

Ninth Circuit Holds Lawyer Has Duty to Investigate Source of Legal Fees to Avoid Constructive Trust

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F.T.C. v. Network Services Depot, Inc., ___ F.3d ___, 2010 WL 3211724 (9th Cir. 2010)

Brief Summary

The U.S. Court of Appeals for the Ninth Circuit ordered a defense attorney to return a portion of his client's flat fee payment because the lawyer had failed to thoroughly investigate whether the payment was derived from a fraudulent financial scheme. The court held that this duty was triggered by the allegations of the Federal Trade Commission (FTC) which indicated that the client may have fraudulently obtained the funds eventually used to pay the attorney's fee.

Complete Summary

During the FTC's investigation of an apparent Ponzi scheme, defendant retained a lawyer and paid him a flat fee. The FTC then initiated a civil suit. The U.S. District Court for the District of Nevada found, *inter alia*, that the flat fee had been paid with funds derived from the fraudulent scheme. Because the attorney failed to rebut evidence that he knew of the potentially fraudulent origin of the funds, the court imposed a constructive trust and ordered the lawyer to return the unearned portion of the funds.

The Ninth Circuit affirmed, reviewing for abuse of discretion or erroneous application of legal principles. The court applied the common law *bona fide* purchaser rule, which allows a transferee to avoid restitution if the transfer was made in good faith, for value, and without the transferee's actual or constructive notice of the underlying wrongdoing. Further, relying on Fifth Circuit precedent, the court applied ABA Model Rule 3.3 (obligation to avoid conduct that undermines the integrity of the adjudicative process), to find that the lawyer had a duty to inquire into the source of the funds. Specifically, because the FTC's allegations indicated that the funds were derived from a fraudulent scheme, at the time the attorney was retained, the court held that the

lawyer had a duty to investigate the source of those funds beyond merely relying on information from his client. Because the attorney had failed to engage in a more thorough investigation, the court was unable to conclude that the payment was made in good faith and without notice.

Significance of Opinion

This opinion demonstrates how ethical standards can potentially affect the application of common law or equitable principles to lawyers and attorney fees. Specifically, this holding points to one potential consequence of a lawyer failing to investigate when there is reason to suspect a client is paying legal fees with improperly obtained funds.

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