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Tax Opinions, Third-Party Opinions and Liability

By Robert W. Wood • Wood LLP

In the push to get a transaction documented and closed, we sometimes do not do our best work. Tax advisers may help structure a transaction, issue an opinion or both. Tax opinions and other legal opinions are often a condition of closing, and the nature and scope of opinion liability can vary. Liability to a client for what one says in writing to the client seems unexceptional. More amorphous is the liability to persons other than clients.

Does liability run equally to all intended addressees? What about unintended distributees? What can a lawyer do to minimize this liability?

My focus will be on lawyers, on potential liability to clients and nonclients for malpractice, misrepresentation, *etc*. Accountants may face similar issues, but the scope of legal malpractice liability may technically be different from the liability accountants may face.

Liabilities to Clients and Nonclients

Suppose a lawyer writes an opinion letter to a client expressing the view that a tax deduction is more likely than not to be upheld. If the deduction is denied, whether liability will attach should be controlled by a mix of factors.

Does the opinion accurately describe the law and apply the facts to the law? Does it require the client to contest the tax determination? Did the lawyer clearly set out what he or she is guaranteeing and what he or she is not?

All of us should be capable of dealing with the issues this presents. Liability to nonclients is tougher to explain and understand. To what extent are nonclients entitled to rely on opinion letters?

What if they are not intended for anyone else? Historically, lawyers have not been held liable for their negligent misconduct in suits brought by nonclients. A lack of privity of contract prevents those not in contract from seeking damages in tort for the attorney's conduct.

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Over time, however, courts chipped away at the privity doctrine. One of the seminal cases, *Glanzer v. Shepard* [233 NY 236 (1922)], involved a real-life bean counter. The court found that the law imposed a duty of care on the public weigher, despite the lack of privity of contract with the buyer. In some respects, it has been downhill ever since.

Third-Party Beneficiaries, Negligence and Misrepresentation

Several legal theories can give nonclients a cause of action against an attorney rendering legal advice. Commentators have attempted to establish a unifying theory, but courts have not yet embraced one. [*See* Eisenberg, *Attorney's Negligence and Third Parties*, 57 N.Y.U.L. Rev. 126 (1982); Zipursky, *Legal Malpractice and the Structure of Negligence Law*, 67 Fordham L. Rev. 649 (1998).] Often, legal malpractice will be pleaded in the alternative to misrepresentation, fraud, *etc*.

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Suppose Borrower seeks a loan from a bank and asks Lawyer to write a letter to the bank. The bank will not make the loan without this letter. Borrower tells Lawyer there are no encumbrances or liens on his equipment.

However, Borrower has already pledged his farm equipment. Even so, Lawyer writes the bank stating that he has conducted a UCC, tax and judgment search and that the equipment is free and clear of all liens and encumbrances. In fact, Lawyer made no search.

Upon receiving the letter, the bank provides the loan. When it is not repaid and the bank investigates, it sues Lawyer. Of course, the bank was not in privity of contract with Lawyer.

Even so, under similar facts in *Greycas, Inc. v. Proud* [CA-7, 826 F2d 1560, 1563 (1987)], the bank recovered. Although a lawyer has no general duty of care toward his client's adversary, the court noted that this maxim is only a general rule. To provide a remedy for a nonclient, the nonclient must prove that the primary purpose and intent of the attorney-client relationship itself was to benefit or influence a third party.

In this case, the attorney wrote the letter for the sole purpose of attempting to influence the bank. The court found that the attorney had a duty to use due care to see that the information was correct. The attorney breached that duty by stating that he had performed a search when he had not.

Due Diligence

Sometimes the conduct will be less extreme. Suppose that Green, the owner of 100 percent of Triad Corporation, sold all of his shares to Stern for cash and a note. Lorri Lawyer represented Stern. Stern pledged the newly purchased shares and all of Triad's assets to secure the note.

The purchase agreement required Lorri to deliver an opinion at closing in form and substance reasonably satisfactory to Green. Lorri's opinion affirmed Stern's authority to enter the agreement, recited the agreement's due execution and stated that Lorri had no reason to believe that any representation or warranty of her client was not true. Stern later defaulted on the notes and filed for bankruptcy.

In fact, Stern had negotiated for a line of credit to finance the purchase and had granted a lender a first-security interest prior to granting

the security interest to Green. Green brought suit against Lorri, alleging that she had a duty to exercise reasonable care and skill in her investigation of the matters contained within her letter and in making the assertions and representations she did. Green alleged that Lorri was negligent in failing to perform a proper investigation of her client's credit, legal and financial history.

If she had, she would have known that the representations in her opinion letter were untrue or misleading. In *Geaslen v. Berkson, Gorov and Levin* [200 Ill. App. 3d 600 (1991)], the court reviewed the nature of the duty owed by an attorney to a nonclient and how it interacts with the duty owed to her client. A duty can arise to a nonclient in a particular transaction or relationship if the client intended that its primary or direct purpose was to benefit the nonclient.

The court found that the primary purpose of the relationship between the defendant and her client, Stern, was to benefit Stern, not to benefit the plaintiff. Nevertheless, upon issuing the opinion to influence the plaintiff's decision to enter the sale, the defendant assumed a duty of care towards the plaintiff with respect to the accuracy of the letter. The duty existed because the defendant's actions (of issuing the opinion letter for the benefit of the plaintiff) would foreseeably affect the plaintiff.

The real issue was the scope of that duty. The plaintiff alleged that this scope included a duty to investigate Stern's financial background to determine his credit-worthiness. Yet the court held the defendant's only duty of care was to the matters requested in the agreement and expressed in the opinion.

The court suggested that to find that the duty went beyond the scope of what was required in the opinion letter could conflict with the attorney's duty of undivided loyalty and confidentiality to her client. The court thus recognized the inherent tension between the attorney's duty to the client and to others. The record did not indicate that the plaintiff had requested the defendant to investigate Stern's background.

Likewise, the opinion letter did not opine on Stern's credit-worthiness. The court concluded that the defendant did not have a duty to investigate. Since it was the defendant's client who asked for the opinion letter, there was a lesser concern with the possibility that an acknowledgment of a duty of care to the plaintiff would engender a conflict with the interests of the client.

Investment Worries

In *Roberts v. Ball, Hunt, Hart, Brown & Baerwitz* [57 Cal. App. 3d 104 (1976)], Red was thinking about loaning money to the Burbank general partnership. Al Attorney represented Booker, a partner in the Burbank general partnership. Booker retains Al to write an opinion to facilitate the deal.

Al writes an opinion letter for Booker, knowing that Booker will show the letter to Red and that the letter will be used to induce Red to make a loan to Burbank. Indeed, the opinion letter itself provides that it will be shown to Red to induce him to make the loan. The opinion letter provides that Burbank is a general partnership, consisting of 14 individual general partners.

In fact, Al knows that there is an issue as to the legal nature of Burbank. He is even aware that the general partnership may have been recently dissolved. Al also knows that the 14 individual owners do not agree as to Burbank's legal entity type and that some owners genuinely believe that their liability to Burbank is limited.

Nonetheless, Al fails to include this information in his opinion letter. Red loans money to Burbank in reliance on Al's letter, and the loan goes bad. Plaintiffs allege that Al had a duty to disclose not only the legal status of Burbank, but also information regarding doubt as to that legal nature and the beliefs of its members.

In other words, plaintiffs allege that the failure to disclose such information made the opinion letter misleading. In *Roberts*, decided under California law, the court allowed a negligent representation cause of action. The court pointed to the California Civil Code to determine the elements of the cause of action.

However, it looked to the multi-factor test to determine whether a duty existed. The court noted that the defendant undertook to assist in securing the loan on behalf of his client. Indeed, the opinion letter was rendered for the purpose of influencing plaintiff's conduct, and the result was clearly foreseeable.

Thus, the court had no difficulty in finding that the issuance of a legal opinion intended

to secure a benefit for the client must be issued with due care. Otherwise, attorneys who do not act carefully will have breached a duty owed to those they attempted or expected to influence on behalf of their clients. The crux of the decision was whether the defendant breached his duty of care by omitting certain information from the opinion letter.

The opinion letter stated that Burbank was a general partnership, when several facts known to the attorney may have cast doubt upon that characterization. The court held that the lawyer had a duty to disclose this doubt. After all, it might have been a determinative factor for the plaintiff to make the loan.

The court noted that expressing half of the truth is often as misleading as stating an outright falsehood. The court acknowledged that an omission of a material fact from an opinion letter can create attorney liability.

Tax Opinions

Tax opinions come in several varieties. In one, a promoter incorporates a tax opinion letter into a prospectus, which is disseminated to potential investors. Nonclients use this offering material to decide whether to invest in the particular transaction.

The second category is a residual catch-all that includes all other opinion letters not included in the first. There is understandable liability to clients to whom one writes such opinions. For example, in *Wright v. Compton Prewett, Thomas & Hickey* [315 Ark. 213 (1993)], a law firm represented to a client that a spin-off should be tax-free.

Plainly, a lawyer who provides negligent tax advice may be liable to his client, and perhaps to others. But the potential liability to third parties is not so obvious. A taxpayer reviews an investment prospectus which contains an attorney's tax opinion letter.

The taxpayer may or may not have an independent attorney review the prospectus. The taxpayer invests in the transaction, which typically generates a loss. The loss is deducted on the taxpayer's return, but the IRS subsequently disallows the deduction.

The taxpayer then becomes a plaintiff, suing the attorney who wrote the tax opinion. The taxpayer frequently also sues the promoter and others involved in the transaction. This situation usually invokes securities laws, but may involve other claims too.

Attorney liability may not be predicated merely upon state tort law. Many aspects of the liability attaching under federal securities law appear to parallel the elements and rationale of state tort law. [*See generally*, *Fortson v. Winstead* [CA-4, 961 F2d 469 (1992).]

The *Kline* Case

The case of *Kline v. First Western Gov't Sec*. [CA-3, 24 F3d 480 (1994)] involved First Western's sophisticated financial transactions. Ernest Kline purchased various forward contracts packaged by First Western. Arvey, Hodes, Costello & Burman issued three opinion letters over a two-year period concerning the tax consequences of these investments.

All three opinion letters written by Arvey Hodes were addressed to First Western. Each was intended for First Western's use only and was not intended to be, and should not be, relied upon by persons other than First Western. Each was based on facts as described by First Western.

The results provided within the letter may be changed by facts unique to individual customer's accounts. The transaction's validity hinged on whether it was entered into with a reasonable expectation of generating a profit. Despite each letter's statement that it was for the exclusive use of First Western, Arvey Hodes was aware that First Western was providing the opinion to potential investors.

In fact, one investor's counsel went so far as to write a letter to Arvey Hodes noting that First Western had provided the tax opinion letter with its brochures. Kline sued under Section 10(b) of the 1934 Act. He alleged that he relied upon these letters and that they contained both affirmative misrepresentations and material omissions.

The misrepresentations concerned the operations of the trading program (*i.e.*, delivery of securities, price movements and margin deposits). There were also statements that the program could support a reasonable expectation of gain (actually, it was designed to obtain tax losses). Arvey Hodes moved for summary judgment on the misrepresentation claim.

The law firm argued that it could not be liable for an opinion which was explicitly based on

an assumed set of facts represented to it by its client. It also argued that it had not conducted any independent investigation into whether the facts from its client were accurate. The court did not concur, noting that an opinion is deemed untrue for federal securities law purposes if it was issued without reasonable genuine belief or has no basis.

Arvey Hodes argued that the opinion letter contained disclaimers, and that it was based solely on facts provided by the client. Arvey Hodes also argued that plaintiff's reliance on the opinion letter was unreasonable. The court articulated factors to determine the reasonableness of plaintiff's reliance, including:

- the existence of a fiduciary relationship;
- plaintiff's opportunity to detect fraud;
- the sophistication of the plaintiffs;
- the existence of a long-standing business or personal relationship; and
- access to the relevant information.

Balancing all of the factors, the court found plaintiff's reliance to be reasonable.

History Counts Too

Arvey Hodes' disclaimers were not sufficient to prevent liability. However, it seems likely that some of the court's reasoning lies in the considerable history between Arvey Hodes and Sidney Samuels. Mr. Samuels had founded First Western in 1978.

Before that, he had been a general partner in Price & Company. The plaintiff alleged that First Western's trading program was substantially similar to one run by Price. In fact, First Western was modeled on it.

Arvey Hodes had assisted in Price's formation, its offering material and represented it in connection with IRS civil and criminal investigations. The plot thickens. The plaintiff alleged that Arvey Hodes made no reference to prior IRS investigations of Price or Samuel's connection to Price.

Interestingly, an IRS investigation ultimately led to a finding that Price's trading programs were sham transactions. Furthermore, the IRS, the SEC and the Minnesota Department of Commence had begun investigations of First Western and its customers by the time Arvey Hodes issued its final opinion letter. The final opinion letter, however, only mentioned the audit of First Western's customers.

Regarding the omissions claim, the plaintiff alleged that the tax opinion was misleading. After all, Arvey Hodes failed to include in its opinion letter information that, if included, would have undermined its conclusions. Finding for the plaintiff, the court found a limited duty to investigate and disclose, when, by the drafter's omission, a public opinion could mislead third parties.

Interestingly, the court considered this opinion public, even though it was addressed to First Western. Even more notably, by its own language, it was not to be shown to anyone else. Of course, in reality it was disseminated to third parties.

In fact, the court specified that when a professional undertakes an affirmative act to communicate, there is a general duty to speak truthfully. This includes a duty not to omit (sometimes referred to as a duty to disclose) qualifying information, the absence of which would render the communication misleading. There is one more lesson from *Kline*.

Arvey Hodes moved for summary judgment, arguing that it could not be liable for its tax opinion because it relied upon the set of facts represented by the client. Moreover, Arvey Hodes argued that it failed to conduct an independent investigation into whether the facts from its client were accurate, and thus could not be liable for its tax opinion. The parties in *Kline* argued before the court on January 25, 1993, and the court filed their decision on May 2, 1994.

That was at a time when Circular 230 was changing in the wake of one tax shelter era. Had the revised Circular 230 then been in effect, this would have been a covered opinion. Arvey Hodes would have been required to perform reasonable due diligence of all the relevant facts to arrive at a legal conclusion.

Arvey Hodes would have been required to: use reasonable efforts to identify and ascertain all relevant facts; base the opinion on reasonable factual assumptions; rely only on reasonable factual representations, statements or findings of the taxpayer; relate applicable law to the relevant facts; base the opinion on reasonable legal assumptions, representations or conclusions; contain internally consistent legal analyses or conclusions; consider all significant federal tax issues (unless limited in scope); provide a conclusion as to the

likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue considered in the opinion; and provide an overall conclusion as to the likelihood that the federal tax treatment of the transaction or matter that is subject of the opinion is proper treatment and the reasons for that conclusion.

Dangers of Updating Liability

What happens when future events intervene that may influence (or even contradict) the advice in a tax opinion? Tax opinion letters generally expressly negate the duty of the author to update the letter for future events. Particularly where there is an express statement of this sort, common sense should preclude finding liability for an alleged failure to update that opinion letter.

Sometimes, attorneys are hoist by their own petard. Perhaps in an effort to be helpful, an attorney may affirmatively offer to update an opinion letter (which by its language is not to be updated). Here, a failure to act may clearly create liability.

For example, in *Lama Holding Co. v. Shearman & Sterling* [758 FSupp 159 (S.D.N.Y. 1991)], the plaintiffs were foreign investors who hired Shearman & Sterling to facilitate an investment in Smith Barney. Included in this facilitation was tax advice for dividends and for a potential later sale of the stock. For those of us old enough to remember pre-1986 tax law, this was a General Utilities strategy.

The plaintiffs alleged that in August or September of 1986, they made a specific inquiry to Shearman & Sterling regarding the possible effects of a tax bill pending in Congress. They alleged that a Shearman & Sterling partner replied that "there were no significant tax changes enacted as of that time, but that the firm would inform plaintiffs if any significant amendments to the U.S. tax laws were enacted."

After the enactment of the 1986 tax legislation, plaintiffs sold their stock without consulting Shearman & Sterling, and suffered a $33 million tax. The plaintiffs brought suit, and Sherman & Sterling moved to dismiss, claiming that the facts were insufficient to state a claim. The court disagreed, noting that "[i]n attorney-client agreements there may be liability when there is a promise to perform and no subsequent performance, or when the attorney has explicitly undertaken to discharge a specific task and then failed to do so."

Ultimately, it appears that the parties settled, so we may never know how a jury would have decided the case. Another variation in fact patterns would be present if the nonclient did not retain counsel. On its face, the nonclient's failure to have counsel may increase support for finding the plaintiff justified in his or her reliance.

With no counsel of his or her own on which to rely, the plaintiff may argue that the opinion provides support for his or her reliance. Conversely, an argument could be made that anyone would be foolish to enter into a sophisticated transaction without counsel. The lack of one's own counsel may strengthen a finding of justifiable reliance.

However, it may simultaneously strengthen the argument that the reliance was not justified. It may matter in this analysis whether the opinion states expressly that "you should get your own tax advice." Such a disclaimer may seem counterintuitive in an opinion that accompanies an offering document.

Yet opinions sometimes weave in such advice, particularly as to certain issues. Such a disclaimer should reduce the appropriateness of reliance in at least some cases.

Conclusions

Attorney liability to clients is fairly straightforward in application. Liability to third parties is far more daunting. It can arise in all sorts of factual situations and can attach under the guise of various legal theories. Indeed, each state may have adopted some or all of these theories, and some states tailor them for their particular needs. Often, suit will be brought under many theories, a true shotgun approach.

Understanding your potential liability may seem overwhelming. Common sense, however, can go a long way. The existence of potential liability should remind attorneys that providing opinion letters to nonclients may either create or modify a duty to nonclients. Moreover, sometimes what looks and sounds like an opinion to one attorney, client, adversary or judge may appear to be quite innocuous.

Plainly, something need not be labeled as an "opinion letter" to be so considered. Casual letters can be so regarded, and it is

not farfetched to wonder about the status of emails. Many forms of communication may import or enhance liability. Many forms of communication may import or enhance liability. Many seem to regard emails as oral communications, characterized by casual banter, a lack of formality and lack of signature.

But their import in lawsuits is anything but casual. It is sobering to think about the impact of a few lines of text. Remember, the case against Frank Quattrone, a former investment banker, stemmed from a single email in which Quattrone recommended that his staff clean out their files.