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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Vanguard: A Cautionary Tale For Whistleblowers

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Brian Kittle


Geoff Collins


Jeffrey Reed

On Nov. 13, 2015, the New York Supreme Court dismissed a False Claims Act suit filed by David Danon, a former Vanguard Group tax attorney, against his former employer, alleging it underpaid its New York taxes. The court dismissed his suit because he violated his ethical obligations to his former client, and it disqualified both Danon and his counsel from bringing another action. It did not, however, rule on the merits or preclude the government from taking the case.

Vanguard offers lessons on the stakes in whistleblower cases and the importance of taking preventative measures ahead of time. Although Vanguard successfully defeated Danon's claims, many of its confidential documents have been turned over to the IRS, to the U.S. Securities and Exchange Commission, and to other state taxing authorities. And the case did nothing to prevent any of those agencies from bringing claims.

Background — False Claims Act and Attorney Ethical Rules

The Vanguard case involves the meeting of two bodies of law, the False Claims Act and attorney professional conduct rules.

The Federal False Claims Act (31 U.S. §§3729–3733) imposes civil liabilities for making "false claims" against the federal government. The act imposes treble damages and allows for compensation to qui tam relators, who bring actions on the government's behalf (the deductibility of False Claims Act payments is discussed further here).[1] Importantly, however, the federal statute does not apply to tax claims.[2]

Like many states, New York has its own version of the False Claims Act.[3] In many ways, the New York

version is identical to the federal: it imposes civil liability for false claims, it imposes treble damages and it allows qui tam actions by relators. But it has at least one extremely important difference. A 2010 amendment allows relators to bring tax claims.

When a qui tam relator is an attorney, a state's attorney professional conduct rules may come into play. These rules impose important restrictions on attorneys' use of client information. For example, ABA Model Rule 1.6(a)[4] commands that an attorney "shall not reveal information relating to the representation of a client ...." Similarly, Model Rule 1.9(c) prohibits disclosure of a former client's information. These prohibitions, however, are subject to several exceptions. One of those exceptions is the "crime-fraud" exception, which appears in Model Rule 1.6(b)(2), which permits a lawyer. The New York version of the crime-fraud exception[5] provides that a lawyer "may reveal or use confidential information to the extent that the lawyer reasonably believes necessary ... to prevent the client from committing a crime."

Case Discussion

In January 2013, Vanguard notified Danon that it would be terminating his employment later that year.[6] A short time later, he collected and took what he describes as "whistleblower documents" from Vanguard's files. He then gave those documents to the SEC, the Internal Revenue Service, and various state tax authorities. A few months later — while still working for Vanguard — he filed a sealed complaint under New York's False Claims Act. In it, he accused his client of "systematically" underpaying its state and federal tax liabilities by failing to pay an arm's-length price for investment services provided by a U.S. subsidiary.[7]

Vanguard moved to dismiss the complaint, arguing — among other things — that Danon violated his ethical duties by suing his client and disclosing its information. Danon argued that the "crime-fraud" exception to the confidentiality rules permitted his suit.

On Nov. 13, 2015, the trial court dismissed the complaint, agreeing with Vanguard that Danon violated his ethical duties. First, the court noted that the crime-fraud exception allows disclosure only "to the extent that the lawyer reasonably believes necessary." The court then held that New York interprets that limitation strictly, permitting disclosure "only when a client is planning to commit a crime in the future or is continuing an ongoing criminal scheme."[8] Next, assuming for the sake of argument that he reasonably believed Vanguard intended to commit a crime, the court found that Danon's suit was unnecessary because he had other options. Indeed, the court noted that he had actually took some of those options, providing information to the IRS, the SEC and state authorities before filing his complaint.[9] Accordingly, the crime-fraud exception did not apply.

In addition to dismissing the complaint, the court disqualified both Danon and his counsel from bringing another claim, adopting the Second Circuit's rule from United States v. Quest Diagnostics, 734 F.3d 154 (2d Cir. 2013). There, the Second Circuit concluded that the Federal False Claims Act did not preempt state attorney rules. Accordingly, it affirmed dismissing a complaint and disqualifying both the relator and its counsel from bringing another qui tam action because doing so was necessary to prevent the use of "unethical disclosures" of client information.

Lessons Learned and Best Practices

Most importantly, Vanguard shows that an ounce of prevention is better than a pound of cure. Yes, the court disqualified Danon and his counsel. But it did nothing to stop the SEC, the IRS or other states.

Indeed, Vanguard has already had to settle other claims, and Danon is receiving more than $100,000 for the information he provided to Texas authorities. Beyond that, Vanguard's documents and confidential information have been publicized, garnering significant negative publicity in the mainstream press.

Admittedly, Vanguard does a great deal to reinforce attorney-client relationships by recognizing the importance of duties of loyalty and confidentiality. But it is limited to the attorney rules, and courts play a unique role in policing those rules. Accordingly, while rules governing accountants protect confidential information as well,[10] it is not a foregone conclusion that the court would have reached the same decision were the relator a former in-house accountant, to say nothing of other unlicensed professional employees.

So What to Do?

- ***Soft Measures.*** Taxpayers should consider so-called "soft measures" for prevention. For example, taxpayers should review their systems for allowing employees to voice concerns and for addressing those concerns. In doing so, taxpayers should evaluate the resources available for addressing employee-raised concerns, including the possible use of internal audit resources in appropriate situations. In addition, solid human resource practices, such as conducting high-quality exit interviews can provide an additional opportunity to address issues.

- ***Information Protection.*** Taxpayers should also review their data security and information-sharing polices. In Vanguard, Danon took the confidential documents at issue after the company notified him that they were letting him go.

- ***Diligence.*** Finally, taxpayers should — in all cases — be mindful of how they handle potential whistleblowers. State and federal law provide a number of protections to whistleblowers, and taxpayers should always consult with counsel when issues arise.

—By Brian Kittle, Geoff Collins and Jeffrey Reed, Mayer Brown LLP

Brian Kittle is a co-leader of Mayer Brown's Tax Controversy & Transfer Pricing practice and a partner in New York.

Geoff Collins is an associate in Mayer Brown's Chicago office.

Jeffrey Reed is an associate in the firm's New York office.

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[1] See 31 U.S.C. § 3729(a) (treble damages); and 31 U.S.C. § 3730(b) (qui tam provisions).

[2] See 31 U.S.C. § 3729(e).

[3] See New York Finance Law §§ 187–94.

[4] New York has adopted Rules of Professional Conduct based on the ABA Model Rules.

[5] Note that the New York rule differs from ABA Model Rule 1.6, which allows a lawyer "to reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary ... to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interest or property of another and in furtherance of which the client has used or is using the lawyer's services."

[6] Danon alleges that the termination was in retaliation for his "persistent and vocal questioning" of Vanguard's tax practices.

[7] The following year, the New York attorney general declined to participate, and Danon filed notice of his intent to proceed on his own.

[8] In doing so, the court quoted NYC Eth. Op. 2002-1, which applied the previous New York rules, in effect prior to New York's 2009 adoption of rules based on the ABA Model Rules.

[9] The court also noted that Danon disclosed information to which the exception could not apply because the information related only to prior years.

[10] See, e.g., AICPA Code of Professional Conduct, at § 1.700.001.01 "A member in public practice shall not disclose any confidential client information without the specific consent of the client."

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