

Accepting Legal Fees From The Client's Employer

BY ROY SIMON

If a company under investigation retains you to represent an employee who is asked to cooperate in an internal investigation, what should you disclose to the employee regarding the scope of your engagement and the nature of any potential conflicts of interest? That question will eventually have to be answered, because in *Salvatore v. Kumar*, Index No. 8565-05 (Suffolk County Supreme Ct., April 18, 2006), Judge Elizabeth Hazlitt Emerson refused to dismiss a legal malpractice suit by a former Computer Associates employee against Kaye Scholer, LLP and one of its partners. The main allegation in the suit is that Kaye Scholer and its partner failed to disclose conflicts of interest that arose because the firm's legal fees were being paid not by the individual client but by Computer Associates.

The court's refusal to dismiss the case has shaken up the bar, because many firms accept legal fees from a client's employer when a company under investigation provides independent counsel to individual employees who are involved in the investigation. What disclosures must a law firm make to these individual employees to avoid being sued for legal malpractice? This article explores those questions.

Background: the internal investigation

Irene Salvatore was a Vice President of Computer Associates and an at-will employee in the company's accounting department for a number of years. In 2002, the SEC and federal prosecutors in Brooklyn began investigating accounting practices at Computer Associates, especially the practice of booking sales contracts (apparently some \$2.2 billion) before customers signed them. When the investigation began, Sullivan & Cromwell, which served as regular outside counsel for Computer Associates, recommended that Computer Associates retain another powerhouse law firm, Wachtell, Lipton, Rosen & Katz, to conduct an internal investigation, and Computer Associates did so.

According to the Complaint in *Salvatore v. Kumar* (which was filed by Irene Salvatore and two other former Computer Associates employees), Computer Associates required Ms. Salvatore and various other employees to meet with Sullivan & Cromwell and Wachtell, Lipton for the purpose of being "interviewed and interrogated" by them. Sometimes the plaintiffs were accompanied to meetings with Sullivan & Cromwell or Wachtell, Lipton by in-house counsel for Computer Associates. Other times, they were not accompanied by counsel at all. Still other times, they were accompanied by counsel provided by Computer Associates.

According to papers filed in the case by Kaye Scholer, Sullivan & Cromwell and Wachtell, Lipton interviewed plaintiff Salvatore four separate times. At the first three interviews, Ms. Salvatore was not represented by counsel. Before her fourth interview, however, Computer Associates realized that she was a potential witness of interest to the government, and Computer Associates offered to pay for a lawyer to represent her individually. The General Counsel at Computer Associates recommended Kaye Scholer, which had never represented Computer Associates. Ms. Salvatore accepted the recommendation and

signed an engagement letter with Kaye Scholer confirming that Kaye Scholer would represent her "in connection with investigations being conducted by the United States Attorney's Office . . . and the Securities Exchange Commission." The letter also stated that "while CA [Computer Associates] has agreed to pay your bills on your behalf, this will also confirm that you, not CA, are our client and our ethical responsibility is to you, not CA." (Emphasis in original.) The letter of engagement did not elaborate on the nature of that "ethical responsibility" and did not mention conflicts of interest.

After Ms. Salvatore signed this retainer agreement, Kaye Scholer partner Jane Parver advised her to cooperate with the investigation by submitting to another interview requested by outside counsel for Computer Associates. Salvatore agreed to cooperate, and Kaye Scholer accompanied her to her fourth (and last) interview by Computer Associates' outside counsel.

Following the investigation, a number of high-ranking Computer Associates officers were indicted for securities fraud and other serious crimes. These officers included Sanjay Kumar, the former CEO of Computer Associates, and the company's Executive Vice President, among others. All of the indicted officers eventually pleaded guilty. Ms. Salvatore was never charged with any crime, violation, or offense, but Computer Associates terminated her employment (along with a number of other employees in the Computer Associates accounting department) after the improper accounting practices came to light.

Plaintiff's legal malpractice suit

After her termination, Salvatore filed suit in Suffolk County Supreme Court against Sanjay Kumar and Computer Associates alleging that Computer Associates had wrongfully terminated her and that the company's 2004 Annual Report had defamed her by describing some of the illegal accounting practices at the company. Those allegations are of no concern to us here. But Salvatore also sued Kaye Scholer and Jane Parver, alleging that they "had a conflict of interest which they failed to adequately disclose or disclose at all to the plaintiffs, to wit: that they were hand picked to represent the plaintiffs by Computer Associates; were paid by Computer Associates; [and] provided little or no legal advice to the plaintiffs" More specifically, Salvatore alleged that Kaye Scholer "failed to represent the best interests of the plaintiffs and led them to believe that they had nothing to worry about in their employment or otherwise if they cooperated with the internal investigation," and she alleged that Kaye Scholer and Ms. Parver "failed to reveal actual or potential conflicts of interest which they had in representing the plaintiff." Furthermore, the Complaint alleged:

27. ... Their failure to make those disclosures created a grave appearance of impropriety. The plaintiffs were encouraged to be "team players" and to give statements under oath to the said lawyers and law firms, which were not in their best interests and which were meant to exculpate the said lawyers, law firms and defendants of wrongdoing while inculcating the plaintiffs of wrongdoing. ...

28. The lawyers and law firms referred to herein used strategies and their political influence or legal contacts ... to exonerate Computer Associates, Wang, Kumar and others of wrongdoing while using the plaintiffs as scapegoats and pinning the blame on them for the alleged corporate wrongdoing. ...

Moreover, the Complaint alleged (somewhat redundantly) that Kaye Scholer and Ms. Parver “violated the Code of Professional Responsibility by, among other things, failing to disclose to the plaintiffs and all others the full nature of their conflicts or to decline employment as counsel to the plaintiffs so that the plaintiffs might secure counsel of their choice, unfettered by conflicts of interest.” Moreover, Parver and Kaye Scholer “gave erroneous and incorrect legal advice” to Salvatore and “sacrificed her interests for their own interests and the interests of Computer Associates” But for this legal malpractice, the Complaint continued, Salvatore would not have been defamed or wrongfully terminated from her employment.

The Complaint further alleged that Parver and Kaye Scholer “failed to disclose the nature of their conflict to Irene, failed to disclose the amount of their legal fees paid for by Computer Associates, and also failed to decline representation of Irene.”

Finally, the Complaint alleged that Parver and Kaye Scholer “failed to properly advise Irene of the legal options that she had aside from cooperating with an internal investigation by Computer Associates, which was geared to lay a foundation for the plaintiffs' wrongful termination of employment and to ‘pin the blame’ on Irene and the other plaintiffs for the alleged corporate wrongdoing of Computer Associates. Specifically:

80. Parver and Kaye Scholer failed to advise Irene that she could be terminated from her employment and failed to advise her of the legal and/or other steps she might undertake to avoid losing her job. Parver and Kaye Scholer further failed to advise Irene on how she might obtain severance pay or reinstatement of her position following her termination.

The essence of these allegations is twofold. First, if Kaye Scholer had not been constrained by a conflict of interest stemming from Computer Associates' payment of its legal fees for representing Ms. Salvatore, then Kaye Scholer would somehow have persuaded Computer Associates not to fire her (perhaps in exchange for her willingness to submit to a fourth interview), or would have persuaded Computer Associates to give her severance pay, or would at least have explained to her how to get her job back after she was fired. Second, if Ms. Salvatore had known about Kaye Scholer 's conflict, she would have hired a lawyer who did not have a conflict (presumably at her own expense, since any lawyer paid by Computer Associates would have had the same conflict) – but she did not know about Kaye Scholer 's conflict because the firm did not disclose it to her.

These are pretty fanciful allegations. Did Ms. Salvatore really not understand that a law firm picked and paid by her employer had a potential conflict? And would an unconflicted lawyer have given Ms. Salvatore any different advice, or been able to save her job or help her obtain severance pay or reinstatement despite a \$2.2 billion accounting fraud that took place partly in the department where she worked? But fanciful or not, the allegations appeared to state a claim, and it would not be easy to persuade the court to dismiss them at the pleading stage, as Kaye Scholer soon found out.

The battle over the motion to dismiss

Kaye Scholer, representing both itself and Ms. Parver (without benefit of outside counsel for either), jointly moved to dismiss the legal malpractice claims. To Kaye Scholer, the case posed “a simple question: can legal advice which is not alleged to be negligent and which is not alleged to have

proximately caused a plaintiff any actual damages constitute actionable legal malpractice?" For two main reasons, Kaye Scholer said the answer was no.

First, Salvatore failed to plead facts indicating how Kaye Scholer's advice was negligent. "She never alleges what advice Kaye Scholer gave her or what the purportedly proper advice should have been," Kaye Scholer said in its brief in support of its motion to dismiss. However, Salvatore was apparently suggesting that Kaye Scholer should have advised Salvatore to "ignore" the demand by Computer Associates that she meet with Computer Associates' counsel and should instead have refused to cooperate with Computer Associates' internal investigation. Kaye Scholer dismissed this straw-man argument out of hand. "The notion that it would have been correct legal advice to recommend that an at-will employee refuse to cooperate with an internal investigation – and still be able to keep her job – is simply laughable," Kaye Scholer said.

Second, Salvatore cannot establish the "but for" causation essential to a legal malpractice suit because her damages – the termination of her at-will employment and her purported defamation by Computer Associates – were acts of third parties over whom Kaye Scholer had no control. In any event, as an at-will employee, Salvatore "had no expectancy of continued employment and any suggestion that any different advice from Kaye Scholer could somehow have prevented the termination of her employment would be wholly and impermissibly speculative" Her allegations of legal malpractice thus "boil down to" an assertion that Kaye Scholer negligently advised her to give truthful information "in a situation where she had no option other than to cooperate with the internal investigation, or face losing her at-will job." She was fired anyway, but "[i]f her choice was either to agree to a fourth interview or be terminated, and Kaye Scholer advised her to not be insubordinate, it is nothing but rank speculation for her to claim that some other advice would have let her keep her job." Thus, in Kaye Scholer's view, she alleged no legally cognizable harm.

As for Salvatore's pivotal allegation that Kaye Scholer gave negligent and incomplete legal advice because it had an inadequately disclosed conflict of interest, Kaye Scholer responded only in a footnote. "The notion that a conflict of interest is created when one party pays the legal fees incurred by another party is silly and would upset decades of settled law and legal arrangements," Kaye Scholer said. "Just as one example, it is entirely commonplace for insurance companies to pay the legal fees incurred by their insureds even in instances where the insurers' interests and the insureds' interests conflict."

The same footnote also observes that Salvatore "does not allege that she was unaware that her legal fees were being paid by CA, nor does she allege that Kaye Scholer had any professional or business dealings with CA prior to, during, or even after its representation of her – it did not." Thus, in Kaye Scholer's view, "[t]here simply was neither a conflict nor a disclosure issue with respect to Kaye Scholer's representation of Salvatore."

Salvatore's brief did not illuminate the conflict issues at all. After reciting some generalities about an attorney's fiduciary duty to "fairly and fully disclose to clients his activities affecting their interests," and after emphasizing that Kaye Scholer's fees were paid by Computer Associates, Salvatore said, in a passage marred by typographical or other errors:

This arrangement is in direct contravention of the disciplinary rules of the code which states, while generally forbidding a lawyer from “knowingly assist[ing] a person or organization that furnishes or pays for legal services to others.” (EC-2-25). ...

This is (to be charitable) incoherent. First of all, it is not a complete sentence – something important is missing (perhaps a cite to a Disciplinary Rule). Second, EC 2-25 is not one of “the disciplinary rules of the code,” but is instead an Ethical Consideration, which is aspirational but not binding on attorneys. Third, EC 2-25 does not contain the quoted language, and if there is an EC that does, I could not find it. (Isn’t all of this ironic in a brief accusing the opposing law firm of incompetence?) Fourth, Salvatore appears to be arguing that an attorney is flatly forbidden from representing an employee whose legal fees are paid by her employer. Certainly there is no authority for such a radical proposition.

Kaye Scholer’s reply brief finally zeros in on the relevant Disciplinary Rule, DR 5-107(A), which provides: “Except with the consent of the client after full disclosure a lawyer shall not: (1) Accept compensation for legal services from one other than the client.” Kaye Scholer deals with DR 5-107(A)(1) in two conclusory paragraphs:

Here, the plain fact of the matter is that it was disclosed to Salvatore that CA was paying her legal fees, and she consented to the representation with that knowledge. Salvatore’s retention agreement made that disclosure and documents Salvatore’s written consent.

Accordingly, there was no violation of DR 5-107(A), as the courts routinely recognize in similar circumstances. *See Carey & Associates v. Ernst*, 22 A.D. 3d 338, 802 N.Y.S.2d 160, 164 (1st Dep’t 2005) (DR 5-107 not violated in lawsuit brought by law firm to recover fees promised to be paid by son for representation of parents because ‘facts at bar, including the retainer agreement itself, overwhelmingly demonstrate that [the son’s] payments were with his parent’s consent’). ... Salvatore knew and consented to CA’s payment of Kaye Scholer’s invoices for representing her and that arrangement cannot constitute legal malpractice.

In my view, the *Carey* case is beside the point. It is a breach of contract action against a son who promised to pay legal fees for his mother and father when the father was facing extradition, not a legal malpractice action by the client whose legal fees were being paid. Neither the son nor the father alleged that the law firm’s work was negligent. The fact that a court enforced a contract against a third party (the son) who agreed to pay fees has little bearing on whether the client (the father) could have alleged that his lawyer failed to disclose fully the conflict of interest arising from the son’s fee payment, or that the conflict led to negligent or incomplete legal advice.

The court’s ruling and its implications

Judge Emerson made short work of the motion to dismiss. After reciting the familiar elements of legal malpractice and noting that a legal malpractice claim could arise either out of a law firm’s negligent advice or out of its failure to give advice, the court said:

The evidence establishes that there was an attorney-client relationship The evidence also establishes that defendants Kaye Scholer and Parver were compensated by CA for their representation of plaintiff. Plaintiff Salvatore alleges that defendants Kaye Scholer and Jane

Parver committed malpractice when they failed to disclose the existence of a conflict of interest and when they failed to advise her as to the possible consequences of her cooperation with the internal investigation. Accepting the factual averments of the compliant as true, the court finds that plaintiff Salvatore has alleged sufficient facts to support a claim of legal malpractice, and defendants' motion to dismiss that claim is consequently denied.

The implications of this ruling are troubling. Third party fee payments are routine. Insurance companies are virtually in the business of hiring lawyers to defend their insureds, and employers routinely pay legal fees for officers or employees who face claims arising out of their employment. (Indeed, in May Judge Lewis Kaplan of the United States District Court for the Southern District of New York held a hearing to determine whether the United States Attorney improperly interfered with KPMG's offer to pay attorney fees for various KPMG officers and employees caught up in an investigation of illegal tax shelters – see Mark Hamblett, *Kaplan Scores Position Of U.S. on Legal Fees*, N.Y.L.J. May 11, 2006.) Is every law firm that accepts legal fees from an employer to represent an employee risking a legal malpractice suit based on an inadequately disclosed conflict of interest if the employee is dissatisfied with the results of the representation?

The key question is whether law firms can take any steps to avoid the problem now faced by Kaye Scholer. To answer this question, we need to return to DR 5-107(A)(1). In particular, we need to flesh out the meaning of the phrase “full disclosure.” What must a law firm disclose to satisfy the requirement that the attorney decline compensation from a third party “[e]xcept with the consent of the client after full disclosure”?

The meaning of “full disclosure”

In N.Y. State 721 (1999), the State Bar Committee on Professional Ethics addressed the meaning of “full disclosure” for purposes of DR 5-107(A)(1) in the context of an insurance company that pays the legal fees of an insured. The committee said, in relevant part (with citations omitted):

[W]here an attorney receives compensation for legal services from one other than the client, DR 5-107(A)(1) requires the client's consent after full disclosure of all material facts and circumstances. The attorney representing the insured should disclose the insurer's contractual rights under the insurance contract and should disclose any limitations or requirements that the insurance company imposes on the lawyer pursuant to the insurance contract or the insurer's policies. Moreover, “it is important that the lawyer fully disclose to the client the lawyer's relationship to the insurer, and at all times act in such a fashion that the insured has no basis to believe his interests are not fully and fairly represented.” ...

The lawyer should discuss with the insured any limitations placed by the carrier on research, motions or briefs, and the lawyer's opinion of whether such limitations are likely to have a material adverse effect on the outcome of the representation and obtain the consent of the client.

...

Translating this disclosure into a disclosure suitable for accepting legal fees from an employer to represent an employee is not complicated. As I say in SIMON'S NEW YORK CODE OF PROFESSIONAL RESPONSIBILITY ANNOTATED 782-783 (Thomson West 2005), DR 5-107(A) reflects a fear that “a

lawyer whose bread and butter comes from someone other than the client might sometimes be tempted to put the interests of the third party payor... ahead of the interest of the client, or to allow the third party to direct or control her professional judgment, or to ignore conflicts with the third party....” To counter this fear, DR 5-107(A) requires a lawyer “to explain these possible temptations to a client and obtain the client’s consent to the arrangement. This allows the client to be on the alert for any division of loyalties or any ‘tilt’ toward the third party on the attorney’s part.”

Thus, the client is entitled to know not only the fact that the employer is paying the employee’s legal fees, but also how this might affect the lawyer’s independent professional judgment on behalf of the client. A full oral disclosure to the client might go something like this:

Your employer has recommended our law firm to represent you in connection with the current investigation into securities fraud, and has offered to pay your legal fees. We will be happy to represent you, but before you sign our retainer agreement, we want you to know that the employer’s offer to pay our legal fees raises a potential conflict of interest. Your interests may be different from the interests of your employer. You may therefore be worried that our firm will favor your employer’s interests over your own interests, and will not take certain steps that might anger or upset your employer even if those steps would be in your best interests.

Let us assure you that our firm will not yield to that temptation. You are our client here, not your employer, and our ethical responsibilities are to you, not to your employer. We will represent you vigorously. We will not allow your employer to regulate or direct our independent professional judgment, and will not allow your employer’s payment of our fees to adversely affect our independent professional judgment on your behalf.

That disclosure ought to be adequate for purposes of DR 5-107(A), assuming the lawyer has no hidden relationship with the employer. Of course, if the lawyer represents the employer in other matters, or receives frequent referrals from the employer, or has close relatives working for the employer, or otherwise receives financial or personal benefits from the employer, then that should also be fully disclosed to the client. (Here, Kaye Scholer says it did not have any other relationship with Computer Associates, and Ms. Salvatore has not alleged any such relationship.)

Kaye Scholer may well have made all of the necessary disclosures orally to Ms. Salvatore. If it did, then those disclosures should come out during discovery, and Kaye Scholer should eventually win this case on summary judgment. But the written disclosures that Kaye Scholer actually made to Ms. Salvatore in the letter of engagement itself (“while CA [Computer Associates] has agreed to pay your bills on your behalf, this will also confirm that you, not CA, are our client and our ethical responsibility is to you, not CA”) were far less extensive and more cryptic. Ms. Salvatore was therefore in a position to allege that Kaye Scholer, inhibited by an inadequately disclosed conflict of interest, provided negligent or incomplete legal advice to her. A conflict of interest with a third party fee payor by itself does not establish legal malpractice, but it gives a law firm a motive to provide substandard legal services, and therefore engenders higher scrutiny by the court.

Conclusion

A law firm that makes full disclosure to its client has a right to accept legal fees from a third party fee payor. The more extensive the disclosure, the less likely the client is to sue based on inadequate disclosure. Although DR 5-107 does not require the disclosure to be in writing, lawyers are well advised to make the disclosure in writing as part of the letter of engagement or retainer agreement.

In making full disclosure, the lawyer should make clear that the employer is paying the employee's legal fees, but that the employee will be the sole client. The lawyer should also highlight the temptation for the lawyer to put the interests of the employer/payor ahead of the interests of the employee/client, and should assure the employee that the lawyer will not succumb to this temptation. (If the lawyer cannot give that assurance, the lawyer should not accept the case.) The lawyer should also disclose any limitations the employer has placed on the lawyer's budget, and any constraints the employer has imposed on the lawyer's freedom to represent the client as the lawyer sees best. Finally, the lawyer should disclose any current or past financial, referral, or other significant relationships with the fee-paying employer.

But *Salvatore v. Kumar* remains troubling because it shows how difficult it is to get rid of a legal malpractice case on a motion to dismiss. That means many lawyers will lose a motion to dismiss (as Kaye Scholer did here) and will have to endure the anxiety and expense of assembling evidence to support a motion for summary judgment. Law firms that have represented their clients competently and without conflicts should be in a position to win a motion for summary judgment, but the more extensive and thorough the disclosures to the client under DR 5-107(A)(1), the less likely the client will be to sue in the first place.

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