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Court Issues Decision Limiting Scope of FTC's Red Flags Rule

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Yesterday, the U.S. District Court for the District of Columbia issued the attached opinion upholding the American Bar Association's challenge to the FTC's Identity Theft Red Flags Rule and enjoining the FTC from enforcing its Rule against lawyers. This memorandum opinion follows an October 29 oral argument and bench ruling. This ruling may have significance beyond the legal profession, and may limit the FTC's ability to enforce its Red Flags Rule against professionals, retailers, health care providers and other businesses that bill their clients and customers in a manner similar to lawyers.

(In the interests of full disclosure, Morrison & Foerster Partner Andrew Smith, the author of this client alert, chairs the ABA task force overseeing the Red Flags litigation.)

The Red Flags Rule applies to "creditors," as that term is defined in the Equal Credit Opportunity Act ("ECOA"), and requires the development of programs to prevent, detect and mitigate identity theft. *See*, *e.g.*, 16 C.F.R. § 681.1. Earlier this year, the Commission issued a formal statement of its enforcement policy to the effect that its Red Flags Rule covers "all entities that regularly permit deferred payments for goods or services," including "professionals, such as lawyers or health care providers, who bill their clients after services are rendered." http://www.ftc.gov/os/2009/04/P095406redflagsextendedenforcement.pdf.

The American Bar Association challenged this assertion, arguing, among other things, that (1) Congress did not intend to sweep lawyers into the Red Flags Rule; (2) lawyers are not fairly considered to be "creditors," given that they do not grant clients the *right* to defer payment but merely bill in arrears as a result of ethical rules and administrative convenience; and (3) the likelihood of identity theft in the context of a lawyer-client relationship is extraordinarily remote. (Subsequent to the ABA lawsuit, a trade association for accountants filed a similar action.)

In yesterday's opinion, the court agreed with the ABA. Applying the two-part test in *Chevron v. NRDC*, 467 U.S. 837 (1984) (*i.e.*, whether a statute is ambiguous, and, if so, whether an agency's interpretation of the statute is reasonable), the court held that the FTC's enforcement policy statement applying the

Red Flags Rule to lawyers does not deserve judicial deference. First, the court held that the Fair and Accurate Credit Transactions Act of 2003 ("FACT Act"), which directed the FTC to make the Red Flags Rule, is not ambiguous: Congress clearly did not authorize the FTC to regulate lawyers, given the historic prerogative of the states to regulate lawyers and the fact that the FACT Act identity theft provisions are "ill-adapted" to the legal profession. Even if the statute can be said to be ambiguous, however, the court also held that the FTC's application of its rule to lawyers is not reasonable.

In the course of its opinion, the court made several key findings, some of which may have implications beyond the legal profession:

- The FACT Act was not intended to eliminate all forms of ID theft, just ID theft "in the credit industry." *See* slip op. at 16.
- The FTC's interpretation was based largely on Federal Reserve Board ("FRB") staff Commentary with respect to the definition of an "incidental creditor" under Regulation B. Although Regulation B implements the ECOA, Congress cannot be presumed to have known of these FRB staff interpretations of Regulation B, given that it incorporated only the ECOA definition of "creditor" into the law authorizing the Red Flags Rule. *See id*. at 22-24.
- The court is not required to defer to the FRB staff's interpretation that lawyers are "incidental creditors" under Regulation B. *See id*. at 25-26. Simply because a lawyer does not demand immediate payment does not mean that the lawyer is granting the "right" to defer payment. *See id*. at 29. Lawyers invoice their clients for their own convenience, because of ethical rules prohibiting payment before services are rendered, and because of the unpredictable nature of the work to be performed, not because of a desire to allow clients to pay over time. *See id*. at 29, 32-34.
- The legislative and rulemaking records do not provide any basis to conclude that there is a risk of ID theft presented by the lawyer-client relationship, and "a *post hoc* rationalization" of such a risk by the FTC is unavailing. *See id*. at 19-20, 35-36.
- Lawyers have an ethical obligation to know the true identities of their clients, and requiring a lawyer to conduct an inquiry into his or her client's identity, as required by the Red Flags Rule, would intrude on the lawyer-client relationship and would undercut the relationship of trust that a client needs to have with his or her lawyer. *See id*. at 36, 38-39.
- The FTC's application of the Red Flags Rule was not subject to notice and comment, but rather "came out of the blue" 18 months after the final Rule was issued. *See id*. at 37.

Several industries, including retailers, securities firms and health care providers, have made arguments that are similar to those of the ABA – *i.e.*, that the FTC has applied its Red Flags Rule to them "out of the blue," after the fact, without notice and comment, without a basis in the FACT Act or ECOA or the legislative history of those two laws, and without any evidence of a risk of the type of ID theft that the FACT Act was trying to prevent. This most recent court opinion may breathe new life into those arguments.

The FTC has not yet announced whether it will appeal the decision.

Please contact us if you have questions or need additional information.