SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 11

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STATE OF NEW YORK *EX REL* DAVID DANON, Index No. 100711/13

Bringing this action on behalf of the State of New York and all local governments within the State of New York,

Plaintiffs,

- against -

VANGUARD GROUP, INC., THE VANGUARD GROUP OF MUTUAL FUNDS and VANGUARD MARKETING CORP.,

Defendants.

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JOAN A. MADDEN, J.:

Defendants The Vanguard Group, Inc. (VGI), The Vanguard Group of Mutual Funds (Funds), and Vanguard Marketing Corporation[1] (VMC) (VGI, Funds, and VMC collectively, Vanguard) move, pursuant to CPLR 3211 (a) (3) and 3211 (a) (7), for dismissal of the complaint, and for the disqualification of David Danon (Danon) and his counsel. Danon opposes the motion, which for the reasons discussed below, is granted.

Background

Relator Danon commenced this "qui tam" action, alleging that defendants submitted false claims under New York State Finance Law §§ 187-194 (False Claims Act), thereby avoiding the payment of taxes due to federal and state taxing authorities. Danon states that he brought this action based on information that he obtained through his employment at VGI, as in-house counsel, as well as his knowledge of federal and New York tax law (complaint, ¶ 20).

Specifically, the complaint alleges as follows: Vanguard is the largest mutual fund service

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[1]In the caption, named as Vanguard Marketing Corp.

provider in the United States that through a multinational corporate group: (1) seeks profit in every jurisdiction in the world other than in the United States, and (2) through illegal price manipulation with controlled parties, seeks zero profits in the United States and the ability to shelter its worldwide income, in violation of dozens of United States laws (*id.*, ¶ 65). In doing so, Vanguard has avoided $1 billion of federal income tax, and at least $20 million of New York tax over the last 10 years (*id.*, ¶ 3). VGI's primary business is providing investment management and administrative services to certain United States funds that are treated as regulated investment companies (RICs or mutual funds) under the Internal Revenue Code (Code) (*id.*, ¶ 21). Vanguard provides brokerage services to Fund investors through defendant VMC, a wholly owned subsidiary of VGI (*id.*, ¶ 22). The Funds constitute the largest group of mutual funds in the United States (*id.*, ¶ 57). Vanguard has been the leader in low cost mutual funds, because (l) under its mutual structure it has been able to avoid providing market rate investment returns to third-party shareholders, and (2) it has flouted tax law rules requiring arm's length prices between commonly controlled parties (*id.*, ¶ 77).

The complaint further alleges that in 2011 and 2012, Vanguard filed false New York State tax returns, ignoring New York's "shareholder based apportionment" (SBA) rule, and reported distorted and artificial income (*id.*, ¶ 10). Section 482 (Section 482) of the Code, section 211 (5) (section 211 [5]) of the New York Tax Law (Tax Law), and the laws of dozens of other jurisdictions, require that transactions between commonly controlled parties occur at arm's length prices, and not at prices designed to avoid federal or state income tax (*id.*, ¶ 11). Vanguard violates section 211 (5) and section 482 by providing services to the Funds at artificially low, "at cost" prices, thereby showing little or no profit, and paying little or no federal or state income

tax, despite managing Funds with nearly $2 trillion in assets (*id.*, ¶ 12). Vanguard fraudulently failed to report and pay federal and state income tax on its $1.5 billion "Contingency Reserve," which Contingency Reserve is under VGI control and used for general Vanguard purposes. It has been funded by Fund service fee payments that reduce Fund net asset value, and which, therefore, reduce the value of a shareholder's investment in a Fund. Moreover, Vanguard represents the Contingency Reserve as a VGI asset to third parties and regulators (*id.*, ¶ 13).

As described in the complaint, Danon alleges that Vanguard's formative documents establish illegal tax avoidance, and that Vanguard has operated as an illegal tax shelter for 40 years (*id.*, ¶ 47). Vanguard's structure was established by the original ll Funds (Original Funds) in 1974 based on three conceptual pillars: mutual ownership, index investing, and low cost (*id.*, ¶ 51). The mutual ownership structure required approval of the United States Securities and Exchange Commission (SEC), because of transactions between affiliated parties (*id.*, ¶ 53). Based on the belief that passive or index investing outperforms active management and, therefore, that RIC returns are maximized through cost minimization, the Original Funds sought, and obtained, approval for the lowest cost structure possible (*id.*, ¶ 54). VGI charges the Funds only the "costs" of providing its services; does not include profit or a return on capital; and, on its federal and state income tax returns, shows aggregate gross revenue received from the Funds equal or close to its costs, and little or no net income (*id.*, ¶ 57).

Danon alleges "[b]ecause VGI profits always benefit the Funds under a mutual structure, the sole purpose of an 'at cost' pricing scheme is income tax avoidance. If VGI were to charge $1 over its at cost price, it would pay net federal/state income tax of approximately $0.40. The $0.60 remaining after tax would benefit the Funds through their ownership of VGI. Thus, 'at cost' plus

an arm's length markup would not transfer value to an unrelated third party (other than taxing authorities). It would merely add tax cost – a cost borne by every other United States business – to VGI's costs" (*id.*, ¶ 59). Taxpayers such as Vanguard are required to charge arm's length prices for transactions with commonly controlled parties. Vanguard "illegally avoids federal and state income taxes by: (1) avoiding corporate level tax on its profit; (2) exploiting differences in tax rates applicable to corporations, individuals, and investment returns taxed at preferential rates (e.g., qualified dividend income and long term capital gain); and (3) exploiting tax deferral on income realized through tax-deferred plans" (*id.*, ¶ 69).

Danon further alleges that New York (as well as other states) has been unable to discover Vanguard's violations of their true income or controlled-party transaction statutes, because Vanguard knowingly failed to file required tax returns in New York (and other states) for decades, and even when it has filed returns, it has done so on a false and fraudulent basis (*id.*, ¶ 84). In addition to its failure to file income tax returns and pay income tax, Vanguard failed to meet its payroll withholding obligations in New York and numerous other states since at least 2004 (*id.*, ¶ 98). Moreover, although Contingency Reserve Fees are deductible by the Funds, and reduce the value of investors' interests in the Funds, Vanguard has not included them in income, because it defers their receipt or transfers them back to the Funds until Vanguard makes an actual disbursement (*id.*, ¶ 119).

Finally, the complaint alleges that Vanguard's representations of benefits arising from its illegal structure in its securities offerings to New York residents, and its misrepresentations of the "Exemptive Order" from the SEC, permitting its mutual structure, are false documents that constitute False Claims (*id.*, ¶ 135). Vanguard committed Class B felonies by knowingly filing

false tax returns and failing to pay New York tax for the 2011 and 2012 years by (l) manipulating prices charged to the Funds to lower, and nearly eliminate, all Vanguard income and avoid New York income tax, and (2) failing to allocate Vanguard's management and service fee income to New York (*id.*, ¶ 136). Vanguard committed a Class E felony under section 1809 (a) of the Tax Law by failing to file New York tax returns and failing to pay New York tax for at least the seven-year period from 2004 through 2010, supporting these failures with false representations and false documentation that constitute False Claims under the False Claims Act (*id.*, ¶ 137).

The complaint contains nine causes of action for the violation of various sections of the False Claims Act by: using false records or statements to avoid tax obligations; failing to pay required taxes to New York and local governments; falsely certifying that it was in compliance with its state tax obligations; conspiring to commit these wrongs; possessing property or money used by a governmental entity, and, intending to defraud such entity, by making or delivering the receipt without fully knowing of the veracity of the information contained therein; and making false statements when applying for tax refunds. The complaint also alleges that, as a result of Danon's acts in furtherance of this action to remedy defendants' wrongful conduct, defendants retaliated against Danon by discharging him, and harming his career and ability to obtain employment.

As remedies, Danon, on behalf of himself and New York State, seeks a judgment equal to three times the amount of damages sustained, plus a civil penalty of $6,000 to $12,000 for each act in violation of the False Claims Act, with interest, including the cost to the state for its expenses related to this action. Since the state opted not to proceed with this action, Danon seeks to be awarded an amount that the court deems reasonable for collecting the civil penalty and

damages, but not less than 25% nor more than 30% of the proceeds of the action or settlement of the claims under the False Claims Act, plus pre-judgment interest.

Danon is a former employee of VGI (affidavit of David Danon, ¶ 2). He is admitted to practice law in New York and Pennsylvania, and worked as an in-house attorney for VGI beginning in August 2008 (*id.*, ¶¶ 3-4). Danon states that, through his work, he became aware of VGI's alleged wrongdoing, and that he made repeated, but unsuccessful, efforts to end VGI's illegal practices, because they would likely cause substantial injury to VGI (*id.*, ¶¶ 5-7).

According to Danon, in January 2013, VGI informed him that his employment would be terminated, which, he opines, was in retaliation for his "persistent and vocal questioning of VGI's unlawful practices" (*id.*, ¶ 8). Thereupon, he states, he began assembling "Whistleblower Documents"; i.e., proof of VGI's tax and securities fraud practices, which, as a tax lawyer, he felt obliged to do (*id.*, ¶ 9). Danon states further that, because he was unable to effect a change, beginning in January 2013, he provided selected Whistleblower Documents to regulatory authorities, including the Internal Revenue Service, the New York Attorney General's office, and the SEC (*id.*, ¶ 11). Danon filed this action in May 2013. One month later, on June 13, 2013, his employment was terminated (*id.*, ¶¶ 13-14). He states that, after termination, he retained the Whistleblower Documents, but subsequently destroyed any that he deemed unnecessary to substantiate VGI's fraud (*id.*, ¶¶ 14-15).

Procedurally, Danon filed the complaint in this action under seal on May 8, 2013 under the qui tam provisions of the False Claims Act. On May 28, 2014, the New York Attorney General's office filed a notice that it was declining to convert or intervene in the action. On June 30, 2014, Danon filed a "Notice of Intent to Proceed" with the action.

In support of the motion, defendants argue that: (1) Danon's lawsuit should be dismissed based on violations of the attorney ethics rules, and he and his counsel should be disqualified from the action because Danon violated his duty of loyalty and confidentiality to Vanguard; (2) Danon's "tax shelter" claims should be dismissed (a) under the public disclosure bar, and (b) because his lawsuit seeks to usurp the authority and discretion of the federal and state taxing authorities; (3) Vanguard did not knowingly submit a false claim; and (4) Danon's conspiracy and retaliation claim should be dismissed, because they are not validly stated.

Danon argues that: (1) he did not violate any ethical rules by reporting Vanguard as a "tax cheat," because (a) the application of ethical guidelines to an attorney's conduct presents questions that cannot be decided at this stage, (b) he was legally permitted to "blow the whistle" on Vanguard's "tax fraud" and bring an action under the False Claims Act, (c) the professional rules expressly permit him to pursue this qui tam action in that (i) he is authorized to take, disclose, and use VGI's information to stop VGI's ongoing "criminal conduct," and (ii) he has not violated the duty of loyalty by bringing this action; and (2) his claims should not be dismissed because (a) the public disclosure bar does not apply, (b) he can bring this action based on Vanguard's alleged tax violations, (c) the complaint properly alleges that Vanguard submitted false claims, and (d) the conspiracy and retaliation claims are validly stated.

Discussion

In this qui tam action, Danon, a private person, or "relator," sued defendants pursuant to the False Claims Act. As a qui tam action, the lawsuit was brought on behalf of the State of New York (*State of N.Y. ex rel. Grupp v DHL Express [USA], Inc.*, 19 NY3d 278, 281 [2012] [the plaintiffs, as relators, sued on behalf of State of New York pursuant to the False Claims Act,

alleging violations of State Finance Law § 189 (1) (a), (b) and (c), asserting that the defendant engaged in a persistent practice of misrepresentation, by shipping packages by ground transportation, but claiming they were delivered by air]).[2] In so doing, Danon seeks "to recover a remedy for a harm done to the Government" (*U.S. ex rel. Feldman v van Gorp*, 697 F3d 78, 84 n 3 [2d Cir 2012]). "*Qui tam* plaintiffs, even if not personally injured by a defendant's conduct, possess constitutional standing to assert claims on behalf of the Government as its effective assignees" (*id.*). "There is, however, no common law right to bring a *qui tam* action; rather, a particular statute must authorize a private party to do so" (*Woods v Empire Health Choice, Inc.*, 574 F3d 92, 98 [2d Cir 2009]). Here, that statute is the False Claims Act which provides, in relevant part:

> "Qui tam civil actions. (a) Any person may bring a qui tam civil action for a violation of section one hundred eighty-nine of this article on behalf of the person and the people of the state of New York or a local government. No action may be filed pursuant to this subdivision against the federal government, the state or a local government, or any officer or employee thereof acting in his or her official capacity"

(State Finance Law § 190 [2]).

As a private individual Danon has the right to bring a qui tam action, and there is no absolute bar to an attorney acting as a relator in a qui tam action against a former client (*see U.S. ex rel. Doe v. X Corp*, 862 FSupp 1502, 1506 [ED Va. 1994]; Sylvia, *The False Claims Act: Fraud Against the Government* § 11:7 [May 2015]). As reflected in the discussion below, the

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[2] "*Qui tam* actions appear to have originated around the end of the 13th century, when private individuals who had suffered injury began bringing actions in the royal courts on both their own and the Crown's behalf" (*Vermont Agency of Natural Resources v U.S. ex rel. Stevens*, 529 US 765, 774 [2000]).

primary issue on this motion is whether under the circumstances here, the complaint should be dismissed based on Danon's alleged violation of several ethical rules by bringing this action against VGI while employed by VGI as an attorney, and by supporting his claims against defendants through the use of confidential information that he obtained through that employment. *(see e.g. Wise v Consolidated Edison Co. of N.Y.* (282 AD2d 335, 335 [1st Dept], *lv denied* 96 NY2d 717 [2001]) [noting that "permitting the action to go forward would entail the improper disclosure by plaintiff, an attorney who was in-house counsel to defendant prior to his termination, of client confidences, including specific corporate tax strategies"]). Notably, Danon, who is admitted to practice law in New York and Pennsylvania, worked at VGI as a tax lawyer with a self-described responsibility for ensuring that VGI complied with federal and state tax laws (Danon aff, ¶ 3, 9).

Vanguard relies on Rules 1.6, 1.7, and 1.9, pertaining to attorney conduct (22 NYCRR 1200.0), in support of its motion. For the reasons discussed below, the court finds that the confidentiality provisions of Rule 1.6 and 1.9(c) are central to, and dispositive of, the determination of the issues raised in this motion.

Rule 1.6, regarding confidentiality of information, provides that:

> "(a) A lawyer shall not knowingly reveal confidential information, as defined in this Rule, or use such information to the disadvantage of a client or for the advantage of the lawyer or a third person, unless:
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> (1) the client gives informed consent, as defined in Rule 1.0 (j);
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> (2) the disclosure is impliedly authorized to advance the best interests of the client and is either reasonable under the circumstances or customary in the professional community; or
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> (3) the disclosure is permitted by paragraph (b).

'Confidential information' consists of information gained during or relating to the representation of a client, whatever its source, that is (a) protected by the attorney-client privilege, (b) likely to be embarrassing or detrimental to the client if disclosed, or (c) information that the client has requested be kept confidential. 'Confidential information' does not ordinarily include (i) a lawyer's legal knowledge or legal research or (ii) information that is generally known in the local community or in the trade, field or profession to which the information relates.

"(b) A lawyer may reveal or use confidential information to the extent that the lawyer reasonably believes necessary:

. . .

(2) to prevent the client from committing a crime;"

Rule 1.9: Duties to former clients, provides that:

. . .

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

> (1) use confidential information of the former client protected by Rule 1.6 to the disadvantage of the former client, except as these Rules would permit or require with respect to a current client or when the information has become generally known; or
>
> (2) reveal confidential information of the former client protected by Rule 1.6 except as these Rules would permit or require with respect to a current client."

The effect that a violation of these rules has on a qui tam action is the subject of *U.S. v Quest Diagnostics Inc.* (734 F3d 154 [2d Cir 2013] [*Quest II*], *affirming U.S. ex rel. Fair Lab. Practices Assoc. v Quest Diagnostics Inc.*, 2011 WL 1330542, 2011 US Dist LEXIS 37014 [SD NY, Apr 5, 2011, No. 05-CV-5393 (RPP) [*Quest I*]) – decisions that both sides recognize as having significance here. "Federal case law is at best persuasive in the absence of state authority" (*Cox v Microsoft Corp.*, 290 AD2d 206, 207 [1st Dept], *lv dismissed* 98 NY2d 728 [2002]; *see also Hartnett v New York City Tr. Auth.*, 86 NY2d 438, 447 [1995] ["Federal precedents are not

binding in interpreting a State statute"]). However, New York's False Claims Act "follows the federal False Claims Act (31 USC § 3729 *et seq.*) . . . and therefore it is appropriate to look toward federal law when interpreting the New York act" (*State of New York ex rel. Seiden v Utica First Ins. Co.*, 96 AD3d 67, 71 [1st Dept], *lv denied* 19 NY3d 810 [2012]).

In *Quest II*, the Second Circuit affirmed the District Court's dismissal of a qui tam action, as the plaintiff entity included an attorney who previously worked for the defendant entity, and relied upon confidential information obtained through that employment. The relator, Fair Laboratory Practices Associates (FLPA), was a Delaware general partnership that three former executives of Unilab Corporation formed in 2005. One such executive was Mark Bibi (Bibi), who worked for Unilab prior to its acquisition by Quest Diagnostics Incorporated (Quest) in 2003 as vice president, secretary, and general counsel from November 1993 to March 2000, and as an executive vice president through June 2000, after which Unilab retained him as a consultant until December 2000 (*id.* at 159). Bibi was Unilab's sole in-house lawyer from 1993-2000, and was responsible for all of Unilab's legal and compliance affairs, such as advising Unilab on matters relating to its managed care organizations contracts (MCOs) and managing all litigation against the company (*id.*).

FLPA alleged that, from 1996 through 2005, Unilab and Quest violated the federal "Anti–Kickback Statute," 42 USC § 1320a–7b, by operating a "pull-through" scheme by which they charged MCOs and independent practice associations (IPAs) commercially unreasonable discounted prices to induce referrals of Medicare and Medicaid business, and then billed that business to the Government at dramatically higher prices than those charged to the MCOs and IPAs (*id.* at 159). Between 1993 and 1996, the individual relators began to question whether

Unilab's pricing structure was lawful (*id.*). After the individual relators left Unilab, the company allegedly "continued its illegal pull-through strategy and as a result significantly improved its profitability" (*id.* at 161 [internal quotation marks and citation omitted]).

The Court found that FLPA, through Bibi, disclosed confidential information beyond what was "necessary" within the meaning of Rule 1.6 (b) (*id.* at 165). According to the Court, Rule 1.6 (b) (2) authorizes a lawyer to "'reveal or use confidential information to the extent that the lawyer reasonably believes necessary: . . . (2) to prevent the client from committing a crime . . .'" and that "'Bibi could have reasonably believed in 2005 that [d]efendants had the intention to commit a crime'" (734 F3d at 164). However, "the confidential information divulged by Bibi, dating back to 1996, went beyond what was reasonably necessary to prevent any alleged ongoing crime in 2005, when the suit was filed" (*id.* at 165). Significantly, the Court held that "[n]othing in the False Claims Act evinces a clear legislative intent to preempt state statutes and rules that regulate an attorney's disclosure of client confidences" (*id.* at 163).

Vanguard argues that the circumstances here are more offensive to the ethics rules, pointing out that whereas, in *Quest*, Bibi previously worked for the defendant, Danon brought this action while still in VGI's employ thereby violating Rule 1.7 involving dual representation (*see Twin Sec., Inc. v Advocate & Lichtenstein, LLP*, 97 AD3d 500, 500 [1st Dept 2012] ["except under certain conditions, a lawyer shall not represent a client where there is a significant risk that the lawyer's judgment on behalf of the client will be adversely affected by the lawyer's own interests"]). Vanguard further argues that Danon appropriated and disclosed confidential information, even though the relevant government agencies could have resolved any alleged improper tax issues without use of that confidential information.

Significantly, Danon states that "this Qui Tam action based on direct information obtained through his employment at VGI as well as his knowledge of federal and New York tax law" (complaint, ¶ 20). This is reflected in the complaint which is replete with allegations based on information that, but for his status as an in-house tax attorney, he would not have been privy to. The following statements from the redacted version of the complaint support this conclusion:

> In 2003, 2008, and 2011, Vanguard falsely stated in "Vendor Responsibility Questionnaires submitted to the State of New York that it had filed all required New York returns and paid all required New York taxes (*id.*, ¶ 4).
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> In 2011 and 2012 — when it filed New York returns and paid New York taxes — Vanguard filed false returns, ignoring New York's "shareholder based apportionment" rule and reported distorted and/or artificial income (*id.*, ¶ 10).
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> No tax authority has ever examined Vanguard's mutual structure or its at cost pricing (*id.*, ¶ 79).
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> Vanguard knowingly disregarded the SBA in filing its 2011 New York Tax Return and in filing its estimated payments to New York for the 2012 and 2013 years . . . and will disregard the SBA on its 2012 Tax Return (*id.*, ¶ 100).
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> Through pricing manipulation in violation of Section 211(5) and Section 482 — achieved through common control of Vanguard and the Funds — Vanguard reported little or no profit on its 2011 and 2012 U.S. federal income tax return and its 2011 New York Tax Return, made the 2012 Estimated Payments and 2013 Estimated Payments based on realizing little or no profit, and will report little or no profit on its 2012 New York Tax Return (*id.*, ¶ 101).
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> As a requirement for being named the administrator of the New York 529 Plan, Vanguard had to fill out Vendor Questionnaires. Question 8.4 on these questionnaires, asked whether Vanguard had been compliant with state tax laws. Vanguard falsely stated that it had complied with New York State tax laws — disregarding that it had failed to file the required state tax returns for the State of New York (*id.*, ¶ 104).
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> Vanguard knowingly created false backup documentation underlying Vanguard's federal income tax return for the Failure to File Years. Because Vanguard reports New York income and pays New York tax based on income reported on its federal income tax return, these false documents were False Claims were [sic] respect to New York returns it failed to file in the Failure to File Years (*id.*, ¶ 107).

> Vanguard knowingly failed to report approximately $10 million of interest required under Section 7872 with respect to the Contingency Reserve in its federal income tax returns for each of the 2011 and 2012 tax years and approximately $200 million for the years 2004 through 2010 (*id.*, ¶ 131).
>
> In keeping with its practice of non-compliance, Vanguard's 2010 and 2011 U.S. federal income tax returns also fraudulently omit several million dollars of "Subpart F income" earned by several wholly-owned "controlled foreign corporations" ('CFCs'), and fraudulently failed to perform the required reporting for these CFCs (*id.*, ¶ 132).
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> As a result of pricing manipulation, disregard of the New York SBA, and failure to report Section 7372 interest, Vanguard under-paid approximately $6 million of New York tax for the 2011 and 2012 years and failed to pay at least $20 million of New York tax for the 2004 through 2010 (*id.*, ¶ 133).

"'[A] lawyer, as one in a confidential relationship and as any fiduciary, is charged with a high degree of undivided loyalty to his client'" (*Keller v Loews Corp.*, 69 AD3d 451, 451 [1st Dept 2010], quoting *Matter of Kelly*, 23 NY2d 368, 375–376 [1968]). "Indeed, the duty to preserve client confidences and secrets continues even after representation ends" (*Keller v Loews Corp.*, 69 AD3d at 451).

Significantly, Danon does not deny that the information he revealed in this action is confidential. In fact, in opposition to VGI's argument that its "at-cost" corporate structure rely on publicly disclosed facts and therefore should be dismissed under public disclosure doctrine bar, Danon states that public statements made by VGI "do not disclose the tax fraud [alleged in the complaint]–or even elements of the fraud" (Opposition Mem., at 18). He also maintains that the action is exempt from the public disclosure bar since he is the "original source" of the information in the complaint, pointing out that the State Finance Law § 183 defines an original sources as one who "has knowledge that is independent of and materially adds to the publicly disclosed allegations or transactions, and who voluntarily provided information to a state or local

government before or simultaneously with filing an action..." (*id,* at 19). Specifically, Danon cites to his "independent, first hand knowledge of Vanguard's unlawful tax practices,[which] materially adds to the public disclosures regarding Vanguard's low costs and costs pricing" and notes that complaint sets forth "detailed a material tax information that has never been publically disclosed" (*id,* at 20). He also refers to statements in his affidavit as to "how he learned about the tax scheme while working at Vanguard" (*id).*

Danon's primary argument is that the "crime-fraud" exception permits him to pursue this qui tam action. Under exception contained in Rule 1.6 (b)(2), "[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." As the District Court stated in *Quest*, this exception[3] ...is "strictly construed ... and is applied only when a client is planning to commit a crime in the future or is continuing an ongoing criminal scheme." *quoting* NYC Eth. Op.2002–1, 2002 WL 1040180, at *2 [Mar. 13, 2002]. Accordingly, disclosure [under the rule] is limited to information necessary to prevent the continuation, or commission, of a crime." 2011 WL 1330542, * 10.

Even assuming *arguendo* that Danon reasonably believed Vanguard intended to commit a crime based on the alleged tax violations,[4] here, as in *Quest*, it cannot be said that bringing this

[3] *Quest* analyzed Disciplinary Rule 4-101(C)(3), which was replaced by Rule 1.6(b)(2) after the adoption by New York of the Rules of Professional Conduct. 4-101(C)(3) provided an exception to the rule against an attorney's disclosure of client confidences to "reveal..[t]he intention of a client to commit a crime and the information necessary to prevent a crime." At the time *Quest II* was decided the New York Rules of Professional Conduct were in effect, and cited in that opinion. As noted by the Second Circuit "[t]he rules are substantively unchanged" (734 F3d, at 157, fn. 1).

[4]Vanguard argues that the conduct at issue does not involve a crime, since it openly reported its tax position for 40 years, and that the statutory provisions on which Danon relies do not mandate

qui tam action through revealing Vanguard's confidential material was reasonably necessary to prevent the Vanguard from committing such a crime *(see Quest II,* 734 F3d at 165 [upholding the District Court finding that the crime-fraud exception did not apply, writing that "the confidential information Bibi revealed was greater than reasonably necessary to prevent any alleged ongoing fraudulent scheme in 2005"]). At the outset, the court notes that Danon had alternate means of preventing the alleged tax violations and, in fact, exercised them in January 2013 (or approximately three months before bringing this action) by providing certain internal Vanguard documents to the IRS, SEC and the New York State Attorney General (Danon aff., ¶¶ 19, 20), authorities which Danon does not claim lack the ability to redress the alleged fraud in the complaint (*see Quest II,* 734 F3d at 164-165 [alternative means existed for exposing alleged kick back scheme which would not have involved that participation of Bibi, the company's former general counsel, as a relator in the qui tam action]).

In addition, the extent of the disclosure of Vanguard's confidential information was broader than reasonably necessary to stop the alleged tax violations. As noted above, Danon acknowledges that he divulged in the complaint confidential tax information, including tax strategies and filings of Vanguard, obtained when he was employed there. In this connection while the core issue in this qui tam action involves Vanguard's "at-cost" corporate structure which is publicly known, the complaint goes well beyond articulating the tax implications of this

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that inter-company transactions between companies be reported in a certain way, or that a particular tax is owed but, instead, vest sole discretion in the taxing authorities to adjust income. Danon counters that the tax authorities have no discretion in these matters and that, in any event, allegations in the complaint that Vanguard under-reported its taxes are sufficient to survive dismissal. The court need not reach whether the conduct was criminal or whether certain types of fraudulent conduct would be sufficient, since, as indicated herein, it cannot be said that the information disclosed was reasonably necessary to prevent Vanguard from continuing the conduct at issue.

structure with respect to future conduct alleging the continuation of a crime. In fact, a review of the complaint reveals that allegations of wrongful conduct involve tax practices and filings in the years 2011, 2012, and 2013,[5] and it contains allegations regarding various purported tax violations, including ones related to payroll taxes and interest deductions, dating back to 2004.[6] It also contains allegations concerning a broad range of tax issues, including those related to record keeping procedures, the Contingency Reserve, and the residence of certain Fund employees.

Significantly, Danon does not attempt to justify the inclusion of this information as necessary to prevent alleged tax violations in the future. Absent any justifiable basis, such broad disclosure of confidential tax information related to past years as revealed in the qui tam complaint, from which Danon stood to profit, was greater than reasonably necessary to prevent Vanguard from committing any alleged future tax violations (*see Quest II*, 734 F3d at 164 [broad disclosure by company's former general counsel in qui tam complaint of client confidences in qui tam complaint dating back to 1996 were broader than necessary to prevent any ongoing crime in 2005] *see also New York County Lawyers' Ass'n, Committee on Professional Ethics Formal Opinion* 746 [Oct. 7, 2013]["As a general principle, there are few circumstances, if any, in which, in the Committee's view, it would be reasonably necessary within the meaning of [Rule] 1.6(b) for a lawyer to pursue the steps necessary to collect a bounty as a reward for revealing confidential material"]).

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[5]Paragraph 101 of the complaint contains allegations regarding 2013 Estimated Payments based on the realizing of little or no profit through pricing manipulation.

[6]In one instance, the complaint alleges a tax violation in 1999.

Moreover, the cases relied on by Danon to argue that the crime-fraud exception is applicable are inapposite as they address whether an evidentiary exception to the attorney-client privilege exists *(see eg Matter of New York City Asbestos Lit.*, 109 AD3d 7, 10 [1st Dept], *lv denied* 22 NY3d 1016 [2013][permitting in camera inspection of document to determine if attorney-client communications were made in furtherance of a fraud or crime such that the crime fraud exception would apply to permit the disclosure of such communications]), as opposed to the issue here, which is whether the exception to confidentiality applies under the ethics rules. In this connection, the courts have held that "[t]he ethical duty to preserve a client's confidences is broader than the evidentiary privilege" (*Heartbreak Carbaret Corp. v. Cruz,* 699 FSupp 1066, 1070 [SD NY 1988], *citing Brennan's v. Brennan's Restaurants*, 590 F.2d 168, 172 [5th Cir.1979]; *see also X Corp v. John Doe*, 805 FSupp 1298, 130-1308 [ED Va. 1992][finding that with respect to issue of whether attorney relator should be permitted to disclose former client's confidential information to bring quit tam action that "any reliance on the evidentiary attorney-client privilege and its crime-fraud exception is misplaced"]).

As for Danon's assertion that he did not commence this action prior to leaving VGI's employ, such assertion is untenable. Danon commenced this action on May 8, 2013, and left the employment in June 2013. His assertion is based erroneously on the contention that the action was not commenced until the action was unsealed and the attorney general declined to intervene (oral argument transcript at 36-38) (*see Hertz v Schiller*, 239 AD2d 240, 241 [1st Dept 1997] ["'In 1992, the Legislature converted New York civil practice in the Supreme and County Courts from a commencement-by-service to a commencement-by-filing system'"]). Moreover, in the complaint, Danon states that he *is*, not that he *was*, an employee of VGI (complaint ¶ 2).

Accordingly, the qui tam action must be dismissed based on the violations of Rule 1.6 and Rule 1.9(c) (*see e.g. Wise v Consolidated Edison Co. of N.Y.* 282 AD2d at 335 [dismissing action "since permitting the action to go forward would entail the improper disclosure by plaintiff, an attorney who was in-house counsel to defendant prior to his termination, of client confidences, including specific corporate tax strategies"]). In addition, as in *Quest,* based upon the above conclusion, not only Danon, but his counsel, are disqualified based on these violations, as Danon's counsel has been put in a position to obtain confidential information and would be in a position to use this information to give any subsequent client an unfair and unethical advantage (*see Quest II,* 734 F3d at 168 [District Court did not err in dismissing complaint and disqualifying the plaintiff, and its outside counsel from bringing any subsequent related qui tam action; such measures were necessary to prevent the use of unethical disclosures against defendants]).

In light of the foregoing, the court need not reach Vanguard's alternative argument that the public disclosure doctrine bars Danon's "tax-shelter" claims, i.e. those based on Vanguard's "at-cost" corporate structure. However, the court notes that a decision as to the applicability of the public doctrine would require an intense factual inquiry that cannot be determined based on the record before the court. The court also need not reach whether Rule 1.7,[7] relating to conflicts

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[7]Rule 1.7 Conflict of interest: current clients

"(a) Except as provided in paragraph (b), a lawyer shall not represent a client if a reasonable lawyer would conclude that either:

> (1) the representation will involve the lawyer in representing differing interests; or
>
> (2) there is a significant risk that the lawyer's professional judgment

of interest with current clients, and/or Rule 1.9(a),[8] relating to side-switching,[9] were violated.

The fifth cause of action alleges that defendants conspired to fail to pay required taxes to

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> on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other personal interests.
>
> (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
>
> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
>
> (2) the representation is not prohibited by law;
>
> (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
>
> (4) each affected client gives informed consent, confirmed in writing."

[8]Rule 1.9: Duties to former clients:

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

[9]In *Quest II*, the Second Circuit did not reach the issue of whether the District Court properly found that 1.9(a) was violated. Rule 1.9(a) precludes a lawyer who formerly represented a client from "*representing another person* in the same or substantially related matter in which that person's interests are materially adverse to the interests of the former client" (emphasis supplied). Of relevance to whether a relator in a qui tam action is representing another person within the meaning of this rule, the Second Circuit wrote that "[i]n evaluating the remedies ordered here, we note FLPA's (i.e. the relator's) unusual posture in this litigation by virtue of its status as relator. While FLPA stands to benefit from any recovery in this case, it brings this suit on behalf of the United States government. As such, it acts neither as the real party in interest nor in a representative capacity"(734 F3d at 167). While not reaching any conclusion here, based on the Second Circuit's statement in *Quest II*, it is unclear whether Rule 1.9(a) is applicable in the context of a qui tam action.

New York and local governments and knowingly presented false claims in violation of the York False Claims Act, State Finance Law § 189 (1) (c). Nevertheless, "[a] parent corporation and its wholly-owned subsidiary are incapable of conspiring with each other" (*Barnem Circular Distribs. v Distribution Sys. of Am.*, 281 AD2d 576, 577 [2d Dept 2001]; *see also People v Sprint Nextel Corp.*, 41 Misc 3d 511, 524 [Sup Ct, NY County 2013] ["Sprint cannot conspire with its own subsidiaries to violate the False Claims Act"], *affd* 114 AD3d 622 [2014]).

The seventh cause of action is for retaliation. To state such claim under the False Claims Act, "a plaintiff must show that (1) the employee engaged in conduct protected under the [statute]; (2) the employer knew that the employee was engaged in such conduct; and (3) the employer discharged, discriminated against or otherwise retaliated against the employee because of the protected conduct" (*Landfield v Tamares Real Estate Holdings, Inc.*, 112 AD3d 487, 487 [1st Dept 2013] [internal quotations marks and citation omitted]). "[I]nternal complaints alone may constitute efforts to stop the violation of a false claims statute and thus rise to the level of protected conduct" (*id,* at 448).

Danon commenced this action in May 2013, and he acknowledges that VGI informed him in January 2013, that his employment would be terminated (Danon aff, ¶ 8). Neither the complaint, nor the additional submissions, contain any allegations that VGI knew in January 2013, that Danon was involved in protected conduct. In his affidavit, Danon states that he "made repeated efforts to put a stop to VGI's unlawful practices"(*id*, ¶ 6); that despite his efforts, "VGI continued its unlawful tax and securities fraud"; and that he believes that his termination was in retaliation for his "persistent and vocal questioning of VGI's unlawful practices" (*id,* ¶¶ 8, 10). He also states that in response to his complaints, the head of Vanguard's legal tax group told him

that his "attempts to stop the illegal practices had harmed [his] relationship with important members of Vanguard's tax department [and that] he should not put his concerns about costs in writing [and] two prior tax directors had suffered professional harm due to expressing [similar concerns]" (*id*, ¶ 7). Notably, Danon does not indicate the dates when he expressed his concerns to Vanguard's employees and, in particular, whether he did so before he was informed of his termination in January 2013.

Moreover, Vanguard points out, and Danon does not deny, that it continued to employ Danon as its attorney until June 2013, and that during those months, Danon continued to have unfettered access to Vanguard's confidential information. In fact, Danon states that after he was notified of his termination, he collected documents to support his concerns about Vanguard's tax practices. These circumstances tend to rebut any suggestion that Vanguard knew at the time Danon was terminated that he intended to use such information to bring a qui tam action or to engage in other protected conduct under the False Claims Act (*see generally, Johnson v. The University of Rochester Medical Center*, 686 FSupp2d 259, 268 [WD NY 2010][dismissing plaintiffs' retaliation claim, noting that plaintiffs pleaded no facts to suggest they complained to hospital administrators or high level personnel, or that the defendants—the Hospital and the URMC—were otherwise aware that the plaintiffs were engaging in any protected activity whatsoever relating to Medicare/Medicaid fraud"]).

Furthermore, even assuming *arguendo* that Vanguard knew of internal complaints made by Danon prior to notifying him of his termination, under the circumstances here, complaints regarding Vanguard's "at cost" pricing structure do not constitute "protected activity" for the purposes of the False Claims Act since, as a tax lawyer for Vanguard, Danon's job duties

included "ensuring that VGI complied with federal and state tax laws" (Danon TRO Aff., ¶ 9). Here, Danon has not shown that his complaints "went beyond the performance of his normal job responsibilities so as to overcome the presumption that he was merely acting in accordance with his employment obligation" (*Landfield v Tamares Real Estate Holdings, Inc.*, 112 AD3d at 488, citing *United States ex rel Schweizer v. OCE N.V.*, 677 F3d 1228, 1238-1239 [DC Cir 2012]).

Based on the foregoing, including the absence of a date that Danon expressed his concerns as to Vanguard's tax practices, the lack of restriction to confidential information after Danon was notified of his termination in January 2013, and as the concerns expressed by Danon were a critical part of his job responsibilities, the retaliation claim fails and must be dismissed.

In reaching the above conclusions with respect to the violation of the New York State attorney ethics rules, the court makes no determination as to the merits, or lack thereof, of Danon's allegations. Nor does the dismissal of this qui tam action affect the ability of the appropriate New York State authority or agency to pursue the allegations regarding Vanguard's tax practices and filings. The only effect of these determinations is that Danon, Vanguard's prior in-house counsel for tax matters, may not proceed with, nor profit from, any disclosure of confidential information to bring this qui tam action in violation of New York State attorney ethics rules; nor may Danon or his counsel proceed with any subsequent related qui tam action.

Accordingly, it is

ORDERED that the motion by defendants is granted, and the complaint is dismissed, and David Danon and his counsel are disqualified from this action and any subsequent action based on these facts; and it is further

ORDERED that the Clerk is directed to enter judgment accordingly.

Dated: November 13, 2015

J.S.C.

HON. JOAN A. MADDEN
J.S.C.