LAWYERS AND ABUSIVE TAX SHELTERS: CIVIL LIABILITY

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"America's Internal Revenue Service has notched up some big wins. Its biggest, in August 2005, was in a court case against KPMG, one of the world's top four accountancy firms. The IRS accused KPMG of peddling a series of tax shelters to rich investors, involving Cayman and other OFCs, which generated $11 billion in phoney tax losses and deprived the government of at least $2.5 billion in tax revenue. KPMG admitted to criminal tax fraud and paid $456m in fines. That sent a signal to tax accountants and lawyers everywhere to watch their step."[1]

"Jenkens & Gilchrist, once the largest law firm in Dallas, has admitted promoting fraudulent tax shelters and will pay the Internal Revenue Service $76 million and go out of business, the IRS and the U.S. attorney in New York announced Thursday.

Dallas-based Jenkens - which at its peak in 2001 had more than 600 lawyers, including 263 here - will cease operations as a law firm on Saturday, although it will continue as a legal entity while it wraps up its affairs. …

U.S. Attorney Michael J. Garcia said the Justice Department has agreed not to prosecute the firm in exchange for its "acceptance of responsibility for developing and marketing fraudulent tax shelters" and its agreement to cooperate as the investigation into the tax shelters continues.

The deal doesn't protect any individuals at Jenkens connected to the tax shelters."[2]

I. Lawyers' Roles in Abusive Tax Shelters

Tax sheltering has been around for as long as taxes. And much tax sheltering is lawful, e.g., tax deductible contributions to retirement plans. But the shelters that are the subject of this panel discussion are of another sort altogether. While abusive shelters take many and complex forms, they typically involve the generation of a tax loss without a corresponding economic loss, accomplished within a complex multi-step transaction designed strictly as a "tax play," i.e., lacking any economic purpose other than tax avoidance. When and if detected by the Revenue Service, these shelters will almost certainly be shut down. That is, the taxpayer is playing the "audit lottery."

The narrative of the rise of abusive tax shelters, although complex, can be boiled down to this. Through the 1990's, while the economy heated up, corporations and hyper-rich individuals had profits and income that they wished to shelter. Meanwhile, the big accounting firms, in response to an ongoing diminution in the auditing income side of their business, had come to look to the "consulting services" side for income. The

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[1] "Rich Pickings," THE ECONOMIST (U.S. EDITION), Survey Section, 2/24/07.

[2] Terry Maxon, "Jenkens & Gilchrist Closing After Admitting Role in Tax Fraud," THE DALLAS MORNING NEWS, p. 1A, 3/30/07.

accounting firms saw the opportunity to construct and market tax shelters to their corporate and high end individual clients as a natural extension of their consulting services. Because the same basic shelter structure could be sold to multiple clients over and over and because the fees could be a percentage of the tax savings, amounting in the aggregate in the billions, the promotion and sale of these shelters was a money machine for the big accounting firms.

Enter the lawyers. The simplest form of participation by lawyers was to render tax opinion letters. The lawyer would opine that the shelter would "more likely than not" be upheld if audited. Lawyers were paid staggering sums of money for the opinion letters and, like the accounting firms, the law firms would simply recycle the same basic letter for each of the taxpayers purchasing the shelter.

The taxpayers to whom the letters were addressed typically had little or no contact with the lawyers authoring the opinion letters. Instead, the real relationships were between the shelter promoters and the lawyers. (The allegations in some of the litigation that has followed the collapse of so many of these abusive shelters suggest that the lawyers and law firms sometimes became even more deeply involved in the shelter schemes, participating in the structuring and promotion of the shelters.) The shelter promoters simply bundled the opinion letters into the package they sold the taxpayers. Their sales pitch for the opinion letters was simple- by obtaining a "more likely than not" opinion letter, the taxpayer presumably was insulated from the risk of underpayment penalties if audited. (The Regulations contain a "reasonable reliance" defense to the penalties.) Thus, the opinion letter functioned as a form of insurance for the taxpayer, or so they imagined.

What made it possible for lawyers to render "more likely than not" opinion letters for transactions that were almost invariably shut down when audited? Some lawyers presumably were simply willing to render bogus opinions for big bucks. But lawyers seeking to find a basis for their opinion typically retreated to a form of literalism in their reading of the tax laws. That is, the shelters typically followed the letter of the laws, even though they were patently inconsistent with the underlying purpose of the rules.[3]

II. Civil Liability

Beginning in the late 1990's, the government, responding in part to media coverage of some of the abusive shelters, began to crack down. The Revenue Service stepped up their efforts to discern and shut down the shelters and the Justice Department had some notable successes in defending in the federal courts the Service's determinations. Also, the Revenue Service tightened disclosure regulations and the regulations governing those who practice before the Service (Circular 230). Sanctions against taxpayers and promoters were enhanced as part of the American Jobs Creation Act of 2004.

[3] On the tax shelter phenomenon and the role of lawyers, see generally Joseph Bankman, *Tax Enforcement: Tax Shelters, The Cash Economy, and Compliance Costs*, 31 OHIO N.U.L. REV. 1 (2005); "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals," (Report by the Minority Staff of the Senate Permanent Subcommittee on Investigations), 108th Cong., 1st Sess., S. Prt. 108-34 (2003).

In an important development, the Revenue Service refused in some cases to accept the opinion letters as sufficient evidence of reasonable reliance to protect the taxpayer from the penalties for underpayment.[4]

To date, the Revenue Service, backed up by the Tax Division of the Justice Department, is keeping the heat on tax shelters. The government is fighting on several fronts important to lawyers. First, the Tax Division continues to defend the Service's determinations in a significant number of abusive shelter cases. Second, the Division continues its aggressive use of summonses directed against the accounting and law firms, seeking the identities of their shelter clients, rejecting claims of attorney-client privilege.[5]

Additionally, the government has brought several significant criminal tax fraud cases against promoters and lawyers and law firms. (The threat of such an indictment and criminal proceeding was certainly a substantial factor in the collapse of the Jenkens firm.) One of the most prominent examples of such criminal enforcement is the deferred prosecution agreement with KPMG with the $456m fine noted in the quote above. This agreement only resolved the criminal charges against the firm. The government is still proceeding with its criminal case against a set of individuals including former officers of KPMG and a former tax partner of the Sidley Austin firm. A corollary issue in the criminal proceeding has been the government's pressure on KPMG to withhold payments to defense counsel for its former employees.[6] The case also has spun off an interesting conflicts question. KPMG has argued that it has a professional relationship with some of the defense counsel for the individual defendants and that KPMG may at some future time choose to bring actions against one or more of its former employees, thus suggesting that these defense counsel are in an impermissibly conflicted position.[7]

As a consequence of this regime of heightened scrutiny, corporate and individual taxpayers who purchased these shelters have faced the imposition of substantial tax liability, along with interest and penalties. Not surprisingly these taxpayers have looked to shift their losses to the promoters and the lawyers involved in these abusive shelters. Some have already succeeded in procuring significant settlements; others will surely follow.

A. Negligence-based liability

The assertion of a negligence-based claim, whether couched as malpractice or negligent misrepresentation, by the taxpayers against the lawyers writing the opinion letters might seem a straightforward avenue for potential recovery. Presumably in all jurisdictions, by one theory or another, the author of an opinion letter is deemed to owe a civil liability duty to the person to whom the letter is addressed. But the tax opinion letter cases pose some special complications.

First, the absence of any real relationship or contacts between the lawyers and the taxpayers might permit the lawyer to argue that any "relationship" was insufficient to

[4] *See e.g.*, Long-Term Capital Holdings, LP v. U.S., 150 Fed. Appx. 40; 2005 U.S. App. LEXIS 20988 (2d Cir. September 27, 2005).

[5] For a summary of the government's enforcement policies, see "Justice Department and Internal Revenue Service Highlights Tax Enforcement Results," (Justice Department Press Release) (April 3, 2007).

[6] See U.S. v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 2006).

[7] *See* U.S. v. Stein, 2006 U.S. Dist. LEXIS 49435 (S.D.N.Y. July 20, 2006).

justify the imposition of a duty. But more importantly, the very nature of the "more likely than not" opinion letter, loaded with standard caveats, provides a difficult ground for a negligence claim. Nonetheless, assertions of negligence-based liability have made some significant headway. For example, before the firm imploded, the Jenkens firm and its insurers agreed to a $75m settlement with a class of individual taxpayers.

B. Rescission and disgorgement of fees

Taxpayers suing the lawyers also typically seek disgorgement of fees. Several bases exist for such a claim. First, it can be seen simply as an element of damages in a negligence or contract-based action. That is, the taxpayer asserts that the client failed to deliver reasonable services and his fees were thus unearned. The claim may also be based on the ethics law principle that a lawyer is ethically precluded from charging an "unreasonable" or "excessive" fee. In other contexts, courts have sometimes used this principle to deny the lawyer any fee in the matter.[8] Finally, courts might deem the lawyers to be in an ethically impermissible conflict of interest position- duties of loyalty to client clashing with the lawyer's felt sense of obligation to the promoters. If so, this would represent a breach of the lawyer's fiduciary duty to the client and could also be the basis for a disgorgement of fees claim.

C. Fraud-based liability

The basic elements of common law fraud are (1) a material false statement, (2) made with the intent to deceive, (3) that the person receiving the statement reasonably relies upon, (4) to their detriment. Because fraud is an intentional tort, the issue of duty does not arise. Also, fraud differs from negligence-based claims in that liability for fraud may likely be excluded from any malpractice insurance policy.

Rendering a legal opinion seems an unlikely basis for a fraud claim. Still, the contemporary taxpayer lawsuits often assert fraud claims, among other theories of liability. And it is clear that the fact that the lawyer's participation takes the form of issuing a legal opinion is not an absolute defense to a fraud claim. If the lawyer is sufficiently aware of the fraud, rendering legal opinions can be a basis for liability.[9]

The strongest defense against fraud-based claims is likely to be the argument that the taxpayers did not in fact reasonably rely on the opinions expressed in the letters. In the case of corporate taxpayers, the taxpayer would have typically had its own tax department professionals review and approve the shelter transaction. The individual taxpayers may have had similar "back up" advice. And in any case, the caveats included in the letters, pointing out that the Revenue Service might audit and disallow the deductions and so forth, would tend to make a reliance assertion less credible.

Nonetheless, courts have shown a willingness to allow plaintiff taxpayers to get to the jury on the reliance issue even when the letters had the usual hedging language. (And of course, "getting to the jury" is pretty much the whole game when the defendants are

[8] *See e.g.*, White v. McBride, 937 S.W. 2d 796 (Tenn. 1996) (denying a probate lawyer who had sought to charge an "excessive" fee any fee at all).
[9] *See e.g.*, Newburger, Loeb & Co., Inc. v. Gross, 563 Fed. 2d 1057 (2d Cir. 1977) (affirming liability on conversion theory against lawyer rendering legal opinion to partners in midst of partnership dissolution).

lawyers.) For example, in one of the lawsuits arising from the KPMG's sale of the BLIPS shelter, the taxpayer survived summary dismissal on the fraud claims even though he had been told that the shelter was "aggressive" and that the IRS might audit and deny the deductions.[10] The court stressed the factual nature of the reliance inquiry in a fraud claim and was thus reluctant to dispose of the matter summarily.

Typically, in the promotion and sales of the shelters the accounting firms, and not the law firms, interacted with the taxpayer clients and made the sales pitches that would later become the primary basis for the fraud claims. Sometimes the lawyers were more active. But even when the lawyer's role is limited to issuing the opinion letters, the risk of fraud-based liability is quite real. If the taxpayer alleges that the fraud essentially consisted of folks selling him a shelter that they knew was almost certain to fail once audited, and if they allege that the lawyers providing the opinion letters knew that was the case, the letters are likely to be enough. (Lawyers who are used to thinking about fraud-based liability in the context of securities fraud may suppose that they are immune from civil suit for secondary or "aiding and abetting" liability for fraud. This is the legacy of *Central Bank of Denver v. First Interstate Bank*[11], and the federal statutes following *Central Bank* that have wiped out private civil actions for aiding and abetting securities fraud. But common law fraud claims not involving securities offer no such immunity from assertions of secondary liability against lawyers.)

D. Statute-based liability: Civil RICO and Securities Fraud

A number of the lawsuits brought against the promoters and lawyers assert RICO-based liability.[12] The legislation, initially aimed at "mob"-related criminal enterprises, has been used against white collar crime because of its inclusion of wire and mail fraud as acts of "racketeering." RICO permits private civil remedies; treble damages and recovery of attorneys' fees are possible.

Two defenses have emerged against RICO-based claims in the tax shelter cases. First, the Private Securities Litigation Reform Act of 1995 ("PSLRA") excluded private civil RICO actions for any fraud that involved the sales of securities. Many of the abusive shelters involved in at least one of its steps a securities transaction and thus a taxpayer purchasing any of those shelters would be precluded by PSLRA from bringing a RICO action. Second, because the underlying acts are some species of fraud, the reliance defense is also in play in the RICO actions.[13]

At the same time, shelters that did involve securities transactions do open up the possibility of securities fraud claims under the federal securities law. Although aiding and abetting claims are unavailable to the taxpayer plaintiffs, assertions of primary liability remain possible. The federal courts have struggled with the appropriate test for determining when a "secondary actor" such as a law firm can be held as a primary violator in securities fraud. But at least some courts seem willing to allow taxpayers to

[10] *See* Swartz v. KPMG et al., 476 F. 3d 756 (9th Cir. 2007).
[11] Central Bank of Denver v. First Interstate Bank, 511 U.S. 164 (1994).
[12] RICO is the Racketeer Influenced and Corrupt Organization Act, 18 U.S.C. Sections 1961-68.
[13] For a simple discussion of RICO and these defenses, see Swartz v. KPMG et al., supra at 760-61.

advance primary liability claims for securities fraud against the law firms. [14] (The Supreme Court seems poised to resolve the issue with the Court's grant of the cert petition in the case, *In re Charter Communications, Inc.*, 443 F. 3d 987 (8th Cir. 2006).[15])

III. Some deeper patterns

The abusive tax shelter narratives reveal the presence of patterns related to the lawyers' conduct that can percolate through other areas of corporate/business practice. That is, even for lawyers not involved in tax shelter work, the pathology of the lawyers' involvement in abusive tax shelters offers some useful points to ponder.

A. Seeing clarity where confusion reigns, or the opposite

Lawyering in virtually all practice areas demands the interpretation of rules. Legal education begins a process of learning to see "confusion where clarity reigns." That is, we teach our students to see the irreducible ambiguity in even the simplest of precepts. (Is an immobilized tank in a public park a "vehicle"? And so on.) Practice hones those interpretive skills. In the tax shelter cases, the lawyers turned this skill inside out. They were able to see tax regulations and read them "literally." The tax laws, from this perspective, simply meant what they said- even when that meaning seemed at odds with any reasonably drawn legislative purpose.

The risk, not restricted by any means to tax shelter practice, is that the lawyer becomes so adept at seeing confusion or clarity, as demanded by the client's desires, that the state's law functionally ceases to exist. The risk of such lawyering is that the state may see the matter differently.

B. Convergence of the counseling and the adversarial roles

Corporate and other business clients operate within a regulatory environment. The agencies vary, the SEC, IRS, FCC, and so on. But the need to take account of the regulations and the regulators is a constant. Lawyers must counsel the client on its obligations within the regulatory environment. Here Brandeis's wisdom is worth recalling.

> I have been asked many times as regard to particular practices or agreements as to whether they were legal or illegal under the Sherman [antitrust] law. One gentleman said to me: "We do not know where we can go." To which I replied: "I think your lawyers can tell you where a fairly safe course lies. If you are walking along a precipice no human being can tell you how near you can go to that precipice without falling over, because you may stumble on a loose stone…but [the lawyer] can tell you where you can walk perfectly safe within

[14] *See* Seippel v. Sidley, Austin, Brown & Wood, LLP et al., 399 F. Supp. 2d 283 (S.D.N.Y. 2005) (denying the defendant law firm's motion to dismiss the securities fraud claims, noting that the plaintiffs had alleged that the law firm was fully enmeshed in the fraud).

[15] *See* Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc., 127 S.Ct. 1873 (March 26, 2007).

> convenient distance of that precipice." The difficulty which men have felt has been rather that they wanted to go to the limit rather than that they have wanted to go safely."[16]

One way to understand the conduct of the lawyers involved in the abusive tax shelters is to see them as lawyers directing the client to the edge of the precipice- and perhaps beyond. And one way this can be rationalized by the lawyer is to merge the counseling and adversarial functions. That is, there is always a fairly distinct gap between the legal positions that a lawyer might see as aggressive but lawful and the positions that a lawyer could imagine coherently defending in an adversarial context after the fact. To counsel a client contemplating action by thinking like a lawyer in an adversarial mode is to jump that gap. This then creates the peril, for both client and lawyer, that Brandeis notes.

C. Reliance on the presence of complexity and multiple helpers

The tax shelter transactions were immensely complicated, in a manner similar to the complex structured finance transactions at the heart of the Enron frauds. It is also true that these complex transactions typically required many helpers- lawyers, accountants, bankers, and others. Finally, it is often the case, and certainly true in both the abusive tax shelter cases as well as the Enron fraud, that the helpers are often firms of national and international standing. Yet, none of these factors- complexity, many helpers, and prestigious firms- is likely to translate into grounds for defending one's conduct if the lawyer is deemed to have been complicit in fraud.

D. Illegal conduct as "efficient breach"

Much of the rationalizing that occurred in the abusive tax shelter work involved reliance on the so called "audit lottery." At its worst, this is simply a euphemism for counseling the client to break the law because the benefits of illegal conduct outweigh the penalties discounted by the risk of detection. Even if this is in the abstract a "rational" choice, and reputational effects make that assumption often problematic even on its own terms, a lawyer's participation in such a venture on such terms is perilous and likely unethical.

[16] Louis D. Brandeis, Hearings before Sen. Comm. on Interstate Commerce (1911).