existence of a signed writing. For a further discussion of e-signatures, the statute of frauds, and a property purchase agreement made by texting, see Darius Brown, *Case Comment: Contract Law/Property Law—Just Text the Contract Over—St. John’s Holdings, LLC v. Two Elecs., LLC*, No. 16 Misc. 000090RBF, 2016 WL 6191911 (Mass. Land Ct. Oct. 24, 2016), 24 Suffolk J. Trial & App. Adv. 278 (2018/2019).

17 *Valiavicharska v. Celaya*, 2012 U.S. Dist. LEXIS 42213 (N.D. Cal.) (holding also that a “declarant cannot affirm under penalty of perjury that the contents of a document are true when she has not reviewed the
"telephone conversation regarding the 'substance' or 'contents' of a proposed declaration does not provide a declarant with enough information to authorize a binding signature on her behalf."18

**E-Signature Exceptions.** There are limits to the ESIGN Act. The Act does not apply to some situations involving:

- Purchases by states or state agencies;19
- Wills, codicils, or testamentary trusts;20
- Adoptions, divorce, or other matters of family law;21
- Transactions regulated by the U.C.C., save that Articles 2 and 2A on sales and leases of goods are covered;22
- Court orders and filings;23
- Notices for cancellation of utility service and health or life insurance, possessory rights associated with a primary residence, or product recalls raising health or safety concerns;24 and
- Transportation or handling of hazardous materials.25

The ESIGN Act further does not actually change any rule of law except to the extent that it might have previously required that records "be written, signed, or in nonelectronic form."26 (Note again that a traditional "signature" may no longer be necessary to establish assent.)

The UETA only partly fills the gap for these exempted areas. The UETA by its own terms is limited to transactions related to business, commercial (including consumer), or governmental matters.27 Many of the more significant areas exempted by the ESIGN Act—trusts and estates, family law, court documents—don’t fit

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18 *Id.*
19 15 U.S.C. § 7002(b). Section 7004 regulates in detail the applicability of the ESIGN Act to federal and state governments.
21 *Id.*
22 *Id.* The UETA commentary notes that some of the excluded UCC sections were already revised to address electronic transactions. See UETA, prefatory note.
24 *Id.*
25 *Id.*
27 UETA § 3.
within the UETA’s intended scope. In addition, there is also always a concern about preemption.28

D. Know Available Notarial Options and Limits

To deter fraud and ensure proper execution, some legal documents require that they be signed in the presence of a notary. Having things properly notarized can sometimes prove inconvenient, which can lead to lawyers, their clients, and notaries bypassing the requirement that the signature occur in the presence of a notary.

Although we have not yet seen this issue become a major claim, lawyers should recognize the dangers of circumventing notary requirements. Not only could the lawyer and other individuals involved be violating the law, it could also negate the authenticity-validity of the document. It’s not hard to imagine how that could have devastating consequences for a case.

There are some alternatives that do not require physical presence. In some circumstances, a declaration signed under penalty of perjury may be a solution.29 In addition, people are using remote notarization services (RON). Virginia was the first state to implement this in 2012, and half the states now allow RON in some form.30

Notwithstanding the classic objection that a person with a gun pointed at the signatory might be just out of camera frame during the interaction with a RON

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28 15 U.S.C. § 7002 sets out an “exemption to preemption” that specifically addresses the UETA, but it’s unclear if much latitude would actually be given were a state enactment contrary to the terms of the ESIGN Act.


provider, we think using a remote notarization service may be a sensible loss prevention measure.\(^{31}\) A reputable service should attend to and ensure all registration requirements for its personnel. RON services often use both challenge questions and I.D. verification to ensure the participant is the purported signatory. Third-party witnesses (or maybe even the lawyer) can be brought into the process when using at least some of these services. The notary typically will also ask some rudimentary questions to test capacity and volition, and the whole event is recorded.

In sum, employment of a third-party remote notary service may go a good way to allay any suspicion that notarization of a key document was “fudged.” Remote notarization by firm personnel—if permissible—may be able to adopt some of these same measures and has the advantage that the lawyer may be able to supervise the process even more thoroughly. However, where neither of these is an option, lawyers should ensure that documents are otherwise properly notarized.

### E. Obtain and Preserve Wet Signatures When Required

As e-signature use becomes more and more common, lawyers may start to forget that some statutes, rules, and orders in these areas—even while accommodating the use of e-transmission to a limited extent—may still require that lawyers obtain and preserve a “wet” signature. Bankruptcy lawyers in particular should be mindful of these rules.\(^{32}\)

Although DocuSign affixations and other software-generated electronic signatures may have a place in certain commercial and other transactions, the court in *Mayfield* held that they did not have a place as substitutes for wet signatures on a bankruptcy petition, schedules, statements, and other documents filed with the court, and they did not comply with the court’s local rules.\(^{33}\)

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\(^{31}\) Firms should ensure that these recordings are stored and memorialized properly and protected from unauthorized access. See David Thun, *Tips For Making Recordings Of Remote Notarizations*, Notary Bull. (Jun. 10, 2020), available at https://www.nationalnotary.org/notary-bulletin/blog/2020/06/tips-recordings-remote-notarizations.


\(^{33}\) *In re Mayfield*, at *9–10.
We suspect that judicial concern for fraud or other e-signature mischief may decrease over time, or at least may become more focused. For now, though, lawyers need to remember that some wet signatures need to be obtained and preserved, even in the face of the push for paperless offices. This may necessitate periodic reminders and a plan for the retention of such documents.

II. CONCLUSION

With the enactment of ESIGN and UETA, there’s now more to signing a document than affixing your “John Hancock” on a piece of paper. By simple email exchange, lawyers and their clients can now form contracts without ever touching pen to paper and without ever reviewing a formal document entitled “AGREEMENT.” Lawyers, however, should take care to exercise diligence with respect to managing the execution of documents and ensure that documents are executed properly.
DAC6: The Impact of the EU’s New Tax Reporting Regime on Law Firms

Betsy Fahey
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I. INTRODUCTION

COVID-19 is not the only alphanumeric acronym law firms need to be concerned with these days. Law firms assisting multinational clients in transactions must also be prepared to address “DAC6,” the European Commission’s Council Directive 2011/16/EU on administrative cooperation in the field of taxation, as amended by Council Directive (EU) 2018/822, effective July 1, 2020.¹

In the last few years, lawyers, accountants, and clients at multinational companies have been busy addressing a wide variety of new legislation from U.S. tax reform (the Tax Cuts and Jobs Act of 2017) to the Organization for Economic Cooperation and Development’s (OECD) Base Erosion and Profit Shifting (BEPS) proposals, and the EU’s General Data Protection Regulation (GDPR). So perhaps it is not surprising that, until recently, DAC6 did not receive very much attention.

DAC6 requires disclosures of certain cross-border arrangements to the relevant tax authorities in EU member states and the United Kingdom. Of chief concern to lawyers is the fact that law firms are subject to its reporting requirements. Specifically, law firms that assist clients with a broad range of third-party or intercompany/affiliate transactions, will be required to report detailed information with respect to those transactions. DAC6 raises a host of issues law firms should consider and address promptly.

This article will first briefly describe DAC6. Then, we will address why lawyers should care about it and conclude with some practical suggestions to help law firms prepare to address the issues DAC6 presents.

II. WHAT IS DAC6?

To start: What is DAC6 and what are its requirements?

In recent years, tax authorities around the globe have increasingly focused on transparency as a way to minimize tax avoidance strategies, and DAC6 is a prime example of this emphasis. DAC6 is a mandatory disclosure regime (MDR) adopted by the European Commission that will be implemented through local legislation in each EU member state and the United Kingdom. It applies to “reportable cross-border arrangements.”

arrangements” (RCBAs) and requires intermediaries to each RCBA, including lawyers, to file reports disclosing specified information.

A. **STEP ONE: Is it a Cross-Border Arrangement?**

As a first step, lawyers must determine whether the matter at issue is a “cross-border arrangement.” DAC6 does not define “arrangement,” but it should be interpreted broadly to encompass an agreement, plan, transaction, or set of transactions. For instance, an arrangement might involve an investment or financing, or the sale or transfer of goods, services, or tangible or intangible assets.

“Cross-border” means an arrangement that concerns more than one EU member state (which, for this analysis, also includes the United Kingdom), or one EU member state and someone in another (non-EU) country. This includes transactions in which:

- not all of the participants are tax residents of the same jurisdiction;
- any of the parties is simultaneously a tax resident of more than one jurisdiction;
- one of the parties carries on business in another jurisdiction through a permanent establishment, and the arrangement forms at least part of the business of that permanent establishment; and
- one or more of the parties carries on an activity in another jurisdiction, even without creating a permanent establishment or being a tax resident.

Thus, for example, a Dutch holding company buying assets from a U.S. pharmaceutical company would be a “cross-border arrangement,” as would a loan from the London branch of a German bank to a German manufacturing company or the acquisition of rental property in Spain by an Irish property management firm.

Please note however, that although DAC6 does not pick up purely domestic arrangements (i.e., within the same member state), some EU member states, including Germany, Poland, Portugal, and Sweden, have adopted or proposed legislation that requires reporting of domestic arrangements similar to the requirements of DAC6. Accordingly, lawyers should review the applicable local law to determine the full scope of their reporting obligations.

B. **STEP TWO: Is it Reportable?**

If the transaction at issue is indeed a cross-border arrangement, the lawyer should next determine whether it is reportable under DAC6. To be reportable under DAC6, the arrangement must have one or more characteristics, also known as

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2 Article 3, point 19 of DAC6.
3 Article 3, point 18 of DAC6.
“hallmarks.” DAC6 lists five different categories of hallmarks that may apply to a cross-border arrangement. Within these categories are 15 specific hallmarks that, if applicable to the cross-border arrangement, will trigger DAC6’s reporting requirements.

The EU Council’s initial intent in drafting the hallmarks was to flag characteristics that may apply to abusive or potentially aggressive tax planning arrangements. In fact, several of the hallmarks are only met if the “main benefit or one of the main benefits of the arrangement is to obtain a tax advantage.” This is called the “main benefit test” or “MBT.” Commentators seem to be in near universal agreement, however, that the current hallmarks are in fact more extensive than this and may capture some routine transactions. Ordinary course transactions that may be reportable under DAC6 include some cross-border leases, securitizations, acquisition financing, and reinsurance arrangements. DAC6 provides no de minimis value threshold for reports and no exemption for transactions with an underlying commercial purpose.

A detailed discussion of each of the hallmarks is outside the scope of this article, but below is a summary description of the categories and individual hallmarks. Note that both the MBT and the hallmarks may be subject to varying interpretations at the local level.

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4 Annex IV to DAC6.

5 Taxes for this purpose do not include value-added tax, customs/excise duties, or social security contributions.
## DAC6 Hallmarks

<table>
<thead>
<tr>
<th>Category</th>
<th>Characteristic of the arrangement</th>
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<tbody>
<tr>
<td><strong>Category A</strong></td>
<td>Confidentiality provisions bind participants</td>
</tr>
<tr>
<td>Generic hallmarks that require reporting if the MBT is also satisfied</td>
<td>An intermediary’s fees depend on the tax advantage from the arrangement, i.e., a success fee</td>
</tr>
<tr>
<td></td>
<td>Standardized documents or arrangement that is available to more than one taxpayer</td>
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<tr>
<td><strong>Category B</strong></td>
<td>Certain tax loss buying arrangements</td>
</tr>
<tr>
<td>Specific hallmarks that require reporting if the MBT is also satisfied</td>
<td>Conversion of income into capital or other revenue categories that benefit from lower taxation</td>
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<td></td>
<td>Circular transactions that result in the round-tripping of funds</td>
</tr>
<tr>
<td><strong>Category C</strong></td>
<td>Arrangements involving tax-deductible payments, in some instances also subject to the MBT; this also includes payments to enterprises that are in EU-blacklisted jurisdictions (such as Panama, the Cayman Islands, and the U.S. Virgin Islands)</td>
</tr>
<tr>
<td>Specific hallmarks relating to cross-border transactions</td>
<td>Depreciation of the same asset in more than one jurisdiction</td>
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<td></td>
<td>Relief from double taxation in multiple jurisdictions</td>
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<tr>
<td></td>
<td>Involves an asset transfer in which the amount treated as consideration varies across borders</td>
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</tbody>
</table>
DAC6 HALLMARKS

<table>
<thead>
<tr>
<th>Category</th>
<th>Characteristic of the arrangement</th>
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<tbody>
<tr>
<td><strong>Category D</strong></td>
<td>Specific hallmarks relating to automatic exchange of information and beneficial ownership</td>
</tr>
<tr>
<td>May undermine or circumvent automatic exchange of information (AEOI) under Common Reporting Standard (CRS) developed by the OECD</td>
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<tr>
<td>Involves nontransparent legal or beneficial ownership</td>
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<tr>
<td><strong>Category E</strong></td>
<td>Transfer pricing hallmarks</td>
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<tr>
<td>Uses unilateral safe harbor rules (for transfer pricing)</td>
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</tr>
<tr>
<td>Transfers of hard to value intangibles between associated parties</td>
<td></td>
</tr>
<tr>
<td>International transfers of functions, risks, or assets in which EBIT of transferor is projected to drop by at least 50% within three years</td>
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</tbody>
</table>

C. **STEP 3: Congratulations, It’s an RCBA! Who Must Report It—and When?**

Under DAC6, “intermediaries” are required to file reports for each RCBA with the appropriate tax authority. The Directive’s definition of intermediary is extremely broad, including anyone with an EU-nexus who designs; markets; organizes; makes available for implementation; or aids, assists, or advises in the implementation of an RCBA. In even if they did not design or propose the tax planning or structure for a given transaction or set of steps, lawyers who advise or assist clients in the implementation of the transaction are clearly intermediaries subject to DAC6’s reporting requirements. In addition to lawyers, typical intermediaries may include accountants, tax advisers, and bankers, among others. Although it is possible that in some cases, an individual will be an intermediary, for lawyers and accountants working in firms, the firm itself generally should be considered the intermediary for reporting purposes. The U.K.’s implementing regulations address this directly, providing that an employee of an

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6 Article 3, point 21 of DAC6.
intermediary entity who would otherwise be an intermediary herself typically should not be treated as one.\textsuperscript{7}

Of course, as lawyers in U.S.-based law firms will have noted, an intermediary must also have an EU-nexus. This could mean that the firm is a tax resident, incorporated, has a permanent establishment, or is registered with a professional association related to legal, taxation, or consultancy services, in an EU member state (or the United Kingdom).\textsuperscript{8} It is likely that U.S.-based law firms with offices in the United Kingdom or any EU member state will meet this nexus requirement. U.S. firms with solely domestic or non-European offices should review their activities to confirm they would not meet the criteria for an EU-nexus. Given firms’ varying structures, firms should confirm the correct reporting entity in each case.

Intermediaries bear the primary responsibility for reporting the RCBA. If there is no intermediary involved, then the taxpayers involved in the arrangement have the obligation of reporting. If an intermediary has a legal professional privilege under the national law of the applicable EU member state (or the United Kingdom) that would excuse it from making the mandatory report, the taxpayer or another intermediary will be responsible for reporting the RCBA.\textsuperscript{9} Whether a law firm may rely on legal professional privilege to claim an exemption from making a DAC6 report will require careful review.

Often there will be multiple intermediaries involved in an RCBA. Generally, no intermediary is exempt from making a DAC6 report until it has confirmed that the RCBA has already been reported. In practice, this means that lawyers, other intermediaries, and the involved clients will need to discuss and agree upon which intermediary will be responsible for reporting the RCBA and for providing evidence of such a report to the other involved parties.\textsuperscript{10} If the law firm is relying on its legal professional privilege to exempt it from making a DAC6 report, then the firm must inform the other intermediaries and the involved taxpayers of this fact.

DAC6 also includes requirements regarding the timing of a report. Generally, RCBAs must be reported to the applicable tax authorities within 30 days of the earliest of:

- The date on which the RCBA is made available for implementation;
- The date after the RCBA is ready for implementation;
- The date when the first step in the RCBA has been taken; and
- The date on which the intermediary provided aid, assistance, or advice.\textsuperscript{11}

\textsuperscript{7} See HMRC’s International Exchange of Information Manual (IEIM) 621080 (Employees).
\textsuperscript{8} Article 3, point 21 of DAC6.
\textsuperscript{9} Article 8ab, point 5 of DAC6.
\textsuperscript{10} Article 8ab, point 9 of DAC6.
\textsuperscript{11} Article 8ab, point 1 of DAC6.
These deadlines obviously raise issues for lawyers and other intermediaries. Many transactions take longer than 30 days from start to finish. Almost certainly, the firm will have provided advice well before the date on which the RCBA was ready for implementation or its first step occurs. Take the example of a firm advising its client on an acquisition that meets the hallmarks for an RCBA: Simply forming a new company to act as a buyer in the transaction may take several weeks in some non-U.S. jurisdictions. This preliminary step cannot be completed until after the proposed structure is analyzed and agreed upon and documents are prepared and executed. In this common situation, it would be nearly impossible to file a DAC6 report within 30 days of the date on which the law firm first advised on the arrangement. There are likely to be differing views among intermediaries and among member states as to the date by which a given DAC6 report should be made. Thus, firms should review any guidance from the local tax authorities on this topic and carefully document their analysis of the appropriate deadline in order to support the approach taken.

Under DAC6 as originally drafted, the above deadlines apply for RCBAAs taken after July 1, 2020. As noted in the introduction, however, DAC6 has retroactive effect to June 25, 2018. By August 31, 2020, intermediaries must file DAC6 reports for each RCBA that was implemented between June 25, 2018 and July 1, 2020. Given the COVID-19 pandemic, however, at the time of press, the EU Commission has proposed to allow member states an option to extend filing deadlines by up to six months. This option would extend the August 31, 2020 date for reporting RCBAAs between June 25, 2018 and July 1, 2020 to February 28, 2021; and would create a new six-month window, so that all RCBAAs between July 1, 2020 and January 1, 2021 would be required to be reported by January 30, 2021.

The amendment to DAC6 authorizing this extension is not expected to be officially issued until the end of June or beginning of July 2020 at the earliest, due to pending approvals by the European Parliament and the EU Economic and Financial Affairs Council. Further, as noted above, extensions will be at the option of member states; some members, such as Belgium and Luxembourg, are expected to adopt extensions, while others, like Poland and Portugal, may not. As of mid-June, given the still-uncertain nature of the proposal, the U.K. was undecided as to its decision, although it had already acknowledged that the pandemic may be a "reasonable excuse" for a delayed filing.

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12 See, e.g., IEIM651030 (UK implementation guidance addressing deadlines in similar scenarios).
13 Article 8ab, point 12 of DAC6.
14 See, e.g., Isabel Gottlieb, EU Agrees to Optional Six-Month Delay for Tax Reporting Deadline, Bloomberg Tax (June 4, 2020); Raluca Enache, Member States representatives reach compromise on deferral of DAC6 deadlines, KPMG EU Tax Centre (June 5, 2020).
15 See IEIM800000 (UK guidance on reporting in light of COVID-19).
Therefore, law firms should currently be reviewing the cross-border transactions on which they advised during the relevant time periods to determine if DAC6 reports must be filed. An analysis of those transactions, and any going forward, should be made by a team familiar with the requirements of DAC6, including its implementing legislation and local guidance in the applicable jurisdictions. In some instances, firms may need to engage outside advisors or local counsel to assist in this analysis and to educate and train lawyers and staff on DAC6 compliance.

D. **STEP 4: Making a Report**

To file a DAC6 report, the intermediary must collect the required information and determine the applicable tax authority with which to make the report. This analysis will depend on the nature of the RCBA being disclosed and the local DAC6 implementing legislation in the jurisdictions involved. The answer may not necessarily be clear-cut, so firms will need to make sure that they have local teams with the requisite expertise in place to evaluate the filing requirements.

In terms of what must be reported, DAC6 requires that the reports identify the intermediaries and relevant taxpayers (including names, taxpayer IDs, and birth dates for individuals); describe the RCBA, its timing for implementation and value; and provide additional information, including designating the hallmark(s) implicated by the RCBA. The national legislation implementing DAC6 across the United Kingdom and EU member states may expand upon this or include additional information requirements. As a practical matter, it may be difficult for the reporting intermediary to collect all of this information. For example, there may be no readily determinable “value” to assign to the transaction; or the involved taxpayers, at least one of whom is also the law firm’s client, may disagree on the value or the proposed description of the RCBA to be disclosed.

DAC6 reports will be made via the same electronic AEOI portal used for Foreign Account Tax Compliance Act (FATCA) and CRS filings. Following this, the

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16 Article 8ab, point 14 of DAC6.
information reported in each DAC6 filing will be shared centrally with all EU member state and U.K. tax authorities on a quarterly basis, with the first information exchange to occur by October 31, 2020 (which may be extended until April 30, 2021 due to COVID-19). This exchange of information is designed to allow tax authorities to identify possibly aggressive tax planning early and to take action if warranted to prevent the erosion of the member state’s tax base.

III. IMPLICATIONS FOR LAW FIRMS

DAC6 presents numerous issues for law firms whose practices may touch the European Union or the United Kingdom. Below, we highlight several key areas of concern for lawyers.

A. Direct Reporting Obligation

DAC6 imposes a primary reporting obligation on law firms and other intermediaries (rather than on their clients). As a result, law firms may face monetary penalties for noncompliance and reputational risk. The EU Council has directed member states to adopt “effective, proportionate and dissuasive” penalties for failure to comply with DAC6.\(^\text{17}\) Thus far, jurisdictions have enacted or proposed an extraordinarily wide range of penalties for noncompliance. On one end of the spectrum, the default penalty in Hungary is approximately € 1,500 and the maximum penalty in Ireland is € 5,000. On the other end, the maximum penalty may reach up to € 5,000,000 in Poland or € 870,000 in the Netherlands.\(^\text{18}\)

B. Multijurisdictional Interpretation

The varying penalties for a DAC6 violation illustrate a second key issue for law firms: its multijurisdictional nature results in a disparate patchwork of local legislation and guidance that must be understood, interpreted, and simultaneously complied with. There are 27 EU member states plus the United Kingdom currently subject to DAC6. As described above, DAC6 reporting requirements may vary somewhat from transaction to transaction depending on the jurisdictions involved. For example, some countries define intermediaries more

\(^{17}\) Article 25a of DAC6.

DAC6 reporting requirements may vary somewhat from transaction to transaction depending on the jurisdictions involved. For example, some countries define intermediaries more broadly than others, interpretations of the MBT and hallmarks may be inconsistent among member states, and differing legal professional privilege exemptions will be available.

Further, this is an evolving area. Local implementing legislation and guidance will undoubtedly change as DAC6 takes full effect, and member states identify gaps that should be addressed or ambiguities that require clarification.

Consequently, lawyers practicing in this area will need to continually monitor developments and keep their partners and firm management informed as to what changes to firm processes and policies may be required. Affected firms should be prepared by having teams of experts, either in-house or knowledgeable local counsel, who can assist in advising firms on their compliance with local DAC6 reporting requirements.

C. Confidentiality

DAC6’s reporting requirements impose upon lawyers a legal responsibility that sharply contrasts with their core duty of client confidentiality. Lawyers in the United States should already be familiar with their professional responsibility to keep client information confidential. While individual states’ rules may slightly vary, ABA Model Rule 1.6(a) provides that, unless an exception applies, “A lawyer shall not reveal information relating to the representation of a client....” Confidential client information need not be information learned from the client, and it consists of more than information protected by the work product doctrine or attorney client privilege. In some places, it may even include the client’s identity. In addition to the U.S. rules of professional responsibility, which will likely apply to at least some of the intermediary law firm’s lawyers, the United Kingdom and EU member states also impose varying confidentiality obligations on lawyers. These rules should be reviewed in light of any DAC6 reporting requirements.

Although lawyers may successfully argue that disclosure of confidential client information in a DAC6 report is “impliedly authorized in order to carry out the representation,” or “to comply with other law,” as allowed in Rule 1.6(a) and 1.6(b)(6), respectively, we suggest firms address this issue directly with clients—ideally at the outset of the representation—to avoid any subsequent misunderstandings. If a DAC6 report may be required in
connection with an engagement, firms should memorialize this in the engagement letter, or in an addendum to it, and obtain the client’s informed consent in writing to disclose information as is necessary to make the DAC6 report.

D. Conflicts of Interest

Another issue that DAC6 may pose for lawyers is the increased possibility for conflicts of interest, which may arise when the lawyers and client do not agree on some aspect of DAC6 reporting.

Under ABA Model Rule 1.7(a), a representation involves a conflict of interest if “there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client or a third person, or by a personal interest of the lawyer.” Further, under U.S. rules, the conflicts of one lawyer in the firm are generally imputed to all of the lawyers in the firm. Other jurisdictions’ rules may differ significantly. However, as explained in Tab IV.G of the ALAS Loss Prevention Manual, as part of a U.S.-based law firm, lawyers in non-U.S. offices of ALAS firms may be subjected to conflicts of interest claims brought in the United States. For this reason, some firms with international offices assume as a matter of policy that the U.S. conflicts rules will apply to all client matters, unless the non-U.S. rule is more demanding. Further, Comment [5] to Model Rule 8.5 expressly acknowledges that for multijurisdictional matters, the lawyer and client may reasonably enter into a written agreement choosing which jurisdiction’s conflicts rules will apply.

As previously mentioned, there are innumerable areas for disagreement in interpreting and applying DAC6. Taxpayer clients and their lawyers may not agree that the arrangement constitutes an RCBA at all. With 15 different hallmarks, many of which are subject to the main benefit test, there is certainly a strong possibility of disagreement as to whether a particular hallmark applies to the proposed transaction. Lawyers, fearing the penalties and possible reputational risks posed by noncompliance with DAC6, may take a more conservative approach than certain clients. Add to the mix additional intermediaries (with their own biases), such as tax advisors who are pitching similar strategies and arrangements to numerous clients, and there’s a recipe for discord. The parties may not agree on whether a transaction should be reported at all or which hallmarks apply. Even if everyone agrees that the transaction must be reported (and under which hallmark), there is still much up for debate. How should the report describe the transaction? What is the value to be reported? What other information must be reported? When must the report be made, and with which tax authority?

In each of those areas of possible dispute, there is also the potential for a conflict of interest to develop with the client. Because the primary reporting obligations of DAC6 lie with the intermediary, there is a risk that an intermediary law firm will place its own interests ahead of those of its client. The law firm’s advice to its client may be colored by the firm’s own interest in avoiding penalties or a possible dispute with tax authorities over the disclosure. There may be a tension between the law firm’s desire to make a specific
Disclosure and the client’s interests in keeping particular information about their business operations confidential and limiting the scope of the information reported. A firm may also have an interest in preserving good relationships with local tax authorities or be advising other clients on similar transaction structures and disclosures, and these factors may unduly influence its approach and advice to the taxpayer.

In most instances, the parties’ interests will be aligned, as each intermediary and taxpayer client will strive to comply with the law. With so many gray areas, however, there is more than a theoretical risk of a conflict developing between the parties involved. With the benefit of hindsight, it is possible that an unhappy client could claim that an overbroad DAC6 disclosure made by its lawyers caused it to lose a competitive advantage in the marketplace. On the flipside, an unhappy client who does not realize the maximum value in a transaction may claim that its lawyers’ desire to avoid a DAC6 report colored the lawyers’ advice on transaction structuring in the first place.

Therefore, law firms working on these cross-border transactions should be cognizant of potential conflicts of interest. Lawyers must be alert to the possibility of an emerging conflict as discussions over the structure and reporting of the transaction develop. To the extent possible, lawyers should address any potential conflicts of interest at the outset of the engagement and, when identified, during the course of the representation. If there is the potential for a conflict, lawyers should consult with the firm’s general counsel or loss prevention partner who can help determine whether there is a conflict, and if so, whether it is consentable, and what language to include in the client’s waiver, or how to otherwise address it. In some countries, like the United Kingdom, a personal interest conflict may not be waived, even with the client’s informed written consent, so the appropriate local expert should also be consulted.

E. Data Privacy

Although outside the scope of this article, it is worth noting that the DAC6 requirements that certain personal information be reported may implicate GDPR or other privacy laws. The personal information that may be included in a DAC6 report includes an individual’s name, date and place of birth, and taxpayer identification number. Law firms dealing with high net worth individuals or families whose personal information must be provided as part of a DAC6 report should confirm that such disclosures are permitted under applicable data privacy laws, and on what basis, and appropriately document these conclusions.
LOSS PREVENTION SUGGESTIONS

We’ve outlined below some steps firms may take to prepare for DAC6.

1. **Determine whether the firm is subject to DAC6.** This requires first confirming the firm’s EU-nexus, and second, determining the types of work performed by the firm’s lawyers. If the law firm has one or more offices in the EU or the United Kingdom, or otherwise has an EU-nexus as set forth above in Part II, then the firm will be an intermediary under DAC6 if its lawyers in these locations advise a client in structuring or implementing an RCBA. Given the scope of the hallmarks delineated in DAC6, it seems probable that most multinational law firms with transactional practices should at least consider whether certain cross-border engagements trigger DAC6 reporting.

2. **Educate and train lawyers and staff.** If the firm is subject to DAC6, then lawyers and staff working on cross-border engagements need to understand its requirements. Firm management and practice group leaders may consider appointing a few lawyers in key EU and U.K. offices to serve as the firm’s DAC6 experts. These lawyers should review the adopted and proposed legislation, as well as guidance and sample filings published by local tax authorities. Once reporting becomes effective, they must stay current on DAC6 legislation and enforcement. The firm should hold mandatory DAC6 training sessions for the lawyers in offices or practice groups who may be impacted by such transactions, such as corporate, tax, banking & finance, and intellectual property, among others. It is particularly critical that lawyers in all applicable practice areas are trained to look for DAC6 hallmarks as engagements unfold.

There are third parties, Big Four accounting firms, for example, and others, like Thompson Reuters and VinciWorks with Intapp, that are offering training tools and software that law firms and other intermediaries may consider using. If the law firm does not have the right team in a particular jurisdiction, firm leaders should be prepared to supplement their expertise with outside help if it becomes necessary.

3. **Use new business intake process to help identify RCBAs.** Firms should consider asking lawyers to identify whether the proposed engagement may require a DAC6 report on their new business intake forms. If the answer is yes, then the engagement can be
highlighted, and an appropriate member of the firm’s DAC6 team assigned to it. In many cases, of course, lawyers will not know for certain at intake if a proposed transaction will be an RCBA. Nonetheless, they should, in most cases, be able to identify whether it might. For example, they should know if the proposed engagement will involve more than one country (including at least one EU member state or the United Kingdom). Any potential cross-border engagement should be flagged at intake for periodic check-ins with the originating lawyer to confirm whether it involves an RCBA.

4. **Address DAC6 reporting in engagement letters.** For each cross-border transaction that may require a DAC6 report, firms should explain this possibility in a written engagement letter with the client. This also helps to put the client on notice that it will be required to create the DAC6 report if the firm is able to rely on a legal professional privilege waiver. In addition to describing the requirements of DAC6, firms should document the client’s express permission to disclose confidential client information to the extent required to make the DAC6 report and provide that the client will supply the firm with all necessary information for the report in a timely manner. Alternatively, if there are other intermediaries involved in the engagement who will handle DAC6 reporting, then firms should document this understanding in the engagement letter by limiting the scope of the engagement, confirming who will be making the filing, and disclaiming responsibility for it.

Firms may consider whether it is appropriate to expressly include (or exclude) DAC6 analysis and reporting within the scope of the engagement (as something for which the firm will charge the client) and also whether to proactively seek an advance waiver from the client for the potential conflict of interest issues described above. Lawyers should be encouraged to consult with the firm’s general counsel and loss prevention partners in crafting the appropriate language to address these matters.

If the need for a DAC6 report is not apparent at intake, or otherwise is not addressed in the engagement letter, then firms should enter into an amendment to the engagement letter or other written agreement with the client confirming these matters.

5. **Adopt additional internal firm controls and policies as necessary to ensure DAC6 compliance.** If a firm’s practice mix and locations are such that firm lawyers may be advising on RCBAs, then the firm
should consider what additional firm controls and policies should be put in place to ensure DAC6 compliance. For instance, firms may want to implement processes for regularly following up on all cross-border engagements to make sure they are not RCBOs. Appropriate firm policies may: (a) remind lawyers to monitor cross-border engagements on an ongoing basis to identify the indicia of an RCBO; (b) require that a member of the firm’s DAC6 team be appointed to review and approve all draft DAC6 reports before they may be filed (even if a different intermediary is making the filing); and (c) mandate the use of specific written documentation with the client to memorialize the parties’ agreements and responsibilities with respect to the DAC6 analysis and filing requirements.

6. **Determine if there is a legal professional privilege exemption.** As described in Part II above, law firms may be able to seek a waiver from DAC6 reporting responsibilities if they can rely on a legal professional privilege exemption. Each member state has its own definition of legal professional privilege (LPP), and some jurisdictions have already noted that this privilege will not fully or automatically exempt lawyers from making DAC6 reports. For instance, in the U.K. and Luxembourg, among others, lawyers may be able to claim LPP, but may still need to disclose non-privileged information like the taxpayer’s name. The French General Tax Code (Article 1649 AE, 4°), which acknowledges an obligation of professional secrecy, would nonetheless allow the lawyer to report the transaction with the taxpayer’s agreement. Germany, the Netherlands, and others would allow an LPP exemption, while in Italy and Portugal, there will apparently be no LPP exemption available. Still other jurisdictions may include different limits on the privilege. Thus, firms should proactively review local laws on this topic as they develop so as to be able to quickly confirm for each RCBO whether the firm may be able to rely on an LPP exemption.

7. **Identify the appropriate DAC6 reporter.** In many RCBOs, the involved law firm will not be the only intermediary. Where there are additional involved intermediaries, law firms should strongly consider whether it would be desirable for a different intermediary to make the DAC6 filing. The larger accounting firms, with substantial tax planning practices, are currently positioning themselves to be able to make DAC6 reports. In addition, banks and financial institutions are already very familiar with the mechanics and logistics of such filings, as they have been making CRS filings using the same AEOI portals as DAC6. Further, while law firms may be able to avoid filing DAC6
IV. CONCLUSION

DAC6 is here. Law firms with multinational practices must proceed accordingly, by training lawyers and staff, communicating with clients (and documenting such communications), and adopting appropriate policies and practices to ensure that they will be able to comply with its reporting requirements.
Real Claims, Hard Lessons: A Developer Disaster

Rawn Reinhard
Senior Loss Prevention Counsel, ALAS
Mistakes have been the leading cause of our claims for over a decade, and they were present in over 65% of our major claim losses during the period 2011 to 2019. Many of our most costly mistakes claims are rooted in simple mistakes, ranging from misplaced commas to just-plain carelessness. This claim, unfortunately, is no different.

A. Beachfront Property Anyone?

The story begins with a Florida developer who wanted to assemble a portfolio of coastal and island properties for current income and future development. The properties consisted of various restaurants and small businesses, in addition to some unoccupied storefronts. In 2012, Kensington Federal (Kensington) and two other banks each funded one-third of a $90 million loan to facilitate this plan.

All went well for a while. The developer was receiving rental income from the occupied buildings and there was interest in renting the other stores. But problems began to arise in 2013: Profits from the rented units weren’t increasing as had been projected, nor were the properties appreciating much in value. In addition, none of the unoccupied space had been leased.

By January 2014, the developer was considering bankruptcy, and the three banks were facing some difficult choices. The various properties were the collateral for the loan, but current market values would not cover the outstanding principal. An immediate sale also would not produce the potential profit that the banks had intended to reap over the loan’s life. Therefore, believing that the real estate market would soon be on the upswing, the banks began to consider the possibility of buying the collateral properties. The banks would then manage them until valuations—and potential profits from eventual sale—had increased.

To explore this option, the banks sought help from an outside consultant. Enter Newhouse Property Management (NPM), which had substantial experience in managing Florida real estate. NPM recommended that the banks enter into a joint venture with NPM, to be called Coastal Management. Coastal Management would acquire all of the developer’s properties and then manage the properties in a way intended to maximize the potential for a future profitable sale when the real estate
market improved. In the interim, profits from the joint venture (mainly current rent income) would be distributed pursuant to a waterfall structure among the various parties. The banks liked the idea, but they decided to bide their time to see what the developer would do.

B. Outsmarted, Outwitted, Outplayed

In March 2014, the developer defaulted on the loan from the banks and filed for bankruptcy. The collateral properties were now worth around $70 million, far less than the outstanding loan principal. The bankruptcy court was going to auction the collateral properties at the end of May. Accordingly, the banks needed to act quickly on NPM’s proposal.

Kensington retained an ALAS firm to help work through the various legal issues. Then, in mid-May—with only two weeks left until the auction—NPM abruptly changed the structure of the transaction. It was still willing to act as property manager, but it now didn’t want to participate in a joint venture or invest in Coastal. Instead, NPM proposed that the banks hold the properties in a simple arrangement by which a third of the profits would be distributed to each bank. NPM, for its part, would receive management fees. This proposal was not acceptable to Kensington because it did not want to have direct ownership of the collateral properties in light of the potential possible liabilities.

With the auction date rapidly approaching, Kensington turned to the law firm for a solution. The firm negotiated an arrangement by which NPM would form a subsidiary corporation called Lagoon. Lagoon would acquire Kensington’s interest in the venture, and it would issue a note that gave Kensington the right to interim payments (from which Lagoon would collect a fee). Kensington would further hold a warrant that would allow it to acquire full ownership of its one-third interest in the venture upon sale of the properties.

The law firm drafted the closing documents, which included a debt assignment and asset acquisition agreement (the Acquisition Agreement), a promissory note (the Note), and an option agreement (the Option). The Acquisition Agreement vested the anticipated assets with Lagoon. The face amount of the Note was $1 million, well below the value of Kensington’s interest. The Note was intended to be merely a vehicle for Kensington to get its share of the current rent payments pending exercise of the Option, and the lower face value reduced some taxes associated with the transaction. The Option, in turn, documented Kensington’s right to reclaim its ownership interest so it could get a one-third share of the ultimate profits.

After additional negotiations between the parties and revisions to the documents, the transaction finally closed in May 2014. Subsequently, the real estate market started to show real improvements, and the venture appeared to be headed toward a tidy profit. Without warning, though, in July, NPM unexpectedly paid off—years before its maturity date—the $1 million Note. NPM also advised that with the early payoff of the Note,
Kensington’s Option was extinguished. Kensington was not only frozen out of the venture’s profits, it was left with a loss on its original loan. For a $1 million payment, NPM (through Lagoon) had acquired a one-third interest in a portfolio of prime Florida coastal and island properties worth at least $70 million and increasing in value every day.

C. Drafting Debacle

What happened? There were some clear drafting errors. Specifically, the documents didn’t explicitly memorialize any agency relationship between Lagoon and Kensington. Furthermore, there was a critical error in the Option’s wording: “Lagoon hereby grants to Kensington the right to acquire the properties from the date hereof until the termination of the Note pursuant to the terms thereof.” Another problem: The Note did not contain a provision prohibiting prepayment, a common provision in such a transaction. Neither Kensington nor the firm noticed the language. Thus, the document allowed Lagoon to pay off Kensington’s Note early and keep Kensington’s interest in the property portfolio.

To say that Kensington was unhappy about these developments would be an understatement. Kensington filed a lawsuit against NPM and its affiliates claiming that their actions violated fiduciary duties owed under an agency theory. The evidence, however, was ambiguous on this point. Kensington also blamed the firm, pointing to the fact that the firm failed to include a run-of-the-mill provision that would have precluded Lagoon and NPM from acquiring the properties from underneath it at a steep discount. The firm couldn’t deny that there were drafting errors but contended that Kensington should also bear some responsibility for the drafting errors. After all, multiple Kensington personnel had reviewed the documents. Nonetheless, the bank steadfastly refused to accept any blame for missing the prepayment and other drafting issues. Kensington claimed it had relied on the firm to catch those issues on its behalf.

It took several years and lots of legal fees to resolve the issues. Eventually, Kensington’s agency arguments provided enough traction to get some concessions from NPM. Instead of its original one-third share of the overall venture’s profits, Kensington settled for a one-sixth interest in the collateral. NPM walked away with a right to more than $11 million in distributions—a hefty return on the $1 million expended to pay off the Note.

Subsequently, Kensington turned to the firm to make up the remainder of the bank’s lost profits, plus reimbursement for the cost of litigating the claim against NPM and Coastal. The resolution of the claim ended up costing ALAS and the firm over $10 million.
LOSS PREVENTION SUGGESTIONS

This was a complicated deal with a number of parties, but basic drafting errors are to blame for what went wrong in this claim. We consider drafting errors as “simple” mistakes—the firm just got it wrong. These situations accounted for 55% of our nonlitigation reserves over the last decade and for a whopping 89% of our posted nonlitigation reserves in 2019. And the same scenarios show up again and again in these claims: there was a rush, often because of third-party complications and delays; the deal had some novel aspects; or the transaction was drafted in pieces, and some of the pieces ended up not working right as a whole.

We suggest the following:

- Slow down strategically, even when things are rushed. Maybe especially when things are rushed. If someone isn’t taking time to reflect and assess, the job may get done, but not done right.

- When drafting a deal, be sure that someone is stepping back and testing how the various provisions work together. When everyone is focusing on particular pieces of the transaction, the big picture can get lost. Errors can likewise occur when a change is made in one part of the deal but not communicated to others, whose work might be affected. Take time to see the forest, not just the trees.

- Review by a disinterested colleague can help to identify mistakes. Often, this can occur in parallel to other continuing work by the deal team (thus no lost time) even when deadlines are tight. What’s the advantage? These colleagues come fresh to the deal, so they aren’t blind to proofreading or substantive errors. They also won’t have the same preconceptions about the parties or the anticipated outcome—in this case, for example, the idea that NPM was acting as an agent. And second lawyer review is therefore particularly valuable if a transaction is complicated or unconventional, as was the case here.

- Finally, we like checklists. We would expect, for example, that any commercial loan checklist would raise the issue of whether prepayment is allowed and on what terms. Here, giving just a little thought to such a routine provision could have prevented a big loss for the client and the firm.
Mitigating Risk through Effective Leadership: Takeaways from the ALAS Leadership Development Workshop Series

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Leadership is essential to building a healthy, ethical, and sustainable law firm culture. As a profession, however, we have underinvested in training law students and lawyers to be effective leaders. Accordingly, most law firm leaders have considerably less training in leadership than those in the top ranks of other types of business organizations. Moreover, lawyers—particularly law firm partners—by their nature tend to resist being managed: they value independence and can chafe at being told what to do. The relatively flat nature of law firms, where even a managing partner serves at the pleasure of the partnership, further compounds the difficulties firm leaders face. Nonetheless, a number of serious lawyers’ professional liability (LPL) claims demonstrate that effective leadership is vital to a firm’s overall success, including its ability to mitigate liability risk.

To help cultivate the next generation of law firm leaders, ALAS and Harvard Law School Executive Education (HLSEE) partnered in 2017 to develop a series of regional Leadership Development Workshops. These workshops, which ran from 2017 through 2019, focused on partners relatively new to firm leadership roles and those likely to assume such roles in the future. From among the vast array of leadership concepts and skills, the workshop sessions focused on a subset selected to help law firm leaders tackle certain challenges that—if not addressed—can increase LPL risk. Such challenges include:

- Undertaking proper lateral due diligence and integration;
- Stopping toxic or high-risk behavior by rainmakers;
- Maintaining motivation and engagement among lawyers;
- Ensuring consistent support for, and compliance with, firm policies;
- Providing constructive feedback, and having other difficult conversations, even with star performers;
- Promoting formal team structure; and
- Establishing frameworks for measuring and improving team processes and health.

This article summarizes the workshop sessions and key takeaways for law firm leaders of all experience levels who were not able to attend the workshops in person.

II. WORKSHOP DESIGN

We structured the workshop series around HLSEE’s leadership development approach, which the organization has used over the past 13 years to train thousands of law firm leaders and general counsel. The key elements of that approach include case-based learning and highly interactive lecture sessions that engage groups of 40-60
participants in exercises and discussions focused on practical applications of important research on leadership and teams.

In addition, for years, ALAS has used its own case-based practice group management workshops to impart risk management principles to practice group leaders. We integrated those principles into the HLSEE model, combining the strengths of both organizations.

Each workshop included a Harvard Business School (HBS) case study session and an interactive, exercise-based lecture session. After considerable debate over the kind of case study to use, we ultimately chose the classic HBS case of Rob Parson at Morgan Stanley, which challenges participants to consider whether to promote a high-performing, but potentially culturally mismatched, lateral hire.¹ We deliberately chose a case set in an investment bank to help participants more objectively consider the challenges involved, all of which also arise within law firms.

Following the case study session, we turned to lectures and exercises on motivational psychology, inclusive team leadership, and levers of influence. These were designed to address specific challenges law firm leaders face, including motivating and influencing others and fostering inclusive teamwork to enhance decision-making.

III. KEY LESSONS: CASE STUDY DISCUSSION

During the case study session, Professor Westfahl used the facts of the case to illustrate important aspects of personal and organizational leadership. Each session was dynamic and interactive, which allowed participants to learn as much from each other as from the facilitator. In addition, ALAS staff connected leadership lessons in the case directly to law firm risk and mitigation strategies. Although each discussion was different, the key leadership lessons were consistent and are described below.

A. Lesson 1: Organizational Culture and Values

A leader must minimize the difference between what the organization says it is, and how it actually behaves.

The case study highlights the importance of strong organizational culture and values to an organization’s success. In that regard, it is important to remember that organizations have both an “espoused theory” (often seen in a mission statement or in the way members of an organization describe their values) and a

“theory in use” (what actually happens day-to-day). A leader must minimize the difference between what the organization says it is, and how it actually behaves.

Workshop participants shared their own experiences with these concepts, and generally agreed that one of the biggest dangers firms face is that their espoused theory often does not match their actual practice. ALAS staff provided data and examples to illustrate how risk can increase significantly when firms fail to live up to their values. For example, a firm may purport to value collaboration and teamwork but structure its partner compensation system in a way that rewards “lone wolves.” That situation is a recipe for increased mistake frequency.

The discussion also emphasized that leaders need to be clear about organizational values, and demonstrably support them. This is consistent with ALAS’s claims experience. Leaders can reduce risk by deputizing the firm’s lawyers and staff to spot and report red flags, including by ensuring they are trained on, and frequently reminded of, the firm’s ombuds and open-door policies. Moreover, a law firm’s written policies, including loss prevention policies, must be consistently and uniformly applied to everyone at the firm. This is particularly true because plaintiffs’ lawyers often seek discovery related to firm policies that have not been enforced, instances when management has made exceptions for top producers, and occasions when the firm has failed to supervise, all in an effort to exploit shortcomings and bolster malpractice claims.

B. Lesson 2: Feedback

Meaningful feedback is essential to improving performance. It is essential both to firm culture and risk mitigation that leaders are willing and able—when necessary—to provide feedback and engage effectively in difficult conversations at all levels. Indeed, as the case study illustrated, failing to give constructive feedback and to engage in other difficult conversations, can have potentially devastating consequences, particularly when a star producer is acting contrary to firm values.


3 Mistakes are the leading cause of loss for ALAS: between 2011 and 2019, more than $1.9 billion was reserved on claims involving a mistake.

4 Lateral hires who are not integrated into the firm can fall into the lone wolf category. These lawyers can significantly increase LPL risk by working in silos, dabbling outside their areas of expertise, hoarding work, and working for unworthy clients. ALAS reserved $439 million between 2011 and 2019 on claims involving lateral lawyers. To reduce potential LPL risk and cultural disruption caused by laterals, ensure formal due diligence and integration plans are in place, and are used. ALAS has examples of such plans.
With that in mind, Professor Westfahl guided workshop participants through the key aspects of delivering feedback and engaged participants in a role-play exercise to practice a simple, but highly effective, feedback model. The model has three main parts: (1) objectively stating an issue; (2) explaining its consequences; and (3) suggesting a better course of action for the future. These concrete steps can help ensure mutual understanding and a clear path forward.

We discussed that lawyers frequently can be passive aggressive when avoiding difficult conversations, and usually are quite thin skinned about receiving meaningful feedback. The need for firms to establish meaningful feedback as a key component of lawyer growth and development was also emphasized. We also explored how leaders can set the tone for such feedback, including by regularly asking others for feedback on the leader’s own performance. Simple questions like “Anything I can do differently to help?” or “Any feedback for me about how we are working together?,” can set the stage for much more inclusive team discussions. They also can help mitigate risk by allowing team members room to speak up if they see red flags or are concerned about how a client is being served.

IV. KEY LESSONS: MOTIVATION, INCLUSIVE TEAMS, AND INFLUENCE

Following the broader case study discussion, the workshops shifted focus to interactive lectures and exercises on specific frameworks and skills useful both in leading and in mitigating risk. The lectures and exercises explored and illustrated several important lessons from the realms of motivational psychology, inclusive team leadership, and levers of influence, including those described below.

A. Lesson 1: Lawyer Motivation

Understanding what truly engages and motivates lawyers helps law firm leaders drive better performance. It also helps de-emphasize financial incentives as the means to encourage not only compliance, but also behaviors like coaching, mentoring, and feedback. A singular focus on financial incentives can increase a firm’s risk profile. Thus, the lectures began by examining intrinsic motivators (those arising from internal factors and motivating behaviors performed because of the sense of personal satisfaction they bring) and extrinsic motivators (those arising from external factors and motivating behaviors performed in order to receive something from others or avoid certain negative outcomes), and applied the research on those topics to the context of lawyers.

The research emphasizes that the vast majority of lawyers display an elevated need for achievement, which they often endeavor to satisfy through a focus on performing challenging work, competing, seeking feedback to self-calibrate, and maintaining a strong sense of autonomy. Although lawyers typically pursue these elements to satisfy their own need for achievement, they often fail, as leaders, to provide these same
elements to others, frequently because they are so focused on their own challenging work. Prompted by these insights, participants engaged in wide-ranging discussion on how to create new and different metrics, and more constructive environments, to support each other’s need for achievement. Many of the suggestions centered on ways to foster clear direction and expectations, effective coaching and feedback, and appropriate recognition.

**B. Lesson 2: Inclusive Team Leadership**

It is important for law firm leaders to facilitate teamwork and broad decision-making discussions. This type of behavior strengthens organizations, whereas poor teamwork and deficient team decision-making can lead to significant risk. To illustrate this, participants were introduced to a research-based decision-making process, and then given an opportunity to practice the process in a customized exercise. That exercise borrowed elements from a costly real-world claim that occurred when a firm allowed a rainmaker to “bully” his colleagues into allowing him to take on a potentially profitable new client despite a likely conflict of interest.

The participants were grouped into teams and instructed to function as a law firm executive committee. The facilitators then challenged each “committee” to arrive at a consensus on whether to overrule their general counsel and allow the partner to represent the risky new client. The essential learning point of the exercise was set up to ensure that each committee member was given the opportunity to articulate his or her perspective, and to have that perspective fully vetted by the committee, in order to prevent undue deference to the most outspoken member. One particularly effective way participants accomplished this was to have each committee member state at least one “pro” and one “con” of representing the new client before proceeding to further discussion and a decision.

**C. Lesson 3: Influence Psychology**

Law firms feature a relatively flat structure, relative to other types of business organizations. As a result, law firm leaders must be particularly adept at influencing others in order to get buy-in and engagement from their peers. To assist in that regard, Professor Westfahl reviewed research on influence levers, including concepts like reciprocity, commitment and consistency, authority, and social proof.

Participants again separated into their “executive committees” and were tasked with brainstorming ideas on how they might influence—and satisfy—a partner like the one in the previous exercise, assuming his request to represent the new client was denied. Participants were quite creative in devising applications of influence psychology principles. Overall, the social proof approach proved quite popular. This powerful concept, which was originated by Robert Cialdini in 1984, instructs that, especially when they are uncertain, people will tend to look to the actions and behaviors of
others to determine their own. In deploying social proof to appease the disappointed partner, workshop participants often suggested comments like, “You’re not alone: [x] other partners were not allowed to bring in potentially huge new clients last year due to perceptions of possible conflicts” or “ALAS tells us that [x]% of their largest claims result from ignoring potential conflicts like this.”

V. CONCLUSION

The feedback from these workshops was quite positive, and we believe they were effective because they tied leadership theory and research directly to certain key challenges faced by law firm leaders that directly correlate with higher LPL risk exposure. ALAS is much more powerful when members engage and learn from each other, and ALAS is grateful to HLSEE for helping to create a very effective forum for engagement on these important issues.

This list identifies upcoming and recent ALAS materials and events. If you have a question about an item, please contact your firm’s loss prevention partner.

<table>
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<th>UPCOMING</th>
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| **Managing Partner Program 2.0**  
July 23, 2020, via Zoom |
| **cLp Today: A Claims and Loss Prevention Production, Ep. I**  
Available July 28, 2020 |
| **Is Your Firm Ready for the CCPA? Webinar**  
July 29, 2020 |
| **cLp Today: A Claims and Loss Prevention Production, Ep. II**  
Available Aug. 25, 2020 |
| **London Forum**  
Sept. 23, 2020, via Zoom |
| **cLp Today: A Claims and Loss Prevention Production, Ep. III**  
Available Sept. 29, 2020 |
| **DataView Webcast—Data & Analytics**  
Oct. 1, 2020, via Zoom |
| **New General Counsel Conference (Sessions 1-3)**  
Oct. 6, 13, and 20, via Zoom |
| **Diversity, Equity, and Inclusion Series**  
Sept. 2020 through Feb. 2021, via various platforms |
| **Legal Ethics in the Cannabis Industry Webinar**  
Nov. 2020 |
RECENT

Events:
- Cybersecurity Conference
- Webcast to Report on 2019 Fiscal Year Results
- Regional Loss Prevention Conferences
- Managing Partner Program
- Annual General Meeting—Virtual Business Meeting

Hotlines:
- Managing Partner Program—Breakout Session Highlights
- Loss Prevention Tips for Litigators Using Videoconference Technology
- Sustaining and Enhancing Well-Being during Challenging Times: Insights for Firm Leaders
- Managing during COVID-19: Employment Liability Considerations for Law Firm Leaders
- New Scam or Large-Scale Fraud? Beware of (Potential) Clients Who Want to Use Your Firm’s Escrow Account
- Act Now to Protect Your Firm from Unworthy Clients
- Handling Risks Related to Fees and Collections in a Down Economy
- Sooner Rather than Later: Terminating the Representation of Nonpaying and Uncooperative Clients
- Meeting Your Clients’ Needs for Bankruptcy Advice during and after the COVID-19 Pandemic
- California Consumer Privacy Act FAQs for Law Firms
- Regional Loss Prevention Conferences Recap
- Secondments and Furloughs During the COVID-19 Pandemic
- Cancel that Contract? Counseling Clients in Trying Times

Hotlines (continued):
- Ethics CLE for Lawyers: Accessing Your ALAS Resources
- Working from Home Loss Prevention Tips
- ALAS Updated Loss Prevention Tips for Addressing Coronavirus
- ALAS Loss Prevention Tips for Addressing Coronavirus

Management Guides:
- Records Management for Law Firms
- Cyber Lawyering—Information Management and Security

Loss Prevention Minutes*:
- Check That Formula
- Digital Assistants
- Wire Transfer Scams
- Are YOU a Low-Risk Lawyer?
- Talking to the Client’s Auditor

Podcasts**:
- The Portable Ethics Lawyer
  - Risks of Using Virtual Assistants
  - Risks of Investing in Clients
  - Preventing Mistakes by Using Checklists
- Speaking of Law Firm Leadership
  - Building the General Counsel’s Relationship With Law Firm Leaders

Schadenfreude Diaries:
- A Mobster Biopic, A Film Investor, and A Law Firm
- Don’t Fall Asleep on the Job
- Not Preparing for the Test Can Be Costly
- Avoid Going Down a Slippery Slope

* Available at ALAS Digital Resources Library.
**Available at ALAS Podcasts.
The materials in this Loss Prevention Journal were prepared and assembled by employees of Attorneys’ Liability Assurance Society (ALAS). It is not the intent of these materials to suggest or establish practice standards or standards of care applicable to the performance of a lawyer in any given situation. Rather, the sole purpose of these materials is to assist lawyers and law firms insured by ALAS in avoiding claims related to legal malpractice, management liability, and employment practices, including meritless and frivolous claims. To that end, the intention of these materials is to advise the lawyers insured by ALAS to conduct their practices in a manner that is well above the accepted norms and standards established by the applicable substantive law. The recommendations contained in these materials are not necessarily appropriate for every lawyer or law firm or for every situation to which they may refer.