Oregon State Bar

Business Law Section

NEWSLETTER

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Letter from the Editor: Welcome and an Invitation

Dear fellow OSB Business Law Section Members:

Welcome to your newsletter! As you know, the Business Law Section is a big group and has attorneys in every corner of the state. The Executive Committee of the Business Law Section has been discussing ways to reach out to the diverse membership in ways that add value. One of the ways that we're experimenting with is this newsletter.

I am delighted to be part of the volunteer team (named on the side panel) that worked to bring this idea to fruition pretty quickly. We've had a series of regular, short phone calls to stay organized and put this first issue together. I know that I speak for everyone on the team when I say that we'd really appreciate your feedback on topics, presentation, or other ways that we can make this newsletter more responsive to your practice needs and interests (bearing in mind that it has to go out to over a thousand other attorneys, who likely have different needs!). Also, if you'd like to volunteer to write, edit, or serve on the committee, please let us know! The time commitment is minimal and it's a really nice group of people to work with.

Very Truly –

Valerie Sasaki

Editor in Chief

IN THIS ISSUE

Some Things to Consider When Dealing With Cannabis Industry Related Clients

By: Timothy B. Crippen, Black Helterline LLP

In 2014, Oregon voters passed Measure 91, which resulted in the legalization of recreational use of marijuana in Oregon.[1] Since Measure 91's passage, the retail marijuana industry in Oregon has taken off and has been a success, at least as measured by the tax revenues it has already generated. On April 20, 2016 the Oregonian reported that Oregon collected $6.84 million in tax revenues in just the first two months of 2016.[2] Even business lawyers who do not focus on serving clients in this new industry may, in their practice, encounter some of the unique aspects of the cannabis industry. Cannabis industry related clients can be divided into growers, extractors, manufacturers of edibles, and retailers. Clients may have expertise in any of these areas or may simply be investors with limited experience in the industry. Other clients may tangentially get involved with cannabis related businesses, including as landlords, lenders, and suppliers, among others.

The following are some of the considerations that Oregon business lawyers should take into account when representing clients involved in the cannabis industry.

Lawyer's Ethical Obligations. Oregon Rule of Professional Conduct 1.2(c) states that "a lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is illegal or fraudulent."[3] Based on this rule alone, it would appear that Oregon lawyers cannot represent clients in cannabis industry related matters because of applicable federal law. In 2015, however, in the wake of passage of Measure 91, the Oregon Supreme Court adopted Oregon Rule of Professional Conduct 1.2(d), which provides that "[n] otwithstanding paragraph (c), a lawyer may counsel and assist a client regarding Oregon's marijuana-related laws. In the event Oregon law conflicts with federal or tribal law, the lawyer shall also advise the client regarding related federal and tribal law and policy."[4] As a result of the adoption Oregon Rule of Professional Conduct 1.2(d), Oregon lawyers are now permitted to advise clients regarding Oregon's marijuana laws, provided they also advise their clients of related federal and tribal laws.

Tax Matters (IRC Section 280E). Section 280E of the Internal Revenue Code of 1986, as amended ("IRC"), disallows deductions and credits for business expenses if the business incurring the expenses is trafficking in controlled substances, which includes cannabis under federal law. Thus, employee salaries, rent, supplies and other typical business expenses that are deductible by most business might not be deductible fully, or at all, by businesses involved in the cannabis industry. For example, a bakery and a cannabis dispensary will have many similar expenses (e.g., employee salaries, rent, supplies), but each may have very different income tax results as a result of disallowing some or all of the cannabis dispensary's otherwise deductible expenses.

The language of IRC Section 280E provides as follows:

"No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted."[5] [Emphasis added.]

A 2007 United States Tax Court decision often referred to as "CHAMP" was an early example of the application of IRC Section 280E to the medical marijuana industry.[6] The Court in CHAMP held that IRC Section 280E precluded a taxpayer from deducting expenses attributable to providing medical marijuana to patients, but that the taxpayer's provision of care services to patients was a separate trade or business,

1 https://www.oregon.gov/olcc/marijuana/Documents/Measure91.pdf
2 http://www.oregonlive.com/marijuana/index.ssf/2016/04/oregon_collects_684_million_in.html
3 ORPC 1.2(c). Retrieved from https://www.osbar.org/_docs/rulesregs/orpc.pdf
4 ORPC 1.2(d). See also https://www.osbar.org/publications/bulletin/15apr/barcounsel.html.
5 26 U.S.C. § 280E.
6 *Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r,* 2007 U.S. Tax Ct. LEXIS 14, 128 T.C. 173, 128 T.C. No. 14 (T.C. 2007).

thus allowing the deduction of the expenses of the separate care related trade or business.[7] The taxpayer in CHAMP argued that supplying medical marijuana was not "trafficking," but the Court rejected this argument, finding that to traffic is "to engage in commercial activity: buy and sell regularly."[8]

The CHAMP decision can be contrasted with the more recent decision from the Ninth Circuit in *Olive v. Commissioner*[9], in which the taxpayer failed to establish that it had any trade or business other than trafficking in controlled substances. In *Olive*, the services offered by the taxpayer other than the sale of medical marijuana were all offered free of charge and therefore were not deemed to constitute a separate trade or business.[10] The Court in Olive also rejected the taxpayer's arguments that Congress' prohibition on using federal funds to prevent implementation of medical marijuana programs[11] precluded the government from pursuing its tax case.

Experienced CPAs and tax preparers will know what types of expenses of cannabis-related businesses can reasonably be characterized as costs of goods sold, rather than impermissible business deductions. But even with the help of an experienced CPA or tax preparer, cannabis businesses should expect to pay more taxes than most other businesses due to the application of IRC Section 280E.

Leasing to Cannabis-Related Businesses. Oregon landlords leasing to cannabis-related businesses need to consider a few issues. First, if the premises is subject to a trust deed securing a loan, the loan documents may prohibit use of the premises for illegal business activity. Indeed, recently drawn loan documents often specifically prohibit leasing to otherwise-legal cannabis-related businesses. As a result of these loan document prohibitions, sometimes Oregon landlords are unable to lease to cannabis related businesses.

Another concern for Oregon landlords relates to federal bankruptcy proceedings. If, for example, a landlord defaults under its loan, the landlord could have issues getting federal bankruptcy relief. In *In Re McGinnis*[12], the Bankruptcy Court in Oregon refused confirmation of a debtor's proposed reorganization under Chapter[13] when the reorganization was dependent upon revenue from medical marijuana operations.

Landlords should also consider several practical issues involved with cannabis businesses, including electricity needs and high temperatures for indoor grow operations, security needs, and county and city prohibitions and rules. Oregon landlords should also be aware that IRC Section 280E may impact their income tax results if they are leasing property to cannabis related businesses, for example, if a component of the rent comes from the tenant's revenues.

Employment Matters. Most businesses have (or should have) an employee handbook or other policies in effect prohibiting illegal conduct. A business operating in the cannabis industry may want to maintain such a broad prohibition against illegal conduct, but will need to modify the policy to permit conduct in furtherance of the cannabis-related business that may be federally illegal but permitted under Oregon's marijuana laws. Likewise, in employment contracts for other than at-will relationships, in the cannabis industry, the employer will want to define a "for cause" termination in a manner that will exclude conduct in furtherance of the cannabis-related business (although such conduct may be federally illegal).

On the other hand, businesses still may prohibit marijuana consumption on the job and prohibit employees from showing up to work with marijuana in their system. As a practical matter, THC, the active ingredient in marijuana, remains in the blood stream for days or weeks after consumption. Drug testing an employee to find out if he or she is under the influence at work may end up catching an employee who previously used marijuana during the past month. Nevertheless, the Oregon Supreme Court ruled in 2010 that an employer may still discipline or terminate a medical marijuana user and that an employer need not accommodate an employee's use of medical marijuana, even when there was no evidence he or she had appeared at work impaired.[13]

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7 *Californians Helping*, 2007 U.S. Tax Ct. LEXIS 14, 18.

8 *Id.* at 18.

9 *Olive v. Comm'r,* 792 F.3d 1146, 2015 U.S. App. LEXIS 11812 (9th Cir. 2015).

10 *Olive,* 792 F.3d 1146 at 1149.

11 Section 538 of the Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, 128 Stat. 2130.

12 See *In re McGinnis,* 453 B.R. 770, 2011 Bankr. LEXIS 2288 (Bankr. D. Or. 2011).

13 *Emerald Steel Fabricators, Inc. v. Bureau of Labor & Indus.*, 348 Ore. 159, 230 P.3d 518 (Or. 2010).

Federal Enforcement Matters. As most people know by now, marijuana remains an illegal drug under the Federal Controlled Substances Act.[14] On August 29, 2013, James M. Cole, the Deputy Attorney General for the U.S. Department of Justice issued a Memorandum for All United States Attorneys (the "Cole Memorandum"). [15] The Cole Memorandum provides guidance on the enforcement priorities of the U.S. Department of Justice with regard to cannabis, and in general, provides that in states with robust regulatory systems with regard to medical and recreational use of cannabis, federal enforcement will not be a priority. More recently, a federal appropriations bill[16] prohibited federal funds from being used to prevent specified states (including Oregon, California, and Washington) from implementing state laws authorizing the use, distribution, possession, or cultivation of medical marijuana.

Other Issues. For clients interested in starting a cannabis business, a few other practical issues are worth examination. First, not all of Oregon has welcomed cannabis producers, processors, wholesalers, or retailers. The OLCC maintains a list of the numerous Oregon cities and counties that have chosen to limit cannabis activity and their various local prohibitions.[17] Second, the business should seek the appropriate license through the OLCC.[18] Third, banking remains an issue. The Financial Crimes Enforcement Network (FinCEN), part of the U.S. Treasury Department, has issued guidelines on how a bank might reasonably comply with its obligations to report illegal activity.[19] Most traditional commercial lenders have not yet found it worthwhile to operate in this space, but some credit unions are filling the void. Finally, once the business is operating and sales are occurring, the operator should work with an attorney or tax advisor familiar with Oregon's sales tax regime for cannabis to ensure the business stays in compliance with its Oregon tax obligations.

An Oregon Lawyer's Guide to New 2016 Washington Business Law

By: Amy E. Geerhart, Sussman Shank LLP

Washington adopted meaningful changes to its business laws effective January 1, 2016, substantially modifying legal requirements for Washington limited liability companies and filing obligations for all forms of business entities. These changes were codified in the revised Washington Limited Liability Company Act (the "Revised Act") and in changes to the Uniform Business Organizations Code, which changes are referred to by the bill name that carried them into law ("Hub Bill").

Oregon lawyers who represent Washington business entities or negotiate transactions with Washington business entities should pay special attention to and be aware of the Revised Act and the Hub Bill. While some of these changes make the Revised Act more similar to the Oregon Limited Liability Company Act (the "Oregon Act"), others are quite different and should be considered with such transactions.

Revised Washington Limited Liability Company Act

Voting Scheme

One of the more notable changes in the Revised Act changes the default rules regarding voting rights of members. Under the prior LLC Act, as is the case with most other types of entities, member votes are based on the percentage of ownership, meaning that a member owning, for example, 60 percent of the ownership interests can always out-vote a member owning the remaining 40 percent. Under the Revised Act, each member gets one vote (per capita), unless the limited liability company agreement states otherwise. RCW 25.15.121. This means a majority owner can be out-voted by minority owners. Members

14 See *Californians Helping,* 2007 U.S. Tax Ct. LEXIS 14-15.

15 *https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf.*

16 Section 538 of the Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, 128 Stat. 2130. Available on LEXIS or at https://www.congress.gov/113/plaws/publ235/PLAW-113publ235.pdf.

17 https://www.oregon.gov/olcc/marijuana/Documents/Cities_Counties_RMJOptOut.pdf.

18 https://www.oregon.gov/olcc/marijuana/Pages/Recreational-Marijuana-Licensing.aspx.

19 https://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-G001.pdf.

may opt out of this default voting scheme by defining alternate voting rights under an LLC Operating Agreement. This distinction may become quite important for those members that fail to timely adopt an LLC Operating Agreement and find themselves with much less control than they originally anticipated.

This new voting scheme in Washington is now very similar to the Oregon Limited Liability Act (the "Oregon Act") provision regarding the same. Oregon Revised Statute (ORS) 63.130(1) provides that in a member-managed LLC, each member is entitled to equal voting rights, meaning one vote for each member. In Oregon, as in Washington, the LLC Operating Agreement may override the default rule and provide voting rights according to ownership interest percentages.

LLC Operating Agreements

Previously, all LLCs were required to adopt a written agreement to govern the operation of the LLC, including but not limited to providing for the voting rights of the members, the duties of the members or managers, the transfer of ownership interests, distributions, and the liquidation or winding up of the LLC. It is critical to document these rights, obligations, and restrictions in order to minimize the potential for disputes between members and managers. Under the Revised Act, as a default rule, the limited liability company agreement and any amendment to the agreement may be oral instead of written. RCW 25.15.06(7). Although this new provision permits more flexibility, it raises concerns that people may enter into and change binding terms of operation with a mere conversation, which could create misunderstandings, ambiguities, and costly disputes among members. The Revised Act allows all members to prohibit such oral agreements by entering into a written operating agreement that requires that all amendments be in writing.

The new Washington rule regarding oral agreements is now more similar to the Oregon Act statute that also permits oral agreements and specifically does not require any express operating agreement. ORS 63.057 provides that: "The operating agreement, if any, may provide for the regulation and management of the affairs of the limited liability company in any manner not inconsistent with law or the articles of organization and may be in writing or oral." In Oregon (as in Washington), a written Operating Agreement that requires written amendments reduces potential disagreements and uncertainty between the members.

Fiduciary Duties of Managers

Washington LLCs historically relied on the courts to delineate the fiduciary duties of managers, as they were not specifically described under the statute. Such case law can create inconsistent or incomplete guidance. These fiduciary duties are now defined under the Revised Act, which allows most duties to be expanded or limited in the LLC's operating agreement.

Under the Revised Act, managers owe a limited duty of loyalty to the LLC and to any other managers. Managers must: (i) report and hold on behalf of the LLC any benefits derived from use of the LLC's property or from appropriating a company opportunity while the LLC is operating or winding up its affairs, (ii) not compete with the LLC, and (iii) not engage in transactions with the LLC where the manager has a conflict of interest. Managers owe a duty of care, which generally will be violated by a manager who is grossly negligent or reckless, who intentionally operates against the LLC's best interests, or who knowingly violates the law in operating the LLC or winding up its affairs. RCW 25.15.038.

In Oregon, a manager's duties are substantially similar and are described in detail in ORS 63.155. In both Oregon and Washington, certain duties may be waived in the Articles of Organization or Operating Agreement.

Allocations of Profits and Losses

The Revised Act contemplates more flexibility in regard to the allocation of profits and losses. While the prior Washington LLC Act required that allocations of distributions, profits and losses be made in proportion to the agreed-upon value of those members' contributions. The Revised Act now provides that allocations of distributions may be made in any manner provided in the limited liability company agreement, and if such Agreement is silent, then allocations of distributions must be made based upon contributions. RCW 25.15.206. The Revised Act is silent as to the allocation of profits and losses. Practically, federal and state tax law, accounting and regulatory requirements govern the proper allocations of profits and losses.

The Oregon Act is notably different from the prior Washington LLC Act and the Revised Act. ORS 63.185, as expected permits the Operating Agreement or Articles of Organization to provide for allocation of profits or losses in any manner. If neither document specifies, then the default rule requires that all profits and losses be allocated equally among the members. If only one of the profits or losses are allocated in the Operating Agreement or Articles of Organization, then the other shall be deemed allocated in the same proportion as the one specified. The statute does not provide for allocations based upon contributions as one might expect. As in Washington, it is critical that members agree to such allocations in the Operating Agreement or Articles of Organization in order to minimize later disagreements regarding such allocations.

Boards as Managers

The Revised Act now specifically authorizes that an LLC may be managed by a board, committee or other group of persons. RCW 25.15.154. Each member of such board, committee or group "(i) is designated, appointed, elected, removed or replaced by a vote, approval, or consent of a majority of the members; (ii) need not be a member of the limited liability company or a natural person; and (iii) unless the [board member] has been earlier removed or has earlier resigned, holds office until a successor has been elected." RCW 25.15.154(1)(b). Each board member has the fiduciary duties discussed above as provided in the Revised Act.

While the Oregon Act does not specifically provide for management by a board, committee or other group, it does not prohibit management by multiple managers, who may be natural persons or entities, and need not be members. See ORS 63.130. As such, the Operating Agreement may describe such members as a board, committee or other group, so long as the responsibilities and rights otherwise comply with the Oregon Act.

Records Requests

The Revised Act provides additional rights of members to inspect the LLC's records. The rights reflect the two-tiered method found in the Washington Business Corporations Act. RCW 25.15.136 requires the LLC to retain the following records for member inspection: (a) a copy of its certificate of formation, (b) a copy of the LLC operating agreement (if any), (c) a statement of record of the members' contributions, additional contribution requirements, rights to distributions, and events triggering dissolution, (d) the LLC's federal, state and local tax returns for the three most recent years, (e) financial statements for the three most recent years, (f) a record of member consents, (g) the three most recent annual reports, (h) articles of conversion or merger (if any), and (i) articles of dissolution or revocation (if any). A member may inspect such records upon ten days' notice, during regular business hours. With a proper purpose and a 10-day advance demand, a member also has rights to (a) a current and past list of each member and manager, (b) excerpts from meetings of managers, (c) and accounting records.

Notably, the records inspection rights in the Revised Act are more expansive than the records available to members under the Oregon Act. Specifically, Oregon members are entitled to (a) a list of the addresses of members and managers, (b) a copy of articles of organization, and amendments (if any), (c) copies of the LLC's federal, state and local tax returns for the three most recent years, and (d) a copy of any operating agreement. Oregon members, however, are not entitled to excerpts from meetings of managers and accounting records. ORS 63.771; ORS 63.777.

The Hub Bill

The Hub Bill focused on consolidating certain legal requirements in order to clarify that the same requirements apply to each form of business entity. The changes generally address filing obligations with the Washington Secretary of the State and do not affect the day-to-day operations of Washington entities or foreign entities registered to do business in Washington. More information is available at the website of the Washington Secretary of State and currently can be found at http://www.sos.wa.gov/corps/CLE-Resources.aspx.

General Filing Requirements

Some filing requirements were streamlined with the creation of a single form that can be used by any type of entity. In the future, such forms should simplify the filing process by reducing the time necessary to identify the appropriate forms. In addition, the Washington Secretary of State introduced several new forms.

One such new form is a Statement of Withdrawal of Filed Record Before Effective, which (as the name suggests) permits a business to withdraw a filed form entirely so long as the effective date has not yet passed. For example, John has two operating companies, each in a separate corporation. John decides to merge the companies effective as of January 1, 2017. John's lawyer will likely file the Articles of Merger in the fall of 2016, stating an effective date of January 1, 2017. Normally, once the Articles of Merger is filed, the matter is final. However, with the recent changes to the Hub Bill, if John determines that he does not wish to merge his companies for any number of reasons, this form can be filed in advance of that effective date, and the transaction will not take effect.

Another helpful form that is now available is the Statement of Correction, which permits a business to rectify an inaccurate statement or defect in execution in a previously filed record. Say, for example, that John filed Articles of Merger only to later realize that the number of shares, the number of shareholders, or the listed officers is incorrect. With the newly available Statement of Correction form, such an error can be easily fixed instead of going through a more arduous process as required in the past.

Foreign Business Entities

If a business is organized or incorporated in a state other than Washington, but conducts business in Washington, it likely filed a Certificate of Authority authorizing it to do business in Washington. Per the Hub Bill, a business no longer files a Certificate of Authority but now completes and files a Foreign Registration Statement. This single form may be used for any form of entity. The Hub Bill also provides for the transfer of a foreign registration. For example, John's companies are Oregon corporations, and only one has a Foreign Registration Statement. This new form permits the registered corporation to transfer the foreign registration to the surviving corporation.

Administrative Dissolution and Reinstatement

The Hub Bill also modifies the grounds, procedures, and effect of administrative dissolution, as well as the reinstatement process. The State may administratively dissolve an entity for failure to pay a fee or penalty to the Secretary of State when due, for failure to deliver an annual report within 120 days after it is due, failure to name a registered agent for a period of 30 consecutive days, or if an entity was formed for a limited duration rather than for perpetual existence. Entities that are administratively dissolved for less than 5 years may file a reinstatement. The grounds and processes regarding administrative dissolution and reinstatement were not substantially changed. Instead, the Hub Bill makes clear that these processes apply to all forms of business entities, including LLCs, corporations, nonprofits, and limited partnerships.

Additionally, an entity may be administratively dissolved or terminated if the name of the entity is not distinguishable from the name of a governmental entity. Any county, city, town, district, or other political subdivision of the state, or any agency thereof, may apply to the Secretary of State for such dissolution if it deems the company name indistinguishable. When selecting the name of an entity, lawyers should advise clients to be cautious if the name of a city or county is included in the proposed entity name.

The changes above are only some of the modifications in Washington business law that became effective as of January 1, 2016. Oregon lawyers should be aware of these changes, and particularly consider the default rules under the Revised Act when advising or negotiating with Washington entities.

New Federal Legislation: Defend Trade Secrets Act of 2016

By: Berit L. Everhart, Associate with Arnold Gallagher, P.C.

On May 11, 2016, President Obama signed into law the Defend Trade Secrets Act of 2016 (DTSA), Pub. L. No. 114-153, bipartisan legislation passed by Congress in April of 2016. Described as the "most significant expansion of federal law in intellectual property since the Lanham Act in 1946,"[1] the DTSA creates a federal cause of action for misappropriation of trade secrets.

Prior to the enactment of DTSA, civil actions for misappropriation of trade secrets were primarily a matter of state law. Forty-eight states, including Oregon, have enacted some version of the Uniform Trade Secrets Act (UTSA), O.R.S. § 646.461 *et seq.*, which provides a state framework for trade secret misappropriation claims. Responding in part to concerns about non-uniform protection for trade secrets, Congress passed the DTSA to open the federal courts to civil misappropriation of trade secret litigation. The DTSA provides for remedies that include injunctive relief, compensatory damages (including awards based on unjust enrichment), exemplary damages (not to exceed twice the amount of the actual damages awarded), and attorneys' fees. 18 U.S.C. § 1836(b)(2).

Based largely on the UTSA, the DTSA seeks to create a uniform federal framework for trade secrets misappropriation litigation. For example, the DTSA preserves the three-year statute of limitations present in the UTSA and Oregon's enactment thereof, O.R.S. § 646.471, and authorizes remedies similar to those available under state law. 18 U.S.C. § 1836(b)(3).

The DTSA has several key provisions that depart from the UTSA, including *ex parte* civil seizure provisions that have been some of the most widely discussed aspects of the new law. 18 U.S.C. § 1836(b)(2). The DTSA permits a court to issue an order providing for the seizure of property "necessary to prevent the propagation or dissemination of the trade secret that is the subject of the action" based on an *ex parte* application. 18 U.S.C. § 1836(b)(2)(A)(i). Under the terms of the DTSA, a court may not grant a seizure order unless certain requirements are satisfied. Further, the seizure provisions are available only in the case of "extraordinary circumstances" and provide damages to victims of wrongful seizures. *Id.* So while a seizure order would provide powerful protection for trade secret owners, the feasibility of obtaining one remains in question.

The DTSA also contains whistleblower immunity provisions that provide civil and criminal immunity for employees who disclose trade secrets to the government or an attorney solely for the purpose of reporting or investigating a suspected violation of law or who disclose trade secrets in a court filing if such filing is made under seal. 18 U.S.C. § 1833(b). Of particular practical significance to employers, the DTSA requires employers to provide notice of the whistleblower immunity in any agreement entered into with an employee that governs the use of trade secrets. 18 U.S.C. § 1833(b)(3). The notice may be provided in the agreement itself or the agreement may reference a whistleblower policy that contains the required notice. Failure to provide the required notice will prohibit employers from accessing the full scope of remedies available under the DTSA if the employee misappropriates a trade secret, including exemplary damages (up to twice the amount of actual damages) and attorneys' fees in the case of willful or malicious violations. The notice requirements apply to all agreements entered into or updated after the date of enactment of the DTSA, May 11, 2016.Therefore, employers should consider updating their employment policies and agreements to notify employees of the whistleblower immunity to preserve the remedies available to them under the DTSA.

The DTSA expressly provides that it does not preempt state law and, therefore, does not replace the Oregon Uniform Trade Secret Act; companies may continue to file misappropriation of trade secret claims in state court under the Oregon Uniform Trade Secrets Act. Instead, DTSA provides companies with a separate federal litigation option. As a result plaintiffs instituting trade secret litigation must now determine whether the federal or state forum provides the more beneficial path forward.

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1 Gershman, Jacob. "Congress May be About to Shake Up Trade Secret Law: Is That a Good Thing?" Wall Street Journal, April 27, 2016.

Deja Fraud All Over Again

By: Wendy Beth Oliver, Policy and Compliance Advisors, LLC

Last year a northwest law firm narrowly avoided a loss of nearly $300,000. The firm had received a cashier's check from a new client and at the client's request, wired most of the funds to a foreign bank. The law firm was a good customer of its bank and although the check had not cleared, the customer requested immediate availability of the deposit and the bank consented to wiring the funds. When it turned out the check was a fake and the bank debited the firm's account, the firm requested that the bank get the wire returned. Fortunately there had been a mistake in the wire information and the bank was actually able to recover the funds. It could have had a very different outcome. Generally once a wire is sent, the funds are not recoverable. Although the law firm blamed the bank, the bank had the legal right to charge back the firm's account for the returned check.

There have been myriad articles and bulletins warning attorneys of fraudulent check schemes. During 2008 through 2010, three articles on this topic were published in the *Oregon State Bar Bulletin* alone, and several other state bar associations, as well as the American Bar Association, have published articles, bulletins, and even ethics opinions on the topic.[1]

Yet despite the warnings, attorneys still fall prey to this fraud. In a 2012 *Wall Street Journal* article, U.S. Postal Inspector Louis Di Rienzo was quoted estimating that law firms had lost at least $70 million through these scams since 2009, when he first began investigating this fraud.[2]

How These Scams Work

The typical scam has many of these characteristics:

- An attorney receives what appears to be a legitimate solicitation email from a prospective client, often based in another country or state, and often requesting assistance with a collection matter.
- After checking the legitimacy of the company on the Internet, the attorney responds and terms are negotiated, including a retainer.
- The new client contacts the attorney to say that the threat of litigation has caused the debtor to suddenly agree to pay up.
- The attorney receives a seemingly valid domestic cashier's check from a known bank as settlement and deposits the check into the client trust account. The attorney believes that cashier's checks are always good funds and the attorney's bank make the funds available before the check has actually cleared.
- The client requests an immediate payment of the settlement funds by wire transfer to a foreign account and approves the retainer or fees to be deducted from the funds and paid from the trust account.
- The attorney retains the fee and wires the balance to the foreign bank account.
- After the funds are wired, the cashier's check is returned unpaid as a counterfeit check.[3]

The attorney's bank debits the attorney's client account for the entire amount of the counterfeit check. When the bank contacts the foreign bank the scammer has already withdrawn the funds. Often the attorney's client account is now overdrawn.

There are also variations of this scenario. These include an out-of-country or out-of-state client seeking to collect a judgment from a divorce where the client purports to have an ex-spouse who has moved to the attorney's jurisdiction and the scammer claiming to be an out-of-state law firm that is representing a foreign client.

Available, Cleared and Returned Checks

One reason that attorneys may fall victim is that they do not understand the difference between funds being available and funds clearing. The availability of funds after deposit into a bank account is governed by Regulation CC,[4] which implemented the Expedited Funds Availability Act (EFAA).[5] The EFAA was intended to standardize the hold time periods that banks placed on deposits. Under Regulation CC a financial institution is required to make funds from a cashier's check available to withdraw the next business day following deposit. The funds for other checks must be available for withdrawal by the second business day following deposit. There are exceptions, including for large deposits above $5,000. In those cases, the first $5,000 must be available within the expedited time frame and the amount above $5,000 within a reasonable time.

But having funds available to withdraw does not mean that the paying bank (the bank on which the check is drawn), has actually transferred funds to the depositary bank (the bank where the check was deposited). Although most checks are now processed electronically, and the clearing times can be as short as a day or two, it can be longer, especially if the check is from outside the country. A depositor who is told that funds are available may assume that the funds have cleared and not be aware of the risk that the check will be returned.

In addition, a check may initially appear to clear because it was processed electronically but following review is returned either by the paying bank because it discovers a discrepancy or error (e.g., an incorrect account number or lack of endorsement) or by the account holder on which the check is drawn. Regulation CC requires expeditious returns of checks by banks (within two business days of presentment) but an account holder can have 30-60 days to claim a forgery. A check that has cleared may still be subject to return.[6]

Liability of the Depositary Bank

When a check is returned, the bank will debit the account of the customer who deposited it. Fraud victims often assert negligence on the bank's part in failing to identify and prevent the fraud as a defense to having the check charged back to their account. The customer may claim that the bank failed to exercise "ordinary care" in evaluating the authenticity of the check, or failed to follow appropriate banking procedures, and therefore the bank is liable for the amount of the counterfeit check. Unfortunately for the victims, this defense is generally unsuccessful if the counterfeit instrument is indistinguishable from a genuine check, because reasonable bank tellers cannot be held to a specialized expertise standard to be able to detect and vet counterfeit checking instruments. There is typically no duty imposed upon a bank to warn the victims of the possibility that the fraudulent checks may be a scam.[7]

Malpractice Insurance Coverage

Attorneys should not rely on malpractice insurance to cover losses from these scams or to reimburse clients. Claims by a bank or fraud victim (e.g., attorney) arising from the scam are generally denied by malpractice insurers based on the argument that the claim does not arise from professional services or that the disgorgement or reimbursement claims do not represent damages as typically defined in the policies.

Ethical Implications of These Scams

The effect of these scams can also have ethical implications for attorneys. If the return of the counterfeit check results in an overdrawn client trust account, the attorney's bank is obligated to notify the Oregon State Bar disciplinary counsel's office. *See* Oregon Rules of Professional Conduct ("RPC") 1.15-2(i) and (ii). Overdrafts are subject to investigation and the attorney may be subject to disciplinary action based on a failure to safeguard client funds.

The New York City Bar Association issued an ethics opinion in 2015 ruling that a lawyer who receives a request for representation via the Internet has a duty to conduct a reasonable investigation to ascertain whether the person is a legitimate prospective client before accepting the representation and that a lawyer who discovers he or she has been defrauded in a manner that results in harm to other clients must promptly notify the harmed clients.[8]

Attorneys may be concerned as to whether reporting the crime to law enforcement breaches a client confidentiality. Attorneys in Oregon may report the crime. In 2010, Helen Hierschbiel, Oregon State Bar deputy general counsel wrote:

[T]he duty imposed by RPC 1.6 and ORS 9.460(3) applies only to actual or prospective clients. If the person contacting the lawyer has no real intention of creating a lawyer-client relationship, but is only interested in victimizing the lawyer, then the person is not an actual client and the duty of confidentiality does not apply. In the absence of such a duty, there would seem to be no reason why lawyers who are the targets of these scams could not cooperate with law enforcement authorities in sharing whatever information they have about the perpetrator of the fraudulent scheme. Before doing so, however, lawyers should take care to ensure that they are, in fact, dealing with a scam.[9]

Protecting Yourself and Your Firm from Scams

Exercise caution when receiving unsolicited e-mails from foreign countries or another state. Scam artists often use the names of actual companies; attorneys and banks should independently verify the names and contact information provided to them. A red flag is a potential client who is reluctant to provide contact information other than an e-mail address or phone number. You can research scams at websites that track Internet scams. These websites include: http://www.scamwarners.com and http://lawyerscam.blogspot.com (this has not been updated since 2014, but offers several examples of email scams).

You can also inspect the check to determine if it is a fake. The amount of the check should match in both figures and words. The bottom of a real check has a series of digits in a distinct font known as MICR (magnetic ink character recognition). The digits represent the bank routing number, account number, and check number, usually in that order. Real magnetic ink will appear dull. Counterfeit checks often have shiny MICR numbers. There should be a check number in the upper right-hand corner and the check number should match the check number in the MICR line. Examine the signature to see if has stains or gaps, is digitized in appearance, or has many up and down pen strokes that would indicate is was printed from a scanned original or was forged. You can also obtain the phone number for the bank that appears on the check from an independent source and then contact the bank to make sure the check is legitimate.[10]

Conclusion

One of the best ways to avoid losses, both to the attorney and the attorney's clients, is to exercise caution in choosing clients and accepting to represent them. In addition, take the recommendation of bar counsel and wait to disburse funds until the paying bank clears the check. Firms should have procedures in place to ensure that they have adequate waiting periods before disbursing funds from client trust accounts.[11]

(Endnotes)

1 *See* Helen Hierschbiel, Bar Counsel: *Scammers Take Aim at Lawyers: How to Avoid Becoming the Next Victim*, *Oregon State Bar Bulletin* (May 2010), available at *https://www.osbar.org/publications/bulletin/10may/barcounsel.html*, which also references OSB Bulletin articles in 2008 and 2009. *See also* Todd C. Scott, *Scammed! Sophisticated Check Fraud Schemes Target Lawyers*, *Law Trends & News Practice Area Newsletter* (Fall 2010), American Bar Association, General Practice, Solo and Small Firm Division, available at *http://www.americanbar.org/newsletter/publications/law_trends_news_practice_area_e_newsletter_home/10_fall_pm_feat1.html*; Jim Calloway, *Preventing Check Fraud-Why 'The Check is in the Mail' Isn't Always a Good Thing*, *Law Practice* (July/August 2010), American Bar Association, available at *http://www.americanbar.org/publications/law_practice_home/law_practice_archive/lpm_magazine_articles_v36_is4_pg38.html*; Ask the Auditor: *Check Fraud Scams*, *Washington State Bar News* (May 2010); California State Bar, *Internet Scams Targeting Attorneys Ethics Hotliner* (January 2011), referencing an article from 2008; *Counterfeit check scams continue to target law firms*, *California Bar Journal* (January 2012), available at *http://www.calbarjournal.com/January2012/TopHeadlines/TH6.aspx*; and Rick DeBruhl, *Fake Check Scams Continue to Target Lawyers*, *State Bar of Arizona News Release* (May 28, 2013), available at *http://www.azbar.org/newsevents/newsreleases/2013/05/fakecheckscamscontinuetotargetlawyers/*.

2 Jennifer Smith, *In Email, Scammers Take Aim At Lawyers*, *Wall St. J.,* Aug. 5. 2012, available at *http://www.wsj.com/articles/SB10000872396390443517104577571453933076304*.

3 The scammers are known to change the nine-digit MICR (magnetic ink character recognition) lines at the bottom of the check. The cashier's check will show a bona fide domestic bank, but the code recognizes the check as originating from another institution, which slows down confirmation of whether the check is valid.

4 12 CFR Part 229.

5 The Expedited Funds Availability Act was originally passed in 1987 and amended in 2011 by the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) of 2010.

6 For more information about check processing and clearing, *see* Office of the Comptroller of the Currency, *Guidance to National Banks Concerning Schemes Involving Fraudulent Cashier's Checks*, *OCC Bulletin* 2007-2, available at *http://www.occ.gov/news-issuances/bulletins/2007/bulletin-2007-2.html*. Note that the reference to nonlocal checks does not apply because there are no longer separate regions for processing.

7 *See SunTrust Banks, Inc. v. Cauthon & McGuigan, PLC*, 78 So. 3d 709, 711 (Fla. 1st DCA 2012) (finding that bank had a right to issue a charge back in Nigerian check scam pursuant to both Florida statutes section 674.2141 and bank's customer agreement); *see also Fisher & Mandell, LLP v. Citibank, N.A.*, 632 F.3d 793, 799-800 (2d Cir. 2011) (granting summary judgment for bank after plaintiff withdrew "available" funds and bank later issued a charge-back on the account after discovering check was fraudulent); *Chase v. Morgan Guarantee Trust Co.*, 590 F. Supp. 1137, 1139 (S.D.N.Y. 1984) (granting motion for summary judgment for bank and noting that it is clear law that provisional credits are subject to charge-back); *Bank One, N.A. v. Dunn*, 927 So. 2d 645, 649 (La. Ct. App. 2006) (discussing Nigerian scam and upholding summary judgment for bank after issuing a charge-back, noting that "Bank One owed no duty to protect [defendant] from his notably poor judgment."); *JP Morgan Chase Bank, N.A. v. Cohen*, 2009 NY Slip Op 52725(U) (N.Y. Sup. Ct. Dec. 31, 2009) (dismissing defendant's defense that bank had acted in bad faith after finding that bank was not negligent when employee stated to customer that the checks had "cleared" but were later found fraudulent and bank issued charge-back); *Call v. Ellenville Nat. Bank*, 774 N.Y.S.2d 76, 78 (N.Y. App. Div. 2004) (finding that until final settlement is made upon check, the depositor bears the risk that the check may be fraudulent, and until such final settlement is made bank may issue a call back of provisional funds); *Bank of New York v. Reichin*, 607 N.Y.S.2d 475, 792 (N.Y. App. Div. 1994) (holding that partial summary judgment for bank was proper because any provisional settlement on account is subject to being revoked if bank never receives final settlement for the check).

8 The Association of the Bar of the City of New York, Committee on Professional Ethics, Formal Opinion 2015-3: *Lawyers Who Fall Victim to Internet Scams*, available at *http://www.nycbar.org/member-and-career-services/committees/reports-listing/reports/detail/formal-opinion-2015-3-lawyers-who-fall-victim-to-internet-scams*.

9 Hierschbiel, *supra* note 1.

10 *See* Sid Kirchheimer, *Fake Checks How to spot them in your mailbox*, *AARP Bulletin*, May 1, 2011, available at *http://www.aarp.org/money/scams-fraud/info-04-2011/scam-alert-fake-checks.html*.

11 Hierschbiel, *supra* note 1.