ATTORNEYS' LIABILITY DEVELOPMENTS IN 2009: THE RISE AND FALL OF THE "RED FLAGS" RULE REGARDING ATTORNEYS

By Nicholas T. Christakos

In response to the serious and growing problem of identity theft, the Federal Trade Commission (FTC) issued in November 2007 the so-called "Red Flags Rule," requiring "creditors" to develop and implement programs targeted to identifying, detecting, and responding to the warning signs of identity theft in the operation of their businesses. The Red Flags Rule attracted the attention of the ABA and other professional associations when the FTC, before the Rule was scheduled to take effect, indicated for the first time in the spring of 2009 that attorneys and certain other professionals are subject to the Rule. Faced with the specter of intrusive and potentially expensive federal regulation as to the business activities of lawyers, the ABA challenged the Rule in the U.S. District Court for the District of Columbia—a challenge that has, at least for now, derailed the FTC's planned implementation of the Rule as to attorneys.

Evolution of the Red Flags Rule

Congress tackled the identity theft issue in 2003 when it passed the Fair and Accurate Credit Transaction Act of 2003 (the FACT Act).[1] The purpose of the FACT Act is "to prevent identity theft, improve resolution of consumer disputes, improve the accuracy of consumer records, [and] make improvements in the use of, and consumer access to, credit information."[2] To achieve its stated purpose, the FACT Act requires several agencies, including the FTC (i) to establish and maintain guidelines for use by each financial institution and creditor regarding identity theft with respect to account holders at, or customers of, such entities, with such guidelines to be updated as often as necessary, and (ii) to prescribe regulations requiring financial institutions and creditors to develop reasonable policies and procedures for implementing the guidelines established. The specific charge given to the agencies in prescribing regulations was "to identify possible risks to account holders or customers or to the safety and soundness of the institution or customers. . . ."[3]

Agencies were given authority to enforce any regulations adopted under the FACT Act, including the right to obtain injunctive relief and impose civil monetary penalties where a violation has been found.[4]

Congress incorporated by reference into the FACT Act the definitions of "creditor" and "credit" found in the Equal Credit Opportunity Act of 1974 (the ECO Act), a statute directed to discrimination by creditors against credit applicants on the basis of sex or marital status.[5] The term "creditor" is defined as "any person who regularly extends, renews or continues credit; any person who regularly arranges for the extension, renewal or continuation of credit; or any assignee of an original creditor who participates in the decision to extend, renew, or continue credit."[6] And the definition of "credit" borrowed from the ECO Act is "the right granted by a creditor to a debtor to defer payment of debt or to incur debts and defer its payment or to purchase property or services and defer services therefor."[7]

Against this legislative background, and pursuant to the grant of authority provided in the FACT Act, the FTC (and several other agencies) published in the Federal Register on July 18, 2006, a joint notice of proposed rulemaking to implement several sections of the FACT Act.[8] The agencies issued their final rule on November 9, 2007, after the required period for notice and comment.[9]

The Rule was originally scheduled to become effective on January 1, 2008, with a "mandatory compliance" date of November 1, 2008.[10] The FTC announced on October 2, 2008, however, that there would be a six-month delay in the enforcement of the Rule until May 1, 2009, resulting from possible confusion among various entities as to the scope of the Rule.[11] The FTC subsequently postponed the May 1, 2009, enforcement dated until August 1, 2009, again because of the perception that many entities were confused about whether they were "creditors" for purposes of the Rule.[12]

Along with its press release announcing the postponed enforcement date of August 1, 2009, the FTC also issued on April 30 a document entitled "FTC Extended Enforcement Policy: Identify Theft Red Flags Rule, 16 CFR 681.1" (Apr. 30, 2009) (Enforcement Policy).[13] For the first time ever, the FTC indicated in the Enforcement Policy that attorneys and other professionals "who bill their clients after services are rendered" are subject to the Rule.

The FTC's attempt to provide clarity in its Enforcement Policy apparently did not have the intended effect, as the FTC on July 29, 2009, issued a further postponement of the enforcement date for the Rule from August 1, 2009, until November 1, 2009. The FTC believed that many entities, particularly small business entities, continued to be confused as to the Rule's applicability to them and needed additional time to assess the Rule and come into compliance.[14]

What the Rule Requires

The Rule requires covered businesses and creditors to develop, implement, and administer identity theft prevention programs. Each program must include four basic elements. First, the programs must include reasonable policies and procedures to identify the "red flags" of identity theft that may surface in the day-to-day operation of the business. Red flags are suspicious patterns or practices, or specific activities, that indicate the possibility of identity theft.[15] Different types of businesses may give rise to different types of red flags. Appendix A to the Red Flags Rule lists several categories of warning signs to consider including in a program.[16]

Second, the program must be designed to detect the red flags that have been identified as potential red flags associated with that business.[17] For example, if fake identification cards have been identified as a potential red flag, the business must have procedures

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in place to detect possible fake, forged, or altered identification. Consideration must be given to how procedures may differ depending on whether identity verification is taking place in person or at a distance, such as by telephone, mail, Internet, or other wireless system.

Third, the program must detail appropriate actions to be taken when red flags are detected.[18] Appropriate responses may include, for example, contacting the customer or client, monitoring a covered account for evidence of identity theft, closing an existing account, notifying law enforcement, or determining that no response is warranted under the circumstances.[19]

Fourth, because identity theft is an evolving threat, the Rule requires periodic updates to the program to ensure a capacity to stay current as to evolving identity theft risks.[20]

The ABA Challenge to the Rule

The ABA Board of Governors adopted a policy in June 2009 "urging Congress and the Federal Trade Commission to exempt lawyers from the Red Flags Rule."[21] The reasons why lawyers would be opposed to application of the Rule to the legal profession are many and varied. As a threshold matter, lawyers are heavily regulated at the state level by statute and the various ethics rules applicable to them in their home states and in other jurisdictions as appropriate. The imposition of a new layer of federal regulation seems unnecessary and certainly should not occur absent a clear indication of congressional intent. Moreover, the cost and inconvenience of forcing lawyers and law firms to develop compliance programs could be significant, particularly in the context of a law plainly targeted to businesses that actually do extend some measure of credit to consumers. Lawyers do not view themselves as "creditors" under the FACT Act, and the requirements of the Rule simply do not translate clearly or easily in the context of professionals rendering a service, such as attorneys.

When the FTC showed no signs of retracting or modifying its view that the Rule applies to lawyers, the ABA filed suit against the FTC in the U.S. District Court for the District of Columbia on August 27, 2009.[22] In its complaint, the ABA sought a declaration that the FTC's application of the Rule to lawyers engaged in the practice of law is "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right" or, in the alternative, is "arbitrary, capricious, and abuse of discretion, or otherwise not in accordance with law" pursuant to relevant provisions of the Administrative Procedures Act.[23] The essence of the ABA's position was that the FTC cannot interpret the Rule to apply to lawyers in the absence of an express statutory mandate, or in the alternative that rendering such interpretation is arbitrary and capricious.

On the ABA's motion for summary judgment with respect to its first theory—that the FTC acted beyond its statutory mandate—the court issued an order on October 30, 2009, granting the ABA's motion and entering summary judgment for the ABA with respect to Count I of its complaint. The court subsequently issued a detailed Memorandum Opinion on December 1, 2009, detailing its rationale. In brief, the court concluded that Congress did not unambiguously express its intent in either the ECO Act or the FACT Act that attorneys should be viewed within the purview of the FACT Act and thereby subject to regulation by the FTC's Red Flags Rule. In the absence of a clear expression of legislative intent favoring attorney coverage, the court held that the FTC exceeded its authority, relying in part on prior D.C. Circuit precedent holding that the regulation of the legal profession has been left to the prerogative of the states.[24] The court further buttressed its decision by finding that, even if Congress did not foreclose the FTC's regulation of attorneys, the FTC's "interpretation of the FACT Act and its resulting application of the Red Flags Rule to attorneys is unreasonable and therefore undeserving of deference."[25]

As a practical matter, the court's decision would seem to moot the remaining claims in the ABA's complaint. The FTC filed a notice of appeal from the court's decision on February 25, 2010. The outcome of this appeal, of course, remains to be seen. For now, however, attorneys can breathe a huge sigh of relief.

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1. Pub. L. 108-159, amending the Fair Credit Reporting Act, 15 U.S.C. § 1681.
2. H.R. Rep. No. 108-396, at 65–66 (2003), *reprinted in* 2003 U.S.C.C.A.N. 1753–54.
3. 15 U.S.C. § 1681m(e)(1)(A)-(B).
4. *See* 15 U.S.C. § 1681m(h)(8)(B).
5. Pub. L. No. 93-495, 88 Stat. 1500 (1974). The incorporation by reference of this statute's definition of "creditor" and "credit" is codified in the FACT Act at 15 U.S.C. § 1681a(r)(5).
6. 15 U.S.C. § 1691a(e).
7. 15 U.S.C. § 1691a(d).
8. *See* Identity Theft Red Flags and Address Discrepancies Under Fair Accurate Credit Transactions Act of 2003, Proposed Rule, 71 Fed. Reg. 40,786 (July 18, 2006).
9. *See* 72 Fed. Reg. 63,772 (Nov. 9, 2007). The Red Flags Rule is published at 16 C.F.R. § 681.2.
10. 72 Fed. Reg. at 63, 718.
11. *See* Press Release, FTC Will Grant Six-Month Delay of Enforcement of 'Red Flags' Rule Requiring Creditors and Financial Institutions to Have Identity Theft Prevention Programs (Oct. 22, 2008), www.ftc.gov/opa/2008/10/redflags.shtm.
12. *See* Press Release, FTC Will Grant Three-Month Delay of Enforcement of 'Red Flags' Rule Requiring Creditors and Financial Institutions to Adopt Identity Theft Prevention Programs (Apr. 30, 2009), www.ftc.gov/opa/2009/04/redflagsrule.shtm.
13. The Enforcement Policy may be found at www.ftc.gov/os/2009/04/P095406redflagsextendedenforcement.pdf.
14. *See* Press Release, FTC Announces Expanded Business Education Campaign on 'Red Flags' Rule (July 29, 2009), www.ftc.gov/opa/2009/07/redflag.shtm.
15. *See* 16 C.F.R. § 681.2(b)(9).
16. 16 C.F.R. Part 681, Appendix A.
17. 16 C.F.R. § 681.2(d)(2)(ii).
18. 16 C.F.R. § 681.2(d)(2)(iii).
19. 16 C.F.R. Part 681, Appendix A.
20. 16 C.F.R. § 681.2(d)(2)(iv).
21. www.abanet.org/media/youraba/200906/article09.html.
22. Am. Bar Ass'n v. Fed. Trade Comm'n, Case No. 1:09-cv-01636-RBW (D.D.C. Aug. 27, 2009).
23. *Id.*, Complaint at Counts I and II, relying on 5 U.S.C. §§ 706(2)(C) and 706(2)(A).
24. Memorandum Opinion at 14 (Dec. 1, 2009, citing Am. Bar Ass'n v. Fed. Trade Comm'n, 430 F.2d 457, 467 (D.C. Cir. 2005).
25. *Id.* at 14–15.

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