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NEWSQUARTERLY

Thinking About Tax Malpractice

by Michael B. Lang*

On Thursday, December 13, at 1:00pm ET, the Tax Section will sponsor its annual **Tax Link Live** member benefit teleconference. This special, 90-minute CLE ethics program, "Thinking About Tax Malpractice" will feature the following speakers: Michael B. Lang, Megan Brackney, Larry S. Dushkes, and Diana L. Wollman. This article is background material for the program. More information can be found on p. 29 of this issue.

When tax practitioners think of who addresses substandard behavior by their colleagues they think of the IRS Office of Professional Responsibility (OPR) and they are right to do so. OPR's mandate, funding and staffing have expanded greatly in recent years as part of an effort to hold those who work in the tax field to higher standards. But OPR, like state bar ethics committees, focuses on professional discipline. It is of no help to the client whose tax lawyer has mishandled the client's representation. This remains the province of malpractice and related causes of action. This article will briefly review some basic tax malpractice-related issues, as well as how tax lawyers may reduce their malpractice risk.

Basic Issues

An unhappy client may seek redress from his tax lawyer through any one of numerous causes of action. Some arise under tort or contract law, such as negligence, breach of contract, breach of fiduciary duty, intentional misrepresentation (known as "deceit"), negligent misrepresentation, civil conspiracy, breach of covenant of good faith, intentional or negligent infliction of emotional distress, or aiding and abetting a breach of fiduciary duty. Others may arise under statutes, such as unfair trade practice provisions, RICO, or securities laws. Plaintiffs' claims often include multiple causes of action because of differences as to the application of the statute of limitations, measure of damages, ability to recover legal fees, to whom liability extends and defenses.

Despite such differences, such causes of action generally require proof that (1) the defendant owed a duty to the plaintiff, be it under tort law, a contract, or a statute; (2) the defendant breached the duty; (3) the breach was the cause (referred to as "proximate cause" in tort cases) of an injury to the plaintiff; and (4) the injury resulted in **actual** damages to the plaintiff. Certain causes of action may require additional elements of proof—for example, deceit requires a showing of scienter—but the basic four elements are the core of the various causes of action.

A traditional negligence action involves a breach of the duty of care or a failure to exercise care, the duty of care requiring the exercise of competence and diligence "normally exercised by lawyers in similar circumstances." Restatement (Third) of the Law Governing Lawyers § 52(1) (2000) ("Restatement"); *see* M.R.P.C. 1.1 and 1.3.

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The relevant standards and practices are generally those of lawyers handling similar matters in the state, but in areas in which there is a national practice (such as federal tax practice), national standards are likely to be relevant. *See* Comment b to Restatement § 52.

A lawyer who lacks the expertise to handle an engagement has a duty to either acquire appropriate expertise or refer the matter to an expert. *See* M.R.P.C. 1.1 and Comment 4; *Horne v. Peckham*, 97 Cal. App. 3d 404 (3d Dist. 1979). One intermediate approach is to associate with or consult another lawyer reasonably believed to be competent. *See* Cal. R.P.C. 3-110(C)(1); *see also* M.R.P.C. 1.1, Comment 6, as amended in 2012. Of course, the duty of care applies to the referral or consultation as well; a lawyer can be sued for a negligent referral.

Another duty that frequently arises in malpractice litigation is the duty to communicate with the client. It cannot be emphasized enough that "a lawyer should promptly respond to or acknowledge client communications." M.R.P.C. 1.4, Comment 4, as amended in 2012. A lawyer also has a duty to explain any matter "to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." Restatement § 20. This is an essential part of any tax advice inasmuch as the exact meaning of the so-called taxpayer accuracy standards is not self-evident; nor is the risk of penalties or even potential criminal liability. Sometimes, simply sending the client a written opinion that explains the lawyer's tax advice may be insufficient if there is any doubt about the client's ability to understand the opinion or if the written opinion is provided at a time when the client cannot be expected to fully consider the opinion before proceeding to act upon the advice. *See, e.g.*, M.R.P.C. 1.0, Comment 6 (Informed Consent); M.R.P.C. 1.4, Comments 5 and 6 (Explaining Matters).

The lawyer acts as a fiduciary for his client. This fiduciary duty to both clients and former clients is reflected in detailed conflict of interest ethics rules as well as indirectly in other rules, such as those protecting client confidential information. For tort law purposes, breaches of this fiduciary duty, which is said to require "absolute and perfect candor" to clients, are actionable. *See* Restatement § 49; *see generally* Vincent R. Johnson, *"Absolute and Perfect Candor" to Client*, 34 St. Mary's L.J. 737 (2003). In the case of a "clear and serious violation" of the duty to the client, the lawyer may be required to forfeit some or all of his fees, in some jurisdictions even absent proof of actual damages. *See* Restatement § 37, listing considerations relevant in determining whether and, if so, how much forfeiture of fees is appropriate. By contrast, in a traditional negligence action, the plaintiff may be able to elect restitution instead of damages.

Some Unresolved Issues in a Tax Practice Context

Certain issues have particular significance in a tax malpractice context. The statute of limitations looms large in this respect since there is often a considerable lag between the time at which legal advice was provided and both the time the client discovers (or should discover) the breach of a duty and the time when the client suffers actual injury, although the statute may be tolled under the continuous representation doctrine or because of fraudulent concealment.

Furthermore, in some jurisdictions, a statute of repose may preclude the action as a result of a delay in either discovering the breach of a duty or the client's having actual damages. In some cases, especially those involving so-called national law and CPA firms, it may be unclear which jurisdiction's statute of limitations is applicable. Furthermore, the same tax malpractice actions filed against a CPA and lawyer may be subject to different statutes of limitations. Indeed, it may not be clear how much injury must be sustained and whether the injury must be irremediable before the statute of limitations starts running. The bottom line is that the applicable statute of limitations and how it applies are often unknown.

The role of Circular 230 and statutory practitioner and taxpayer accuracy standards in malpractice litigation is also uncertain. While there is considerable overlap between actions of a tax lawyer that may trigger OPR or state bar discipline and those that may lead to a malpractice claim, the overlap is by no means perfect. In most jurisdictions, however, the breach of a state bar ethical rule by a lawyer may be offered as evidence to establish a breach of the corresponding duty to the client on the theory that the ethical rule is designed to protect the client. *See, e.g.*, *Ruden v. Jank*, 543 N.W.2d 605, 611 (Iowa 1996). (Some states give the breach of an ethical rule greater weight, while in a few states violation of a rule is not admissible as evidence for the plaintiff. The leading case for this view is *Hizey v. Carpenter*, 830 P.2d 646 (Wash. 1992).) Restatement § 52(2) applies the same general principle to both rules and statutes, stating that a rule or statute may be considered as "an aid to understanding and applying" the standard of care or fiduciary duty to the extent it is designed to protect persons like the claimant and there is proof that the provision is relevant to the claim.

Whether the rationale of the majority view and the Restatement will apply to breaches of a provision of Circular 230 is not clear, partly because some of Circular 230 is designed to protect the interest of the Service rather than that of the client. For example, consider section 10.27(b)(2), generally disallowing the charging of contingent fees for services in connection with a matter before the Service, and section 10.35, providing detailed rules for so-called "covered opinions," although the latter provision is on the verge of repeal at this writing. On

the other hand, breaches of Circular 230 rules that either parallel state bar ethics rules or are designed to protect clients are likely to be treated like breaches of such state bar ethics rules. Accordingly, violations of provisions such as Circular 230 section 10.21, requiring prompt advice to a client of the client's noncompliance with tax laws or error in or omission from any return, document, affidavit or other paper submitted or executed under the federal tax laws, and section 10.22, requiring practitioners to exercise due diligence as to the accuracy of documents and representations, are likely to be allowed to be offered in court as evidence of the breach of a duty to the client.

In addition to Circular 230, tax practitioners must deal with statutory accuracy standards for both taxpayers and return preparers. The duty of practitioners to advise clients must also be viewed in this light. At a minimum, a practitioner must advise a client whether a position advised is consistent with the taxpayer accuracy standards and, if it is not, of the penalty to which the taxpayer may be subject in the event a substandard position is taken on the return. Failure to do either of these things should be at least evidence of a breach of the practitioner's duty to communicate with the client. The practitioner also needs to explain the applicable taxpayer accuracy standard (*e.g.*, "substantial authority") fully enough for the taxpayer to be able to make an informed decision with respect to taking any position involved on the tax return. It is unclear whether the return preparer accuracy standards, in a malpractice context, add anything to the mix.

General Malpractice Prevention and Avoidance

Tax lawyers seeking to prevent or avoid malpractice should start with basic procedures. While experts advise developing a comprehensive risk management program, there are certain steps short of this that can make a big difference. The first is the use of calendaring systems, both to prevent missing deadlines and to schedule regular communication with clients, the former because it is an obvious source of largely preventable malpractice claims and the latter because communication with clients may help prevent some malpractice claims. Some lawyers consciously or serendipitously use dual calendaring systems, with everything listed on both the lawyer's calendar and a paralegal's or secretary's calendar.

Client screening procedures are also crucial. Virtually all law firms of any significant size have conflict screening systems. These systems are only as good as the data entered into them. Firms should consider developing a list of categories of persons, entities and interests that, taking into account the firm's practice, should be entered into the database. In some cases, such as in an estate planning or probate practice, including staff members such as paralegals in the database may be a good practice. For extensive discussion about persons and entities to include in the database, *see* Susan Saab Fortney & Jeff Hanna, *Fortifying a Law Firm's Ethical Infrastructure: Avoiding Legal Malpractice Claims Based on Conflicts of Interest*, 33 St. Mary's L.J. 669 (2002).

In addition to avoiding conflicts of interest, client screening can help avoid problem clients, those who can't or won't pay, and those who keep changing lawyers or are otherwise "difficult." Careful screening also allows the firm to decide if it has the expertise (or can acquire it), the staff and the financial resources to handle the case.

The final category of basic practices that can help avoid or prevent malpractice is careful documentation of all dealings with clients or prospective clients. All engagements should be reflected in an engagement letter signed and dated by the client covering important matters such as the scope of intended representation, fee arrangements, anticipated expenses and how they will be handled, staffing plans, conflict disclosures and informed consents if necessary, expectations about communications and cooperation between the attorney(s), firm staff and the client, and any other important matters. However, it may be wise to put the informed consent in a separate document in light of the possibility that the Service may ask to see it. Changes in firm practices should be communicated in writing to the client and should not be inconsistent with original expectations. For example, if the firm wants to increase its fees periodically, this should be spelled out in the initial engagement letter. In addition, any important advice to clients should be confirmed in writing.

One possible source of trouble is "accidental" clients, prospective clients that the firm declined to represent and former clients. In the first situation, the firm should send the prospective client a written non-engagement letter (preferably by certified mail, return receipt requested). In the latter situation, a client termination letter can be sent when the engagement is completed, perhaps with the final statement and a "thank you" for having been engaged. Otherwise, there is always a risk that the client will claim that the lawyer promised either to provide further services or to at least let the client know of any new developments in the law that would impact the client's situation. This could lead to a substantial malpractice claim. *See Lama v. Shearman & Sterling*, 758 F. Supp. 159 (S.D.N.Y. 1991) (allegation that law firm partner responded to inquiry by saying firm would inform plaintiffs if any significant changes to tax laws impacting their transaction were enacted; held, jury question whether such a commitment was made and later handled negligently).

Problem Areas in the Tax Field

There are two important sources of potential malpractice risk in the tax field that merit special comment. The first is conflicts of interest between the client's interest and the lawyer's interest, while

the second is a function of the competence required to give tax advice that satisfies either a statutory or trade usage accuracy standard or level of confidence. These two problems are often intertwined. In a malpractice action based on the lawyer having provided substandard tax advice, evidence of a conflict of interest on the part of the lawyer may make it easier for the plaintiff's counsel to persuade the trier of fact that the advice was negligent.

Often the toughest conflicts for lawyers to see are those involving their own personal interests. The conflicts inherent in business transactions with clients and referral arrangements with other lawyers or nonlawyers are clear and the subject of considerable guidance in ethical rules. Other conflicts are less apparent. A tax lawyer, for example, may agree to provide a tax opinion at a stated level of confidence on an aggressive tax plan (*e.g.*, a tax shelter transaction) that the lawyer planned. The agreement may entitle the lawyer to a larger fee or bonus if the transaction is implemented than if it is not implemented. In addition, the closing of the transaction may be conditioned on issuance of the opinion. The lawyer then has a strong incentive to provide the opinion necessary to assure that the transaction will proceed, regardless of what an objective analysis of the transaction would conclude. This appears to be what happened in *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010), discussed in Michael B. Lang, *Conflicts about Conflicts: Implications of the Tax Court Canal Corp Decision For Disciplinary and Malpractice Actions*, 53 BNA Tax Management Memo. 3 (2012). A trier of fact in a malpractice action, observing this conflict, may be more inclined to find the opinion itself negligent, if not intentionally misleading.

Avoiding such conflicts of interest reduces the risk to the lawyer, but there is still an inherent difficulty in providing an opinion on a transaction with uncertain tax consequences. The usual source of trouble is an overly optimistic opinion on a transaction the desired tax consequences of which are not sustained on the merits. However, the lawyer who counsels against either undertaking a transaction or taking a reporting position out of fear that the desired tax consequences will not be sustained is also at risk of being sued for malpractice if the client can establish that the transaction or reporting position would have been less risky than the lawyer advised. In either instance, to avoid possible liability the lawyer's advice must be within the range of what a reasonable lawyer would have advised in like circumstances, a somewhat nebulous standard. The bottom line is that providing a tax opinion at a stated level of confidence demands a high level of skill, objectivity and diligence on the part of the tax lawyer. ■

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