# SPECIAL REPORT:
# "PRIOR WORK" CAN CREATE ETHICAL AND MALPRACTICE RISK

*by Christopher S. Rizek**

**INTRODUCTION:**
On **Wednesday, April 11, 2007, at 1:00-2:30 pm ET**, the Tax Section together with ABA-CLE will sponsor its annual **Tax Link Live** member benefit teleconference. This special 90-minute ethics program will feature a discussion on **"The Top Ten Things That Get Tax Lawyers in Trouble for Malpractice."** Speakers will include: Aaron E. Hoffman, Attorneys' Liability Assurance Society, Inc., Chicago, IL; Paul M. Koning, Hughes & Luce LLP, Dallas, TX; Christopher S. Rizek, Caplin & Drysdale, Chartered, Washington, DC; and Janette M. Lohman, Thompson Coburn LLP, St. Louis, MO (*Moderator*). This article constitutes a portion of the program materials.

To register and obtain CLE ethics credit for this teleconference, please call **800/285-2221** or sign up online at **www.abanet.org/cle/programs/t07tll1.html**. There is a discounted registration fee of **$50 for Tax Section Members**; $125 for Non-Section Members; $150 for Non-ABA Members; and $30 for add'l participants using the same phone line.

ABA Tax Link Live
CLE TELECONFERENCE

Tax practitioners are often asked to defend, in an audit or in litigation with the Service, the tax treatment of an item or transaction about which the same practitioner (or colleagues in the practitioner's firm) previously advised the taxpayer, for example in a structuring or return-reporting context. In some respects, this factual situation is the routine, "bread and butter" of a tax practice: lawyers naturally want to continue to assist their clients in reaching what they believe is the right tax result, and of course we want to cultivate good ongoing relations with clients and generate repeat business.

Unfortunately this recurrent scenario—commonly referred to as "prior work" representation—is also fraught with ethical and malpractice risk, and is fertile ground for malpractice claims, disciplinary actions, or other disputes with clients or regulatory authorities. In a Tax Link Live Presentation entitled "The Top Ten Things That Get Tax Lawyers in Trouble for Malpractice," to be held on Wednesday, April 11, 2007, we will be discussing this and nine other frequent causes of malpractice claims against tax lawyers.

**The dangers that conflicts create.** When the average practitioner thinks about a conflict, his or her concern is with possible disqualification from a matter, and perhaps even the need to disgorge fees or at least soothe the hurt feelings of an "abandoned" client. Those of a more sober mindset might also consider the possibility of a disciplinary proceeding. However, as we will detail below, veteran legal malpractice defense lawyers will tell stories of a conflict—or an alleged conflict—that turned an otherwise defensible malpractice claim into a nightmare.

The problem in the "prior work" scenario arises in part because the lawyer's previous conduct or advice, and often the client's reliance on that advice, can become issues in later proceedings. One of the most common situations is when a lawyer's opinion on the correct tax treatment of the transaction is intended to be (or actually is) proffered by the taxpayer as part of a reasonable cause or reliance on counsel defense to the imposition of accuracy-related penalties. Practically no significant transaction is consummated without an opinion regarding the tax consequences, and the taxpayer's reliance on that opinion can become an issue once the Service has determined to adjust the taxpayer's treatment of the transaction. Although in recent years this scenario has occurred with great frequency in connection with alleged tax shelter transactions, it is also routine in many other, non-shelter-related business transactions. Even when the lawyer's advice is not directly at issue, an ethical problem may exist where deficient transactional work may have contributed to the litigation.

The prior work scenario often creates a conflict in which the lawyer's own interests—in defending the correctness, or at least non-negligence, of the lawyer's prior advice or opinion—may be different from the client's interest in escaping the situation with the least amount of penalties and interest, not to mention tax. The fear is that a lawyer who represents a

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client in a matter arising from the lawyer's own work product will avoid taking positions that bring the quality of the prior work product into question, even if it might be in the client's best interest to do so. The specific accusation might be that the lawyer failed to advise the client to settle when that possibility was open; or that the lawyer "pulled his or her punches" by choosing a defense strategy that was not the strongest one available, but that did not expose the shortcomings in the lawyer's work. Even if the lawyer never pulls any punches, there is a good chance that the client will accuse the lawyer of having done so if the litigation turns out badly.

Lawyers who were previously involved in a transaction can also become fact witnesses in the later proceedings. Common issues that arise in the opinion context include the reasonableness of representations by the taxpayer or other participants in the transaction, the extent to which the lawyers "negotiated" those representations with the parties, and the extent to which the lawyers were involved in "promoting" the transaction. Other factual issues that can arise, even in a non-opinion context, include the parties' intention behind various contractual documents, the (tax or non-tax) legal reasons for structuring the transaction a certain way, or other similar issues.

Because the "prior work" scenario is so common, there is not surprisingly an abundance of law addressing the ethical issues it presents.

**Conflicts rules.** Start with the ABA's Model Rules of Professional Conduct,† Rule 1.7(a) of which provides that a "concurrent conflict of interest exists if … there is a significant risk that the representation of one or more clients will be materially limited … by a personal interest of the lawyer." Section 10.29 of Circular 230 repeats this rule almost verbatim for tax practitioners (including non-lawyers), stating that "a conflict of interest exists if … there is a significant risk that the representation of one or more clients will be materially limited … by a personal interest of the practitioner."

Both Model Rule 1.7(a) and section 10.29 of Circular 230 permit this kind of conflict of interest to be avoided in certain circumstances. Again using practically identical terms, they both provide that the conflict can be waived by the client if: the lawyer or practitioner reasonably believes that he or she will be able to provide competent and diligent representation to the affected client; the representation is not prohibited by law; and the client gives informed consent, confirmed in writing.‡ Circular 230 adds that the written consent waiving the conflict must be maintained for at least 36 months after the conclusion of the representation and must be provided to the Service upon request.

The Tax Court Rules of Practice contain a similar rule, Rule 24(g), which provides that if any counsel of record was "involved in planning or promoting a transaction or operating an entity that is connected to any issue in a case … then such counsel must either secure the informed consent of the client," withdraw, or "take whatever other steps are necessary to obviate the conflict of interest or other violation of the ABA Model Rules of Professional Conduct." The rule adds that "the Court may inquire into the circumstances of counsel's employment in order to deter" violations.

Rule 1.10(a) of the Model Rules generally provides that one lawyer's conflict under Rule 1.7 is imputed to all lawyers in the same firm, but Rule 1.10(c) also provides that an imputed disqualification "may be waived by the affected client under the conditions stated in Rule 1.7." Comment 6 to Rule 1.10 notes, however, that "In some cases, the risk may be so severe that the conflict may not be cured by client consent." Neither Circular 230 nor the Tax Court Rules appear to address the imputation issue.

**"Lawyer as witness" rules.** The second related aspect of this problem arises when the lawyer may be called as a witness to testify regarding the facts of the transaction or the advice previously given to the client. Another provision of the Model Rules, Rule 3.7(a), provides that "a lawyer shall not act as advocate at a trial in which the lawyer is likely to be a *necessary* witness."§

Rule 3.7 and the comments under it recognize that this factual situation in itself presents a kind of conflict of interest between the lawyer and client, and indeed the problem is frequently analyzed in those terms.** Rule 3.7(b) provides that the disqualification of one lawyer in a firm under this rule is not necessarily imputed to other lawyers in the firm, who may continue to serve the client "unless precluded from doing so by Rule 1.7…." In other words, Rule 1.7 may apply and require withdrawal of the entire firm, not just of the testifying lawyer, if the conflict is sufficiently serious that the standards of Rule 1.7 for informed consent and waiver of the conflict cannot be met. Moreover,

† Most state bar authorities have adopted versions of the Model Rules, although many variations exist. As always, practitioners should check the rules applicable in the particular jurisdiction(s) in which they practice.

‡ DR 5-101(A) of the ABA's Model Code of Professional Conduct similarly provided, "Except after the consent of his [sic] client after full disclosure, a lawyer shall not accept employment if the exercise of his professional judgment on behalf of his client will or reasonably may be affected by his own financial, business, property, or personal interest."

§ Emphasis added. The ABA's Model Code again had similar rules, with a slightly different triggering point. DR 5-101(B) provided, "A lawyer shall not accept employment in contemplated or pending litigation if he [sic] *knows or it is obvious* that he or a lawyer in his firm *ought to be called* as a witness" (emphasis added), with certain enumerated exceptions such as uncontested matters, fee disputes, etc.

** For instance, the Reporter's Note to section 108 of the Restatement of the Law Governing Lawyers mentions that the old Model Code "treats the advocate-witness problem primarily as one of conflicts of interest" under DR 5-101(B).

the disqualification of the specific lawyer-witness generally cannot be remedied by the client's informed consent or willingness to forgo the lawyer's testimony. These facts, coupled with the potential that opposing counsel may tactically abuse the rules by seeking a lawyer's testimony and creating a disqualification, account for the high, "necessary witness" threshold in Rule 3.7. The Restatement of the Law Governing Lawyers, §108(4) and Comment b thereto, states a related rule—that a lawyer should not be permitted to call opposing counsel as a witness unless there is a "compelling need" for counsel's testimony.

Tax Court Rule 24(g) provides an analogous rule for litigators in that court, still under the caption "conflict of interest." It provides that if counsel "is a *potential* witness in a case," then counsel must withdraw or take such other steps as are necessary to cure the violation. Note that the Tax Court's rule is implicated whenever counsel is merely a "potential" witness, while the Model Rule is triggered only when counsel is a "necessary" witness. This lower threshold may encourage litigants to seek the testimony of opposing counsel as a tactical matter to obtain disqualification, and since the Service is ordinarily at a discovery disadvantage in the Tax Court and has comparatively less information about any transaction, it would usually be the party invoking this rule.

The Tax Court recently held that its rule cannot be satisfied by obtaining the client's informed consent and waiver. *Calderone v. Commissioner*, T.C. Memo. 2005-151. The Court in *Calderone* nevertheless found that counsel had taken sufficient steps to "obviate a conflict of interest or other violation … of [Rule] 3.7," including stipulating to the facts of his testimony and retaining other counsel for trial if that became necessary. The lurking potential for tactical abuse of its rule is implicit in the Court's efforts to find that counsel had satisfactorily obviated the conflict. Indeed, in *Calderone* the taxpayers themselves, and not the Government, were seeking to have their own prior counsel disqualified after a stipulated decision on the merits, arguing that his failure to disqualify himself constituted a "fraud" on the Court. Although the Court rejected that argument, the very fact that it was made, coupled with the separate malpractice lawsuit the taxpayers had filed against the former attorney, illustrates how ugly and contentious these situations can get.

**Informed consent.** Does every case arising out of a firm's transactional work create a potential conflict or "lawyer as witness" problem? Clearly not. The provisions described above incorporate the conscious policy decision that informed consent and a client waiver of the potential violation can cure many such problems—although, as noted, that is not the case when the lawyer really will be a witness.

The Restatement of the Law Governing Lawyers points out that the ultimate decision regarding this kind of "consentable" conflict is left to the client. Section 122, Comment b, states that "the conflict rules are subject to waiver through informed consent by a client who elects less than the full measure of protection that the law otherwise provides." Similarly, Model Rule 1.0(e) defines "informed consent" as "the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct."

Needless to say this puts considerable pressure on the lawyer to ensure (and be able to prove) that the client is fully informed, capable of consent, free of coercion, etc. In particular, the amount and nature of the disclosures that must be provided in order for consent to be fully informed are a frequent source of difficulty in these kinds of conflict cases. At the very least, a firm's procedure for obtaining informed consent should include the following elements:

- Someone intimately familiar with the ethical rules—an in-house counsel, member of the firm's ethics or conflicts committee, loss prevention partner, or in extreme cases outside counsel specifically retained for this purpose—should be involved in both the analysis of the issues and the consent waiver discussions. It is best if firm management has endorsed the authority of the "ethics gurus" to make these judgment calls for the firm; this will add credibility if litigation ensues with the client and a court is reviewing the steps the lawyers took.
- The analysis and discussion of the issues, and if necessary the disclosure to the client, should occur as early as possible after the problem is recognized. Not only is this an important problem that deserves prompt and full attention, but from a practical standpoint you don't want to continue investing time and effort into a case if you're going to have to withdraw because a waiver cannot be obtained.
- Consider whether a firm lawyer may be called as a witness. A lawyer's testimony can provide an emotional element that might later push the client over the edge toward a claim. The client will look to the lawyer to be a champion witness. Particularly if the lawyer's (truthful) testimony provides less support than the client had hoped for, that will grate on the disappointed client. The client's (next) lawyer and expert witness will chew on the "lawyer as witness" rules as possible additional ammunition for their argument that the lawyers were only out to protect themselves, even at the expense of their ethical obligations to their client. Even if it is hard to find a sound analytical basis for concern, this is a factor to weigh in the balance.

- In deciding whether to seek client consent, the firm should consider whether there is any good faith argument that the prior work was legally deficient and contributed materially to the litigation. The firm should also consider whether the work product itself is likely to be at issue in the litigation. If the answer to either question is "yes," the firm should probably seek client consent before beginning to handle the litigation.
- If it is decided that the issue is consentable by the client—that is, that there is a potential conflict under Rule 1.7 or its analogs but that it is unlikely the lawyer will be called as a witness (which is ordinarily non-consentable)—then obviously full disclosure of all the facts and legal issues should be made to the client. "Full disclosure," says a leading treatise,†† includes "the source of the competing demands on the lawyer's loyalties, the posture of the matter, the potential ways in which the conflict could change (either for worse or for better), and the potential harm that could result." The client has to be able to make an *informed* consent, and the client's sophistication and capacity to consent, and the scope and sufficiency of the lawyer's disclosures to the client, will certainly be considered carefully by any reviewing court.
- The disclosures and request for consent should be in writing. Most jurisdictions' rules require this (*see, e.g.*, Model Rule 1.7 and Section 10.29 of Circular 230), and in every jurisdiction it is good practice, if only from a later evidentiary standpoint.
- The letter disclosing the issues and seeking the client's consent should point out that by the very nature of the conflict the lawyer and/or law firm cannot offer the client disinterested advice on what to do. In serious cases, therefore, the client should be advised to consult separate, independent counsel regarding the correct course of action.
- If it is concluded that informed consent will not cure the problem—either because the lawyer will still not be able to render "competent and diligent representation" (*see* Rule 1.7(b)(1)) or because the problem is not "consentable" in the first place—the lawyer may have to withdraw from the representation. Obviously in such cases there is an ongoing duty to provide a smooth transition to new counsel so as not to affect the client adversely.

**Malpractice risk.** The foregoing discussion has largely focused on the ethical rules governing "prior work" conflicts and the related need for a lawyer to appear as a witness. These rules are largely enforced by state bar authorities, or in the case of tax lawyers, by the Service's Office of Professional Responsibility (which enforces Circular 230) or the Tax Court (with respect to its rules).

However, these issues can also create malpractice exposure for lawyers and their firms. An alleged conflict can greatly complicate the defense of a claim. Often in a malpractice case the lawyer's alleged mistake may not have been a mistake at all, but perhaps one of several legitimate judgment calls. Or maybe the lawyer really did make a mistake, but the mistake had nothing to do with the damages that the former client claims. Those damages may have arisen from the client's own business ineptitude or simple bad luck.

Good defense lawyers will take those cases to trial with a good success rate. But extensive work with jury focus groups and actual case experience demonstrate that the addition of a conflict allegation will greatly complicate the defense of the case. Savvy plaintiffs' lawyers, aided and abetted by ethics experts, will focus on the lawyer's "heinous conduct." Jurors, who may or may not take the time to focus on the complex details of the underlying representation, expect a lot from lawyers and will focus on the alleged misconduct. The results can be disastrous.

Tax lawyers are not immune from the risk. As noted at the outset, prior work conflicts are among "The Top Ten Things That Get Tax Lawyers in Trouble for Malpractice." The books are full of cases in which one or more of these issues—failure to recognize a prior work conflict, inadequate analysis or disclosure of it, not obtaining an informed consent, not taking other necessary steps to cure the problem, etc.—has led not only to disciplinary sanctions but also to malpractice liability.

To take just one example previously mentioned, the lawyer in *Calderone* was sued for malpractice by his former clients, and according to the opinion settled with them for a total of $2.9 million. Although it is unclear from the opinion whether the alleged malpractice occurred in connection with the prior, substantive tax work (formation and management of an ESOP), or the handling of the Tax Court proceedings, or both, the facts surrounding the prior work conflict were surely factors in the decision to settle.

**Conclusion.** Careful attention to the issues surrounding prior work conflicts can help avoid both disciplinary proceedings and malpractice risk. You may also find that your clients actually appreciate lawyers who are careful to disclose potential conflicts and discuss them fully; it shows attentiveness to detail and a commitment to integrity in the practice of law. In fact, clients who don't respond positively to a discussion of these issues may not be the kind of clients you want. But then, poor client intake processes are another of "The Top Ten Things That Get Tax Lawyers in Trouble for Malpractice." ■

†† Geoffrey C. Hazard, Jr. & W. William Hodes, *The Law Governing Lawyers* § 10.8 (2004 Supp.).