Tax Opinions and Nonopinions: How Far Does Liability Go?

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The world seems to enjoy scandal. Whether involving movie stars, corporate executives, politicians, or lawyers, a good yarn about malfeasance is hard to resist. Perhaps our fascination with such fodder is deeply imbedded in human nature.

Surprisingly, some of those recent stories have even involved tax attorneys, a group rarely in the limelight. Those tax lawyers have acquired their newfound notoriety in unexpected ways. Some have blessed the conduct of corporate executives only later to find their own conduct questioned, and both they and the executive have been accused of misconduct. Some tax lawyers have passed judgment on Long Term Capital's (or some other company's) complex tax saving machinations. Some have written tax opinions for aggressive deals arguably devoid of business purpose.

The IRS and the media continue to focus on what each perceives to be malfeasance. The press coverage, perhaps understandably, rarely focuses on the technical analysis and the line drawing it subsumes, even though tax lawyers have been drawing lines since the birth of the profession. Given the volumes of litigation and the copious finger pointing, the spotlight seems unlikely to fade anytime soon.

The IRS has shown increasing concern with what it perceives as tax scams and their architects and participants. The IRS has issued a barrage of press releases, notices, proposed and final regulations, and similar items. That plethora of guidance is designed to heighten transparency, promote ethical and regularized tax practice, and lead to penalties on promoters, practitioners, and taxpayers alike. In a new-age vocabulary, we have reportable transactions, list maintenance requirements, and covered opinions.

Indeed, the IRS now tallies so-called listed transactions it considers unacceptable. Special penalties apply to taxpayers, practitioners, and promoters who fail to disclose them. Even outside the area of perceived abuses, tax opinions are also becoming much more tightly regulated. In a kind of reverse hit parade, the hits just keep on coming.

The IRS issued proposed regulations to amend Circular 230 on December 30, 2003.[1] Circular 230 consists of regulations governing representation before the IRS. The revisions to Circular 230 were meant to restore and maintain public confidence in tax professionals. They give ''best practices'' for tax advisers who provide advice relating to federal tax issues or IRS submissions. The IRS also proposed to modify the standards for issuing certain tax opinions. It held public hearings on February 19, 2004, to discuss the proposed regulations.

On December 17, 2004, the IRS published the regulations in final form.[2] The accompanying news release positioned the final regulations as elevating the ethical standards for tax professionals, giving new ''tools to battle abusive tax avoidance transactions and to rein in practitioners who disregard their ethical obligations.''[3] Ensuring that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law is a top enforcement goal.

Historically, a practitioner who violated Circular 230 could be censured, suspended, or disbarred from practice before the IRS. With no monetary penalties attaching to violations, Circular 230 did not have sharp enough teeth. The IRS got new teeth in the American Jobs Creation Act of 2004. That act authorizes Treasury and the IRS to impose monetary penalties against practitioners who violate *any* provision of Circular 230.

Opinions — Take Mine, Please!

Tax lawyers and other tax professionals are asking themselves and each other how those developments affect the way they work and the work product they deliver. Particularly in this climate of increased scrutiny, all of this talk of ethical mandates and transparency should prompt tax professionals to take stock of their liability not only to governmental agencies but also to their clients, and even to third parties. Liability to clients has always been present and arguably hasn't changed much, at least not in a momentous or pivotal way.

One segment of a tax adviser's liability comes from opinions and other less formal advice. Lawyers usually don't need a reason to express their opinion. Any venue

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[1] REG-122379-02, *Doc 2003-27121*, *2003 TNT 249-4*.
[2] T.D. 9165; 2005-1 C.B. 357, *Doc 2004-23933, 2004 TNT 244-4*.
[3] IR-2004-152; *Doc 2004-23935, 2004 TNT 244-13*.

will do just fine, thank you. While an opinion letter provides that venue, it may also provide a road to perdition.

As opinion liability is clearly a topic worth considering, I suggest some ground rules about the persons to whom one may be liable. Liability to a client for what one says in writing to the client seems unexceptional. More amorphous is the liability of lawyers who provide opinion letters (or something that *looks* like an opinion letter) to a person *other* than a client. Frequently, that may be done at a client's direct request. Not all of the potential plaintiffs are clients. That expansion of classes of potential plaintiffs can be frightening.

Also, what do we mean by an opinion? I use the term "opinion" here loosely. In some cases, the letters I'll examine are nothing more than representations written to another party, such as "Joe is in good financial condition" or "There are no liens pending against Joe." In some cases, the letters may be technical. An example would be a letter admonishing that "you don't need to issue a Form 1099 to any client for this payment." Those letters or e-mails are usually written to help one's own client, not to help the addressee. Indeed, the author of the letter might be adverse to the addressee.

I believe there are a far greater number of these communications than most of us realize. In fact, I believe there is greater risk of liability to clients and third parties than there is liability for discipline or penalties to the IRS. Although we live in an age of increased IRS scrutiny, we also need to fear scrutiny from clients, and even from nonclients, who receive our opinions.

From what sort of liability can a lawyer suffer by rendering an opinion? Does the liability run equally to all intended addressees? To unintended distributees? Perhaps most importantly, what can a lawyer do to minimize that liability?

Those questions must be tempered by concerns over how that issue fits into the lawyer's ethical duties, and for nonlawyer tax professionals, to their similar obligations. A lawyer's primary duty is to his client. Lawyer rules *require* a lawyer to ceaselessly advocate for his client. The Model Code of Professional Responsibility admonishes lawyers to "represent a client zealously."[4] A professional who worries about his own liability either to his client or to others may find that those worries interfere with the client's interests.

I must also clarify the class of tax advisers I will cover. I recognize that tax advisers may increasingly be accountants, not lawyers. Further, tax advisers — both lawyers and accountants — often view themselves as part of a single profession. Circular 230 does much to reinforce that notion.

My focus here will be on lawyers and their potential liability to clients and nonclients for malpractice, misrepresentation, and so on. Accountants probably face the same or similar issues, but I stress that I have analyzed only the scope of legal malpractice liability, which technically may be different from the liability accountants may face.[5] Although lawyers and accountants may perhaps stand on equal footing when it comes to claims for negligent or intentional misrepresentation or fraud, I have not attempted to address an accountant's liabilities as distinguished from a lawyer's.

Finally, I recognize that I am providing more of an introduction than a complete exposé. I merely scratch the surface of the liability an attorney may face for writing tax opinions. There appear to be relatively few cases pertaining to third-party liability for tax opinions, except for tax shelter cases. Moreover, many of the tax cases involving third-party liability have been decided on procedural grounds, such as the lapse of the statute of limitations, rather than on the facts of the case. However, in many of those cases, the courts have addressed whether plaintiffs have sufficient grounds to sue defendant law firms for writing tax opinions.

Liabilities to Clients

I would first like to dispense with cases that involve direct liability to clients, because they are reasonably straightforward. If Tom Tax Lawyer writes an opinion

[4]American Bar Association Model Code of Professional Responsibility, Canon 7 (1986); *see also* Model Rules of Professional Conduct, rule 1.3, cmt. 1 (1993).

[5]A quick glance at accountant liability suggests that accountant liability is evaluated in a similar fashion to lawyer liability. *See generally Credit Alliance v. Arthur Andersen & Co.*, 483 N.E.2d 110, 118 (before accountants may be held liable in negligence to noncontractual parties who rely to their detriment on inaccurate financial reports, prerequisites must be satisfied: (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes, (2) in the furtherance of which a known party or parties was intended to rely; and (3) there must have been some conduct on the part of the accountants linking them to that party or parties that evinces the accountants' understanding of that party or parties' reliance); *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 189 (7th Cir. 1994) (Accountants are liable to investors who rely on their work product only if they intend the use eventually made of the financial statement. To establish liability, a plaintiff must show that the auditor (or other professional) was aware that the report would be used for a particular purpose, in furtherance of which a known third party would rely, and the professional must show an understanding of that impending reliance.); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 184 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982) (recognizing securities fraud claim against an accounting firm based on materially false representations contained in an opinion letter); and, in the latest of KPMG LLP's woes, see *Simon v. KPMG LLP*, 97 AFTR2d (RIA) 2806 (D.N.J. June 2, 2006). (Plaintiffs granted motion to certify class and approve settlement of damage claims against tax firm and other professionals who allegedly fraudulently induced them to invest in abusive FLIP and other tax schemes that cost them millions in back taxes and penalties. The plaintiffs allege that defendants and some other parties engaged in a scheme to defraud the plaintiffs and others similarly situated in connection with particular tax strategies by fraudulently misrepresenting that the tax strategies would reduce tax liability and were more likely than not to be approved by the IRS when in fact defendants knew that the tax strategies were abusive tax shelters that would not pass IRS scrutiny. The plaintiffs allege the defendants are liable on multiple theories, including fraud, civil conspiracy, breach of fiduciary duty, breach of contract, professional malpractice, unjust enrichment, and the charging of unethical, excessive, and illegal fees.)

letter to Cassandra Client expressing the view that a tax deduction is more likely than not to be upheld, Tom may face direct liability to Cassandra if the deduction is denied. Whether liability will attach should be controlled by such factors as the accuracy with which the opinion describes the law and applies the facts to the law, the degree to which the opinion requires the client to contest the tax determination, and the extent to which the lawyer has clearly set out what he is guaranteeing and what he is not.

All of us should be capable of dealing with the kinds of issues this presents. Sometimes the answers may be in shades of gray. For example, in *Whitney v. Buttrick*,[6] the plaintiff client brought a legal malpractice action against his lawyer, claiming the lawyer was substantially negligent in structuring a sales transaction that resulted in a large income tax liability to the client. The plaintiff alleged that his lawyer negligently misrepresented to him that the sale of his interest in a business could be tailored to avoid tax.

However, as a result of the sale, the plaintiff incurred a significant tax liability. At trial, the jury found the tax lawyer 75 percent negligent (and the plaintiff 25 percent negligent). Thus, the plaintiff recovered from his lawyer 75 percent of the taxes he had paid.

Liability to Nonclients

Liability to nonclients deserves special attention. It's hard enough to be loyal, honest, and tireless with respect to one's own clients without worrying about potential duties to (and liabilities from) third parties. Lawyers have strict conflict of interest rules that control their actions, and it may seem hard to undertake any duties to nonclients without risking some dilution of those conflict standards.

Given all those constraints, does a lawyer owe a duty to a nonclient? To what extent are nonclients entitled to rely on opinion letters, whether written expressly for them, indirectly to the public at large, or not intended for them at all?

Historically, lawyers have not been held liable for their negligent misconduct in suits brought by nonclients. The stated rationale for what may sometimes appear to be lawyer protectionism is the lack of privity of contract between the lawyer and the nonclient. That lack of privity prevents those not in contract with the attorney from seeking damages in tort for the attorney's conduct. Attorneys owe a duty of care only to their own clients.

The privity of contract doctrine dates to the 19th-century English case of *Winterbottom v. Wright*.[7] There, the postmaster general contracted with the defendant to maintain mail coaches. The plaintiff, a postal employee who drove one of the coaches, suffered injuries when one of the coaches broke down. The plaintiff sued the defendant for breaching its contract with the postmaster general, arguing that the defendant's failure to maintain the coach as required by contract caused the accident. The court refused to allow a negligence action based on the duty contained in the contract, because that duty was owed solely to the postmaster general.

Several decades later, the U.S. Supreme Court in *Savings Bank v. Ward*[8] expressly adopted the English privity-of-contract doctrine. In that case, a bank lent money for the purchase of real estate in reliance on a title report prepared by the defendant attorney for the purported landowner, not the bank. The defendant certified the title even though the land had previously been sold. Since the defendant was not in privity-of-contract with the plaintiff, the court found no liability.

During the first half of the 20th century, the privity of contract doctrine reigned supreme. Courts and businesspeople liked it; it was predictable and efficient. Over time, however, courts chipped away at the privity doctrine.[9] One of the seminal cases, *Glanzer v. Shepard*,[10] involved a bean counter — yes, an actual bean counter, not an accountant (although perhaps both are faced with similar issues regarding professional liability to nonclients).

In this case, a bean seller employed a public weigher (aka bean counter) to certify the weight of the beans he sold. The buyer sued the public weigher, claiming negligence in being overcharged for beans. 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. The court considered the ''public'' nature of the weigher and noted that since the weigher provided a certificate directly to the buyer, the bean counter was aware of the risk of misperformance.[11]

Balancing of Factors

The bean counter case itself may not seem significant, and not much changed for several more decades. The case opening the floodgates to change was *Biakanja v. Irving*,[12] in which the California Supreme Court rejected strict privity of contract in favor of a balancing-of-factors approach. The case involved a notary's negligently drafted will (which also constituted the unauthorized practice of law). The legal question was whether the notary owed a duty of care to the beneficiary under the will, a party who was not in privity of contract with the notary. The court stated:

> The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to

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[6] 376 N.W.2d 274 (Minn. Ct. App. 1985), *appeal after remand*, 1989 Minn. App. LEXIS 1366 (Minn. Ct. App. Jan. 2, 1990).

[7] 152 Eng. Rep. 109 (Ex. 1842).

[8] 100 U.S. 195, 200 (1879).

[9] *See generally MacPherson v. Buick Motor Co.*, 217 N.Y. 382 (1916) (manufacturers owed a duty of care to consumers if the article sold was reasonably certain to be dangerous if negligently made, despite lack of privity); *Mentzer v. Western Union Tel. Co.*, 93 Iowa 752 (1895) (telegraph company owes a duty of care to addressee of intended telegraph despite lack of privity).

[10] 233 N.Y. 236 (1922).

[11] *But see Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931), for limitations places on *Glanzer*; both opinions by Justice Cardozo.

[12] 49 Cal.2d 647 (1958).

him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm.[13]

Using the multifactor test, the court found that the notary had a duty to the beneficiary under the will.

Just three years later, the same California court decided *Lucas v. Hamm*,[14] another case brought by a beneficiary claiming benefits under a will. That time, the defendant draftsman of the will was an attorney. Again, the court found that the attorney had a duty to the beneficiaries under the will, and it added another factor to the multifactor test: whether recognition of liability would impose an undue burden on the profession.

Will drafting cases are the paradigm privity-of-contract case. After all, how can the deceased party (who is really in privity with the attorney) bring his own action to enforce his *own* wishes? By definition, he's already dead. If someone is going to complain or sue, it is going to be a beneficiary or intended beneficiary.

Although few would quarrel with that kind of third-party liability in will drafting cases, one might question how far those principles should go. Indeed, once the courts opened the floodgates by striking down privity of contract in will drafting cases, it was not long before the courts allowed diverse types of plaintiffs to recover under various legal theories.

Third-Party Beneficiary Theory

Although courts generally followed the will drafting examples, some courts were unpersuaded by the prevailing legal theory,[15] finding the multifactor test unworkable and troublesome.[16] Those courts looked to third-party beneficiary law, which is merely a special exception to the privity-of-contract doctrine.

Third-party beneficiary law provides a remedy to a person who is not in privity of contract with the alleged wrongdoer. Types of third-party beneficiaries must be subclassified. Historically, the courts have provided a remedy for a "creditor beneficiary" and a "donee beneficiary," but not for an "incidental beneficiary." The modern view reduces the semantic differences between those archaic sounding classifications and generally provides a remedy for the "intended beneficiary."[17]

Courts adhering to third-party beneficiary law are likely to provide a remedy for a nonclient who was the *intended* recipient of an opinion letter, as opposed to a nonclient who merely was an *incidental* reader of an opinion letter. However, courts vary in their application of the third-party beneficiary doctrine, especially as it relates to the foreseeability of an attorney's intent to benefit the third party.[18] As a result, lawyers should be careful to review the prevailing law in their own jurisdiction. Indeed, the peculiarities of each state's laws, coupled with the sometimes similar fact patterns that may be analyzed differently, are reasons to always check local law in this area.

Negligence Theory

Some courts look to state negligence law to determine attorney liability to third parties.[19] That may make sense. Malpractice liability to one's own client, after all, is usually determined by negligence law. The elements of a negligence cause of action are the existence of a duty toward the plaintiff, a breach of that duty, causation, and damages.[20] The crux of a negligence claim in that context is usually proving that there was a duty. When the defendant's actions create a foreseeable risk of harm to the plaintiff, the defendant owes the plaintiff a duty of reasonable care.[21]

Courts and legislators have often tailored negligence rules specifically for professional liability. For example, under Illinois law, a third party suing someone else's attorney for negligence must prove that the primary purpose and intent of the attorney-client relationship itself was to benefit or influence that third party.[22] In the opinion letter context, a claim for negligence usually spills over into one for negligent misrepresentation, since an opinion letter is by itself a representation. Yet, one significant difference between negligence and misrepresentation liability is that in the latter kind of case, a plaintiff must generally prove justifiable reliance on the communication, an element that is usually lacking in a pure negligence case.

Also, state laws can vary considerably. Some states (such as California) may not allow a nonclient to bring a negligence claim against an attorney. The nonclient may well be able to sue, but he may need to bring a claim under a different legal theory. Of course, it may be little comfort to an attorney that a suit against him by a nonclient is brought under one theory rather than another. Moreover, even from an observer's perspective, there is a frustrating degree of overlap in those cases.

Misrepresentation Theory

Some courts look to state misrepresentation law, sometimes called negligent misrepresentation.[23] Those courts usually rely on guidance from the *Restatement (Second) of Torts*. The elements for misrepresentation under the *Restatement* are similar to negligence, with the following differences: the attorney must intend to supply information to the nonclient; the nonclient's reliance must be

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[13] *Biakanja* at 650.

[14] 56 Cal.2d 583 (1961).

[15] *Pelham v. Griesheimer*, 417 N.E.2d 882 (Ill. App. Ct. 1981), *aff'd*, 440 N.E.2d 96 (Ill. 1982); *Gerlich v. Courtney Indus.*, 581 A.2d 825 (Md. 1990).

[16] *See, e.g., Guy v. Liederbach*, 459 A.2d 744, 749 (Pa. 1983).

[17] *See Restatement (Second) of Contracts* section 302 (1981).

[18] *Pelham, supra* note 16; *Gerlich, supra* note 16; *Franko v. Mitchell*, 762 P.2d 1345 (Ariz. Ct. App. 1988)).

[19] *See Cargill, Inc. v. Boag Cold Storage Warehouse*, 71 F.3d 545 (6th Cir. 1995).

[20] *Restatement (Second) of Torts* section 281 (1965).

[21] Feinman, *Professional Liability to Third Parties* at 51, American Bar Association (2000).

[22] *Pelham, supra* note 16 at 100.

[23] *See Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 332 N.C. 200 (1988); *Bily v. Arthur Young & Co.*, 3 Cal.4th 370 (1992).

justifiable; and the parties must be interacting in a commercial setting.[24] Those requirements may limit the class of nonclients who can bring a suit alleging reliance on an attorney's communication.

Some courts beef up the misrepresentation rule, requiring that the reliance be "detrimental."[25] Some courts merely infer that the reliance is detrimental. Other courts stray from the *Restatement*. In California, for example, the elements of negligent misrepresentation consist of: a misrepresentation of a past or existing material fact, without reasonable grounds for believing it to be true, and with intent to induce another's reliance on the fact misrepresented; ignorance of the truth and justifiable reliance thereon by a party to whom the misrepresentation was directed; and damages.[26]

Back-end mitigating elements sometimes may undercut a misrepresentation claim. For example, some courts do not allow a recovery for economic losses under a negligent misrepresentation theory when adverse parties are dealing with one another at arm's length.[27]

Disclaimers

Disclaimers also merit discussion and are serendipitously in vogue under Circular 230. Because of the ease of sending written documents by electronic communications, it is virtually impossible to ascertain where a document will end up and who will use the document as a basis for a lawsuit. This e-mail culture, coupled with the broad potential ambit of Circular 230, has caused attorneys providing tax advice to include disclaimers or legends in nearly all written messages, including private offering material, letters, memoranda, e-mails, and draft documents, to help alleviate liability concerns.

One reason for the disclaimers is the wrath of Circular 230. Another is potential liability to clients and nonclients. However, the effectiveness of the disclaimers is debatable.[28]

In some instances, however, a disclaimer may prevent liability from attaching to a communication.[29] For example, a lender was held not to be justified in relying on an opinion letter that specifically disclaimed any responsibility for its statements.[30] Still, it is prudent not to rely too heavily on disclaimers without performing research within the relevant jurisdiction. Indeed, in the current climate, even in a favorable jurisdiction, disclaimers alone may not be enough.

Nonclient Liabilities

As the above discussion suggests, there are several legal theories that may give a nonclient a cause of action against an attorney rendering legal advice. Most states have fashioned their own versions of those rules, frequently intertwining various theories.[31] At least one state has even codified attorney liability to a nonclient.[32] Commentators have attempted to establish a unifying theory, but courts have not yet embraced such a concept.[33]

To make matters more confusing, states often have their own special rules for legal malpractice separate and apart from misrepresentation or negligence. Often legal malpractice will be pleaded in the alternative to the theories described above. In contrast, some states, notably California, do not allow nonclients to bring suit for "legal malpractice" at all, although suits in other guises are permitted.

Attorneys must find their own way through this Byzantine maze when issuing legal opinions — or letters that might be taken as legal opinions, even though they fall short of the traditional definition. The liability considerations should be first and foremost to clients, but nonclients cannot be safely ignored.

Examples

The four examples of opinion letter liability below are based on actual cases; however, I don't focus on the particular legal theory applied by the court, given the similarities and degrees of overlap between each theory.

Example 1: The Sucker Punch. Greycas runs a farm a few hours away from the town where Larry, his lawyer and brother-in-law, practices law. Greycas is seeking a loan from a bank and asks Larry to write a letter to the bank on which the loan is conditioned. In other words, the bank will not make the loan without the letter.

Greycas tells Larry that there are no encumbrances or liens on his equipment. However, Greycas has fallen on hard times and has already pledged his farm equipment to Savings & Loan. Regardless, Larry provides Greycas with a letter stating that Larry has conducted a Uniform Commercial Code, tax, and judgment search and that the equipment is free and clear of all liens and encumbrances. In fact, Larry has made no effort to verify

[24]*Id.* Regarding the commercial element, see *Robinson v. Omer*, 952 S.W.2d 423 (Tenn. 1997), *reversing* 1996 WL 274406 (Tenn. App. 1996).

[25]*Greycas, Inc. v. Proud*, 826 F.2d 1560, 1563 (7th Cir. 1987), *quoting Williams, McCarthy, Kinley, Rudy & Picha v. Northwestern National Ins. Group*, 750 F.2d 619, 624 (7th Cir. 1984).

[26]*Home Budget Loans, Inc. v. Jacoby & Meyers Law Offices*, 207 Cal. App.3d 1277 (1989).

[27]*Onita Pac. Corp. v. Trustees of Bronson*, 843 P.2d 890 (Or. 1992) (*en banc*).

[28]*See generally* Crystal Tandon, "Practitioners Demanding Clear Outlines of Circular 230's Scope," *Tax Notes*, Aug. 29, 2005, p. 977, *Doc 2005-17652*, *2005 TNT 162-2*; and Sheryl Stratton, "Circular 230 E-mails, T-Shirts Attain 'Legendary' Status," *Tax Notes*, July 4, 2005, p. 48, *Doc 2005-14211*, *2005 TNT 127-1*.

[29]*Mark Twain Kansas City Bank v. Jackson, Brouillette, Pohl & Kirley, P.C.*, 912 S.W.2d 536 (Mo. Ct. App. 1995); *Conroy v. Andeck Resources '81 Year-End Ltd.*, 137 Ill. App.3d 375 (1985).

[30]*See Mark Twain Kansas City Bank supra* note 30; *Banc One Capital Partners Corp. v. Kneipper*, 67 F.3d 1187 (5th Cir. 1995). *But see Kline v. First Western Gov't Sec.*, 24 F.3d 480 (3d Cir. 1994).

[31]*See Trask v. Butler*, 123 Wash.2d 357 (1992); *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536 (1985); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis.2d 376 (1983).

[32]Ark. Code Ann. Section 16-22-310 (Supp. 1997).

[33]*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).

Greycas's statements. Also, the bank is unaware of Larry's relationship with Greycas.

On receiving the letter, the bank provides the loan to Greycas. Shortly thereafter, Greycas seeks bankruptcy protection and the bank commences an action against Larry to recover on the portion of the loan not yet satisfied. Of course, the bank was not in privity of contract with Larry.[34] Nevertheless, it is hard to imagine that Larry would not be held liable for *something* based on his arguably intentional, certainly reckless, and at the very least, corner-cutting behavior.

In *Greycas*,[35] a case decided under Illinois law, the court first pondered why the bank did not bring an action for fraud or another intentional tort, speculating that perhaps an insurance recovery might be predicated on a lesser offense. Instead, *Greycas* involved a negligent misrepresentation action. The court pointed out the similarities between the Illinois law governing suits for negligent misrepresentation and those for legal malpractice based on a false misrepresentation. In fact, the court said it had "great difficulty in holding them apart."[36] The court even noted that the defendant had also confused the two theories.

Despite confusion over the theories, the court brought swift justice. Although a lawyer has no general duty of care toward his client's adversary, the court noted that this maxim is only the 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.

Here, 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 done so.

Example 2: The Close Call. Green, the owner of 100 percent of Triad Corp., sold all of his shares to Stern for cash and a note. Lorri, a lawyer represented Stern. Stern pledged the newly purchased shares and all of Triad's assets to secure the note. The purchase agreement, drafted by Green's attorney, required Lorri to deliver an opinion letter at closing "in form and substance reasonably satisfactory" to Green. Lorri's opinion letter affirmed Stern's authority to enter the agreement, recited the agreement's due execution, and stated that Lorri has 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 with Allegheny Credit Corp. to finance the purchase and had granted Allegheny a first security interest before granting the security interest to Green.

Green brought suit against Lorri, alleging that she had a duty to exercise a reasonable degree of care and skill in her investigation of the matters in her letter and in making the assertions and representations contained therein. 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. Green did not allege that the opinion letter contained any negligent misrepresentation, or that Stern made any misrepresentation. Interestingly, the purchase agreement, which contained the representations and warranties, was not included in the complaint.[37]

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. Deciding the case under Illinois law, the court noted that an attorney's duty owed to her client is paramount. Yet, 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. That rule limits the scope of duty owed by an attorney to nonclients.[38]

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. However, on issuing the opinion letter to influence the plaintiff's decision to enter the sale, the defendant assumed a duty of care toward the plaintiff with respect to the accuracy of the letter. The duty existed because the defendant's actions (issuing the opinion letter for the benefit of the plaintiff) would foreseeably affect the plaintiff.

The real issue was the *scope* of that duty. Although the plaintiff alleged that the scope included a duty to investigate Stern's financial background to determine his creditworthiness, the court held that 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.[39]

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 (or Stern for that matter) had requested the defendant to investigate Stern's background. Likewise, the opinion letter did not opine on Stern's creditworthiness. The court concluded that the defendant did not have a duty to investigate.

Since it was the *defendant's* client that asked for the opinion letter in this case, 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.[40] If a nonclient had asked for an opinion letter, a strong argument might exist for a duty of care to the nonclient, thus creating a conflict.[41]

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[34]*See Greycas, Inc. v. Proud, supra* note 25.

[35]*Id.*

[36]*Id.* at 1563.

[37]*Geaslen v. Berkson, Gorov and Levin*, 200 Ill. App.3d 600 (1991).

[38]*Id.* at 605.

[39]*Id.* at 606.

[40]*Id.* at 607.

[41]*But see United Bank of Kuwait PLC v. Everture Energy Enhanced Oil Recovery*, 755 F. Supp. 1195 (S.D.N.Y. 1989) (when a nonclient asked for an opinion letter and the law firm

(Footnote continued on next page.)

That case shows that attorneys may be able to limit the scope of the duty owed to nonclients. Attorneys can speculate why the purchase agreement was not included in the complaint (for example, perhaps the agreement was silent regarding the creditworthiness of the buyer). Even so, attorneys need to be careful, not only in what their own opinion letters say but also in any references their opinions make to other agreements.

Example 3: The Investment Shuffle. Red is thinking about lending money to the Burbank general partnership. Al Attorney represents 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, because he is 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. However, Al fails to include that information in his opinion letter.

Red lends money to Burbank in reliance on Al's letter, and the loan goes bad. The 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, the plaintiffs allege that the failure to disclose such information made the opinion letter misleading.[42]

In a case decided under California law, the court allowed a negligent representation cause of action. Although the court pointed to the California Civil Code to determine the elements of the cause of action, it looked to the multifactor test to determine whether a duty existed.[43] The court noted that the defendant undertook to assist in securing the loan on behalf of his client.[44] Indeed, the opinion letter was rendered for the purpose of influencing plaintiff's conduct, and the result was ''clearly foreseeable.''[45]

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, or 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.''[46] The crux of the decision was whether the defendant breached his duty of care by omitting specific information from the opinion letter. The opinion letter stated that Burbank was a general partnership although several facts known by the attorney may have cast doubt on that characterization.

The court held that the lawyer had a duty to disclose that doubt because it might have been a determinative factor for the plaintiff to make the loan.[47] The court noted:

> Half the truth is often as misleading as outright falsehood. Where a defendant makes false statements, honestly believing them to be true, but without reasonable grounds for such belief, he may be liable for negligent misrepresentation.[48]

Thus, the court acknowledged that an omission of a material fact from an opinion letter could create attorney liability.

Example 4: Slip of the Tongue. B.L.M., a partnership formed to develop land, approached the city of Rialto, Calif., in hopes of constructing a building. The draft agreement prepared by B.L.M's counsel called for Rialto to issue public financing to construct the project and consequently would require public bidding and the payment of the prevailing wage. Because that would have made the project economically unfeasible to B.L.M., B.L.M. suggested some material changes to the project.

B.L.M. proposed to construct the building itself and for Rialto to later purchase it. Rialto accepted B.L.M.'s proposal. Rialto appointed a financial adviser and a legal adviser, Sabo & Deitsch, to represent it.

B.L.M.'s complaint alleges that Sabo told him that public bidding and payment of the prevailing wage were not required on a project financed in this new manner. When B.L.M. later learned that the payment of the prevailing wage was in fact required, it stopped work on the project and brought suit against Sabo. The complaint alleges only that Sabo gave a false *oral* opinion.[49]

In a case brought under California law, the plaintiff brought several causes of action against the law firm, Sabo. The first cause of action was professional malpractice, the elements of which, under California law, are similar to pure negligence. The court held that B.L.M. could not recover on that cause of action because of *Bily v. Arthur Young & Co.*,[50] which held that under California law, nonclients may not recover on a pure negligence theory.

The court further held that B.L.M. also could not recover under a third-party beneficiary theory, because Sabo's opinion was not intended to benefit B.L.M. B.L.M. claimed it was a third-party beneficiary because it was mentioned in a resolution passed by the Rialto City Council that appointed the defendant as legal counsel. The court held, however, that that alone was not sufficient to render B.L.M. a third-party beneficiary. Instead, a third-party beneficiary must show that it was the intention of the client, the party in privity, to create a duty, and

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provided it without informing its client, the court did not hold the law firm liable for negligent misrepresentation).

[42] *Roberts v. Ball, Hunt, Hart, Brown & Baerwitz*, 57 Cal. App.3d 104 (1976).

[43] *See supra* for the list of factors.

[44] *Id.* at 111.

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *B.L.M. v. Sabo & Deitsch*, 55 Cal. App.4th 823, 834 (1997).

[50] *Supra* note 24.

that the "imposition of the duty carries out the prime purpose of the contract for services."[51]

More interesting was B.L.M.'s negligent misrepresentation claim. Under that cause of action, B.L.M. needed to show that the defendant intended to influence B.L.M. and that B.L.M. justifiably relied upon the communication. The court noted that the intent element created an "objective standard" under which the specific circumstances had to be examined to determine whether the defendant had "undertaken to inform and guide the third party with respect to an identified transaction or type of transaction." The court concluded that B.L.M. was unable to establish that the defendant intended to influence B.L.M. in its discussions, because the plaintiff did not allege that in its complaint.

Even if B.L.M. would have been able to prove the element of intent, it still would not have been successful, because it was not able to show justifiable reliance. B.L.M. alleged that it relied on the oral opinion of opposing counsel that the payment of the prevailing wage was not required. However, B.L.M. was represented by its own counsel, and its counsel had, at least once before, provided a legal opinion directly contrary to the advice on which B.L.M. was claiming to have relied.

Also, an attorney's duty is to protect his client in every possible way. It would be a breach of that duty for an attorney to assume a position adverse or antagonistic to his client. (There's the old tension again.) The court noted that it would be anomalous to allow a person who has an interest adverse to an attorney's client to rely on the legal opinion of the attorney without *some* sort of justification.

Although that lawyer avoided liability, the dissenting opinion made an ominous comment: The parties may *not* have been adverse parties. Indeed, the two came together to construct a building, and one party was even a governmental entity. The majority opinion rebutted that contention, noting that because the parties were negotiating at arm's length, they were in fact adverse parties.

Consequently, the defendant owed a duty of loyalty to the city. The court found that the plaintiff did not have sufficient justification to rely on the defendant's opinion. Still, the dissent's suggestion that there are different standards when there are different degrees of adversity makes sense, although that may be difficult to administer.

Tax Opinion Letters

All of this talk of liability and reliance to third parties brings us (finally) to tax. Tax opinion letters arguably come in two primary flavors. In one, a promoter incorporates a tax opinion letter into a prospectus that is disseminated to potential investors. Nonclients use that offering material to decide whether to invest in the particular transaction. Examples include sales of securities (stocks or bonds) and real estate. I don't find the first category of letter terribly frightening, perhaps because issues of liability to third parties are predictable (if not downright expected) with this category.

The second category is a residual catchall basket that includes all opinion letters not included in the first. Again, I use a fairly loose definition of opinion here, since many of these letters may look nothing like a formal opinion letter. Examples might include:

- a letter opining (or advocating) whether a defendant should issue a Form 1099 to a plaintiff resulting from a lawsuit settlement, or whether a plaintiff should include his contingent attorney fees in income;
- corporate counsel's letter to nonclient shareholders regarding the likely tax effects of a corporate distribution;
- counsel for a domestic trust's letter to a foreign nonclient beneficiary of the trust regarding the U.S. income tax effects of a distribution; or
- corporate counsel's letter to employee plan participants regarding the effects of a stock option plan and the availability of a section 83(b) election.

There is understandable liability to clients to whom one writes such opinions. That liability will depend on whether the letter is accurate and on precisely what it guarantees. For example, in *Wright v. Compton, Prewett, Thomas & Hickey*,[52] a law firm represented to a client that a spinoff should be tax-free. Later, the corporation and its shareholders collectively filed a malpractice action against the law firm and an attorney of the firm after they had to pay tax. The tax attorney prepared a letter to the corporation stating that it could reorganize its business tax-free under section 355.[53] The attorney also prepared various documents to effectuate the reorganization.

Later, when the IRS audited the corporation, it determined that the plaintiffs were required to pay tax and interest.[54] The IRS ruled that the reorganization did not qualify as a tax-free reorganization and was taxable.[55] Although the trial court granted summary judgment to the defendant based on the lapse of the statute of limitations, the Arkansas Supreme Court reversed and remanded the case for trial, as there was a genuine issue of fact related to the timing of the reorganization.[56] The case stands for the proposition that a lawyer who provides negligent tax advice may be liable to his client, and perhaps to others.

Yet, the potential liability to third parties is not so obvious. This second category of communications encompasses a huge universe of correspondence, and for that reason, the liability possibilities to nonclients are troubling. Although some of the examples noted above may appear to involve a type of derivative liability or duty (for example, when corporate counsel makes statements to shareholders or employees about the tax effects of a distribution or a stock option plan), many do not.

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[51] *Id.* at 832, *quoting Johnson v. Superior Court*, 38 Cal. App.4th 463, 472 (1995).

[52] 315 Ark. 213 (1993).
[53] *Id.* at 214.
[54] *Id.*
[55] *Id.* at 215.
[56] *Id.* at 217.

Type 1 Letters: Tax Shelters

Cases generated by the first type of tax opinion letter often present the following generic fact pattern. A taxpayer reviews an investment prospectus that 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 later 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. That situation often invokes securities law. When invoked, attorney liability may not be predicated merely on state tort law. Many aspects of the liability attaching under federal securities law appear to parallel the elements and rationale of state tort law.[57]

Before proceeding to discuss those elements and rationales, a caveat is in order. I am a tax lawyer and do not practice in the securities area. The securities discussion is intended only as the broadest of overviews. I suggest consulting a securities lawyer should you need more assistance in that area. (I hope that my disclaimer works better than the disclaimers used in the opinion letters discussed below!)

In a type 1 situation, attorney liability can stem from violations of section 10(b) of the Securities and Exchange Act of 1934 (the 1934 Act)[58] and Rule 10b-5 promulgated thereunder.[59] Those rules prohibit misrepresentations and misleading omissions in connection with the sale of securities. Under those rules, a plaintiff bringing suit must prove that: (1) the defendant made misstatements or omissions of material fact, (2) with scienter, (3) in connection with the purchase or sale of securities, (4) on which the plaintiff relied; and (5) the plaintiff's reliance was the proximate cause of the injury.[60]

Those elements are similar to the state law elements of negligence, negligent representation, third-party beneficiary law and the balancing-of-factors test. For tax lawyers scratching their heads, trying to recall what scienter means, *Black's Law Dictionary*[61] defines scienter as ''a degree of knowledge that makes a person legally responsible for the consequences of his act or omission.'' However, in the securities law context, *Black's* provides that scienter means the ''mental state consisting in an intent to deceive, manipulate or defraud.''

Scienter thus creates a noticeable difference between federal securities law and state law. Under federal securities law, a higher threshold of intent seems to be required. In fact, the Supreme Court noted that in establishing scienter with respect to projections and opinions under the 1934 Act, it is not sufficient to show mere negligence.[62] Of course, state law also contains actionable torts that may require a higher level of intent. For example, the common-law tort of fraud is invoked in many of the examples discussed here, if the plaintiff can show the requisite enhanced level of intent.

The *Eisenberg* Case

Eisenberg v. Gagnon[63] well illustrates the tax shelter fact pattern. Martin Eisenberg and Arthur Nissen purchased interests in a limited partnership whose only asset was land containing coal. They argued that the defendants orchestrated a scheme to sell securities in worthless coal rights as tax shelters while concealing that they would take the lion's share of the proceeds. Defendant Wasserstrom wrote a tax opinion that was included in the offering memoranda distributed to the plaintiffs.

The tax opinion said that the IRS would allow the deduction of large advanced royalty payments by nonrecourse notes. The plaintiffs alleged that the tax opinion contained fraudulent financial projections and that no reasonable basis existed for that position. Rule 10b-5 of the 1934 Act prohibits misrepresentations and misleading omissions in connection with the sale of securities, and fraudulent financial projections are actionable under that rule. When an attorney who has greater access to information or a special relationship to investors makes a representation in an opinion letter, the attorney has an obligation to disclose data indicating that the opinion or forecast may be doubtful. Indeed, the court in *Eisenberg* noted:

> When the opinion or forecast is based on underlying materials which on their face or under the circumstances suggest that they cannot be relied on without further inquiry, then the failure to investigate ''may support an inference that when [the defendant] expressed the opinion it had no genuine belief that it had the information on which it could predicate that opinion.''[64]

At trial, the jury found for the defendants on the 10b-5 claim. On appeal, the plaintiffs challenged the jury instructions because the trial court refused to instruct the jury regarding projections and forecasts. Because the plaintiffs presented sufficient evidence, the court vacated the judgment. At the new trial, the court noted that the jury must determine whether the circumstances generated a duty for the defendant to investigate.

The plaintiffs also brought a state law negligent misrepresentation claim. Under Pennsylvania law, which is based on *Restatement of Torts* section 522, the plaintiffs had to prove justifiable reliance. Although the jury found for the plaintiffs, the court found in favor of the defendants (granting judgment notwithstanding the verdict), noting that there was insufficient evidence to support the plaintiff's reliance. The appellate court reversed, reinstating the jury verdict.

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[57] *See generally Fortson v. Winstead*, 961 F.2d 469 (4th Cir. 1992); *Latimer v. Hall Financial Group*, 1991 U.S. Dist. LEXIS 2033 (N.D. Ill.) (1991); *Ahmed v. Trupin*, 809 F. Supp. 1100 (S.D.N.Y. 1993); and *Hudson v. Capital Management International, Inc.*, 565 F. Supp. 615 (N.D. Cal. 1983).

[58] 15 U.S.C. section 78j(b) (1982).

[59] 17 C.F.R. section 240.10b-5 (1985).

[60] *Kline v. First Western Gov't Sec., supra* note 31, at 487.

[61] *Black's Law Dictionary*, 1347 (7th ed. 1999).

[62] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

[63] 766 F.2d 770 (3d Cir. 1985), *cert. denied*, 474 U.S. 946 (1985).

[64] *Eisenberg* at 776, *quoting McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979).

The appeals court found the plaintiffs' reliance to be justified despite some sketchy facts. Indeed, plaintiff Nissen testified that he ''spent an hour or two'' reading the offering documentation and invested in reliance of those documents. Plaintiff Eisenberg testified that he had read half of the offering memoranda and skimmed the other half. According to the court, that was sufficient evidence to present the question to the jury. ''Plaintiffs need not prove that they read the materials in their entirety, or that the recommendation of an agent or advisor did not play a part in their investment decision.''[65]

The *Eisenberg* court thus sets quite a low bar for what is considered justifiable reliance. Indeed, the court noted that one can justifiably rely without even reading the entire document, or by just spending an ''hour or two'' with the materials. Perhaps that suggests that tax opinions should be full of disclaimers and easy-to-read language rather than technical jargon.

Emulating *Eisenberg*, the court in *Turtur v. Rothschild Registry International*[66] held that it is not enough for a plaintiff taxpayer to rely on offering documents without *actually* reading the tax opinion. The court affirmed the district court's grant of summary judgment for the defendant law firm because there was no evidence that the plaintiff taxpayer relied on the opinion in making his decision to invest in a transaction.

Turtur, the plaintiff taxpayer, learned of tax-advantaged limited partnerships that leased computer equipment. Rothschild Registry International Inc. was the architect behind the limited partnerships. Turtur learned that the IRS had questioned various Rothschild equipment leasing limited partnerships, and in some cases, disallowed related tax deductions. Even with that knowledge, Turtur received and reviewed a private placement memorandum and tax opinion related to the various limited partnership units (LPI). The tax opinion was prepared by the New Jersey law firm of Stein, Bliablias, McGuire, Pantages & Gigl.

When Turtur sought to invest in LPI, a representative at Rothschild stated that LPI was fully subscribed but that another partnership, LPII, would soon be available. Turtur relied on representations from Rothschild that the substance of the offering documents and tax opinion in LPII would be identical to those presented in LPI. Based on those representations, Turtur invested in LPII before reading or receiving the LPII private-placement memorandum.

The offering documents and the tax opinion in respect to LPII were identical to the offering documents and tax opinion in LPI. The Stein firm prepared the tax opinion for LPII, and Turtur claimed that the Stein firm also helped author the LPII private placement memorandum. The memorandum included a disclaimer, stating that prospective investors should rely only on representations contained in the LPII documents.

As it turned out, the IRS disallowed various deductions and losses Turtur had claimed on the basis of his investment in LPII. Turtur filed a complaint alleging common-law fraud, violation of the Texas Securities Act, and violation of the Texas Consumer Protection Act. Turtur named a large number of defendants, including Rothschild, the Stein firm, PLII, and others. Over time, all of the claims against all of the defendants except for the Stein law firm were dismissed from the action. Once the Stein firm was left as the sole defendant, the court transferred the common-law fraud claim to the United States District Court for the Southern District of New York.[67]

In August 1993 the fraud claim was dismissed on summary judgment. The district court found that Turtur failed to establish (as required by New York law in a claim for common-law fraud) Turtur's ''actual, direct reliance upon the alleged misrepresentations'' made in connection with PLII.[68] The fatal flaw in Turtur's claim, according to the district court, was that Turtur never actually saw, much less relied on, the supposed misrepresentations that appeared in the PLII offering materials.

On appeal, Turtur contended that a claim for fraud may lie — even when a plaintiff does not directly rely on a fraudulent representation made by the defendant, if the plaintiff received the information from someone who had received it from the Stein firm — and the Stein firm intended the misrepresentations to be conveyed to him.[69] The court found that the Rothschild representative who stated that the PLII documents were the same as the PLI documents was acting for Rothschild, not for the Stein firm. And, while Stein (being the drafter) was presumed to have known of the documents' similarity, the court stated that the plaintiffs provided no evidence that the Stein firm ever authorized, encouraged, or expected anyone to tell investors that they could rely on the private placement memorandum and tax opinion from one venture as a sufficient basis for investing in another venture to which the earlier documents did not expressly refer.

Moreover, in granting the motion for summary judgment, the court stated that Turtur failed to show that the memorandum and the tax opinion even existed when Turtur spoke to the Rothschild representative about PLII. In affirming the district court's grant of summary judgment based on a lack of reliance, the court stated that the Stein firm's position was strengthened by the disclaimer found in the PLII private placement memorandum.[70] The court found that the disclaimer refuted any inference that

[65]*Id*. at 779.

[66]26 F.3d 304 (2d Cir. 1994).

[67]The defendants removed the case from the Texas state court to the United States District Court for the Southern District of Texas. The district court dismissed the Texas state claims. *Id*. at 306.

[68]*Id.* at 307.

[69]*Id.* at 310.

[70]*See Gilmore v. Berg*, 761 F. Supp. 358 (D.N.J. 1991). *Gilmore* involved a claim against an attorney who, in a tax opinion letter, represented that the purchase price of the real property involved in the tax shelter at issue was fair ''as determined by the general partner.'' *Id.* at 370. The plaintiffs contended that the attorney knew that the property had been purchased out of bankruptcy for less than one-half the stated price. The court stated:

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the Stein firm intended or should have expected Rothschild representatives or others to use the legal papers drafted for one partnership as the basis for an investor to enter into another.

While the *Eisenberg* court[71] found that a plaintiff who spends a couple of hours reading through documents can justifiably rely on those documents, the court in *Turtur* found that a plaintiff must *actually* see and read the documents pertaining to a particular investment strategy to bring an action against an individual who issues an opinion.[72]

The *Kline* Case

First Western Government Securities engaged in sophisticated financial transactions. Ernest Kline purchased various forward contracts packaged by First Western.[73] Arvey, Hodes, Costello & Burman issued three opinion letters over a two-year period concerning the tax consequences of those investments. All three opinion letters written by the Arvey firm were addressed to First Western. According to the court, specific themes were present in each letter:

- Each was intended for First Western's personal use only and was not intended to be, and should not be, relied on 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, the Arvey firm 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 the Arvey firm noting that First Western had provided the tax opinion letter with its brochures.

Kline sued under section 10(b) of the 1934 Act, alleging that he relied on the letters and that they contained both affirmative misrepresentations and material omissions. The misrepresentations concerned the operations of the trading program (delivery of securities, price movements, and margin deposits), and statements that the program could support a reasonable expectation of gain (actually, it was designed to obtain tax losses).

The Arvey firm moved for summary judgment on the misrepresentation claim, arguing that it could not be liable for an opinion that 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 is issued without reasonable genuine belief or it has no basis."[74]

The Arvey firm argued that the opinion letter contained disclaimers and that it was based solely on facts provided by the client.[75] The court, however, noted:

> The court agrees with the plaintiffs that a jury could find [the attorney's] statement that "the purchase price of $5.3 million reflects the fair market value of the property as determined by the general partner" is grossly misleading as to constitute actionable fraud in failing to disclose important facts underlying the determination of fair market value. [The attorney] seeks to exculpate his misleading statement by pointing to the qualifying language, "as determined by the general partner." *Id.*

However, the plaintiffs presented evidence that the attorney knew the FMV of $5.3 million was unsupportable. The court denied the defendant attorney's motion for summary judgment and remanded.

[71]*See also Alpert v. Shea Gould Climenko*, 160 A.D.2d 67 (N.Y. 1990). The plaintiffs faced a substantial income tax liability and decided to invest in a tax shelter to obtain tax deductions related to royalties for the right to mine coal. The IRS disallowed the deductions, and the plaintiffs sued the law firms that issued tax opinions (reasonable basis) related to the investment. The plaintiffs claimed that the law firms committed fraudulent misrepresentation and sought to amend their initial complaint, which failed to state such a claim.

The court denied the plaintiffs' motion to amend. The court reasoned that there was no support for the conclusion that a fiduciary relationship existed between the plaintiffs and defendants in the absence of a contractual relationship. Moreover, the court found that the complaints and supporting documents failed to suggest the existence of any relationship between the parties approaching privity sufficient to support a claim in ordinary negligence. *Id.* at 73. The court used a three-part test established in *Credit Alliance Corp. v. Andersen Co.*, 65 N.Y.2d 536 (1985), *remitter amended,* 66 N.Y.2d 812 (1985), for determining when accountants may be held liable in negligence to noncontractual parties who rely to their detriment on inaccurate financial reports. The three-part test includes an analysis of whether (1) the accountant was aware that the reports were used for a particular purpose; (2) a known party was intended to rely on the reports for the furtherance of the purpose; and (3) there was some conduct on the part of the accountant linking him to that party that evinces the accountant's understanding of that party's reliance. *Id*. The test has been applied to other professionals as well. *See Viscardi v. Lerner*, 125 AD.2d 662 (2d Dept. 1986) (court dismissed a complaint for failure to state a cause of action due to the lack of privity between the sisters and the attorneys who drafted the subject will). The court found that the plaintiffs failed to meet the *Credit Alliance* test. While the plaintiffs allege that the defendant law firms were aware that their tax opinion letters were to be relied on by potential investors and that they in fact were relied on by the plaintiffs, there was no allegation or evidence of conduct by the defendants, such as communications with potential investors, evincing their understanding of that reliance. *Id.* at 74.

[72]In Judge Jon Mewman's concurring opinion, he states that "strict insistence that the investor see and rely upon the opinion

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concerning the precise investment in which he placed his money eliminates a needless ground of controversy." *Tutur* at 312.

[73]*Kline*.

[74]*Id.* at 486, *quoting Herskowitz v. Nutri/System, Inc*. 857 F.2d 179, 184 (3d Cir. 1988), *cert. denied sub nom. Nutri/System, Inc. v. Herskowitz*, 489 U.S. 1054 (1989).

[75]The court denied Arvey the use of the "bespeaks caution" doctrine:

> Under that doctrine when an offering document's forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the "total mix" of information the document provided investors. In other

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> When a law firm knows or has good reason to know that the factual description of a transaction provided by another is materially different from the actual transaction, it cannot escape liability simply by including in an opinion letter a statement that its opinion is based on provided facts.[76]

The firm next argued that the plaintiffs' reliance on the opinion letter was unreasonable. The court articulated a variety of factors to determine the reasonableness of the plaintiffs' reliance, including: the existence of a fiduciary relationship, plaintiffs' 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.[77] While Arvey argued that plaintiffs were sophisticated investors, they were not so sophisticated that they should have recognized that the descriptions of the transactions in the ''opinion letters bore little relation to reality.'' Indeed, the court noted:

> A potential First Western investor, armed with Arvey opinion letters and the information about his own account that Arvey stressed might be important, could have obtained a tax opinion from his attorney that would have been wrong simply because of the misleading way in which the program allegedly was described in the opinion letter.[78]

Mere reliance on the Arvey firm's legal conclusions, without more, would have been unreasonable. Yet it may have been reasonable for the plaintiffs to rely on the factual descriptions of the trading program. Balancing all of the factors, the court found the plaintiffs' reliance to be reasonable.

A vigorous dissent argued that the reliance was not reasonable because the letters:

1. were addressed to someone besides the taxpayer;
2. were, by their terms, intended only for use by someone else;
3. by their terms could not be shown to the investor;
4. were predicated on facts not supplied by the author of the letter;
5. warned that the IRS likely would challenge the claim for favorable treatment, as it had in similar situations;
6. explained the basis for challenge;
7. stated that the courts might take a strong stance contrary to the opinion; and
8. flatly announced that it was ''impossible'' for the author of the letter ''to express an opinion as to the deductibility of any particular loss incurred by'' an investor.

Unfortunately for the Arvey firm, the majority of the court was not persuaded by that litany.

Historical Explanation?

Arvey's disclaimers were not sufficient to prevent liability. However, it seems likely that some of the court's reasoning lies in the considerable history between the Arvey firm and Sidney Samuels, the founder of First Western. Samuels founded First Western in 1978. Before that he was a general partner in Price & Co. The plaintiff alleged that First Western's trading program was substantially similar to Price's and was indeed modeled on it. Arvey assisted in Price's formation its offering material, and represented it in connection with IRS civil and criminal investigations.

The plaintiff alleged that the Arvey firm made no reference to prior IRS investigations of Price or of Samuels's connection to Price. Interestingly, an IRS investigation led to a finding that Price's trading programs were sham transactions.[79] Also, the IRS, the Securities and Exchange Commission, and the Minnesota Department of Commerce had begun investigations of First Western and its customers by the time Arvey issued its final opinion letter. The final opinion letter, however, mentioned only the audit of First Western's customers.

Regarding the omissions claim, the plaintiffs alleged that the tax opinion was misleading. After all, Arvey failed to include in its opinion letter information that, if included, would have undermined its conclusions. Finding for the plaintiffs, 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 the 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, yet 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. That 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 moved for summary judgment, arguing that it could not be liable for its tax opinion because it relied on the set of facts represented by the client.[80] Moreover, Arvey argued that

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> words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.

Id. The court noted that the disclaimers must relate directly to that on which investors claim to have relied. Moreover, the court stated that the cautionary statements must be substantive and tailored to the specific future projections, estimates, or opinions in the prospectus that the plaintiffs challenge. *Id.* The court found that the ''bespeaks caution'' doctrine did not apply because the opinion letters did not contain statements from which the plaintiffs should have inferred the risk that Arvey was knowingly and recklessly misstating the structure of the entire First Western trading program.

[76] *Id.* at 487.

[77] *Id.* at 488, *quoting Straub v. Vaisman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976).

[78] *Id.* at 488.

[79] *Price v. Commissioner*, 88 T.C. 860 (1987).

[80] *See also Ackerman v. Schwartz*, 947 F.2d 841 (7th Cir. 1991). In *Ackerman* investors brought a suit against a law firm that wrote an opinion letter concluding that the investors were entitled to specific deductions for their investments in a tax shelter. The opinion letter recited facts that made the transaction seem legitimate but that were fictitious. The letter cautioned that the

(Footnote continued on next page.)

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 its decision on May 2, 1994. However, had the new rules of Circular 230 been in effect at that time, Arvey's arguments would at least have faced a tougher standard.

Arvey's tax opinion, undoubtedly a ''covered opinion,''[81] was relied on as the basis for the plaintiff's tax position. As a covered opinion, Arvey would be required to perform reasonable due diligence of all the relevant facts to arrive at a legal conclusion. In fact, under the ambit of Circular 230, Arvey would be required to:

- use reasonable efforts to identify and ascertain all relevant facts and 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.[82]

Had the new Circular 230 rules been in effect at the time, even the vigorous dissent in *Kline* might have found that the plaintiffs justifiably relied on Arvey's opinion.

Miscellaneous Correspondence

The above cases illustrate attorney liability arising from an opinion (or perhaps a communication less than an opinion) provided to a nonclient. That raises the question of what exactly constitutes an opinion. While we usually think of an opinion as being written, even a verbal opinion may be actionable.[83] Although there do not appear to be many authorities of this type, the fact patterns in which those issues can arise are legion.

For example, take the situation in which Lenny Lawyer represents a victorious client during the settlement of litigation. For Lenny's representation, the court has ordered attorney fees paid directly to Lenny as the attorney. The opposing party is preparing to present an award of $100 to Lenny's client, plus $80 of attorney fees to Lenny. The defendant asks Lenny and his client how he would like to receive the payments.

Lenny drafts a letter to the defense counsel (copying the defendant) explaining that the defendant should cut separate checks and issue separate Forms 1099. Lenny does so at his client's request and for his benefit. Is Lenny's letter an opinion, and can the nonclient bring an action on it?

Although I find no authority directly on point, I suppose the letter could be considered an opinion. Regardless of whether it is labeled as an opinion, it would appear that a letter of this sort could be actionable under several legal theories. Tax practitioners should be mindful of those risks when providing any sort of communications to nonclients.

Let's take another example. Lucy Lawyer's client asks her to write a letter to a bank to persuade the bank to make a loan to her client. The letter may discuss Lucy's relationship with her client, or it may discuss the client's financial matters, known or unknown to the bank. The details recited in the letter aside, the question is whether this could be considered an opinion letter and whether it could create liability for the attorney. The nomenclature of the letter is debatable, but it is not hard to imagine the letter meeting the requirements of a negligent misrepresentation.

Updating Liability?

What happens when future events intervene and may influence (or even contradict) the advice in a tax opinion? Usually, tax opinion letters expressly negate the duty of the author to update the letter for future events. Particularly when there is an express statement of that sort, common sense should preclude finding liability for an alleged failure to update that opinion letter. Interestingly, perhaps to be helpful, an attorney may affirmatively offer to update an opinion letter (which by its language is *not* to be updated). In that case, a failure to act may clearly create liability.

For example, in *Lama Holdings*,[84] the plaintiffs were foreign investors who hired Shearman & Sterling to facilitate an investment in Smith Barney. Included in the facilitation was tax advice regarding dividends and a potential later sale of the stock. (For those of us old enough to remember pre-1986 tax law, that was essentially a *General Utilities* strategy!)

The plaintiffs alleged that in August or September of 1986, they made a specific inquiry to Shearman & Sterling

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firm had ''relied on unnamed persons for specified facts,'' *id*. at 843, and added that ''we have not made an attempt to independently verify the various representations.'' *Id.* The court held that the district court's grant of summary judgment in favor of the law firm was improper. The court reasoned that summary judgment was improper because under Rule 10b-5, the lack of an independent duty to ''blow the whistle'' does not excuse a material lie. *Id.* at 848.

[81]Circular 230, section 10.35, states that a covered opinion is written advice (including electronic communications) by a practitioner concerning one or more federal tax issues arising from a listed transaction; a plan or arrangement that has a principal purpose to avoid or evade tax; or a plan or arrangement that has a ''significant'' purpose of tax avoidance or evasion but only if the written advice is a ''reliance opinion,'' ''marketed opinion,'' or is subject to conditions of confidentiality or contractual protection.

[82]*Id.*

[83]*See B.L.M.*, 55 Cal. App.4th (1997).

[84]*See Lama Holding v. Shearman & Sterling*, 758 F. Supp. 159 (S.D. N.Y. 1991).

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.''[85]

After enactment of the 1986 tax legislation, the plaintiffs sold their stock without consulting Shearman & Sterling and incurred $33 million in 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 ''in 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.''[86] Ultimately, it appears that the parties settled, so we may never know how a jury would have decided the case.

Back To Shelters

It is hard to discuss even the second catchall type of communication to nonclients without again reverting to tax shelters. Tax shelter letters may fall into the offering circular discussion above (what I label Type 1 liability), but they may also fall into my second, or catchall, category. A typical shelter invites investors to invest by providing a prospectus that contains a tax opinion (or memo) written by an attorney. What happens when a sophisticated businessman receives the prospectus and then has his *own* personal attorney review it?

In *Kline*,[87] the court believed that the tax opinion was so misleading that an attorney — let alone a tax attorney — may not have understood what was occurring. Let's suppose a particular tax opinion is not misleading but is exceedingly complicated, perhaps incomprehensible even to some tax attorneys. I suspect that is not uncommon. Go a step further and suppose that whether the transaction works to achieve its desired tax treatment is somewhat doubtful, but the degree of doubt is disclosed.

Suppose the nonclient's attorney reviews the prospectus including the tax opinion and provides his blessing. Based on that review and advice, the nonclient decides to invest. A few years down the road, the IRS disallows the deductions.

Can the nonclient claim to have relied on the tax opinion letter in the prospectus even though his own counsel reviewed the transaction and blessed it? It seems arguable that the nonclient has relied on the advice of his *own* attorney. The answer may be affected if the nonclient's attorney contacted the author of the tax opinion to obtain clarification. Perhaps that would import additional liability.

The *Kline* court suggests that the plaintiff may justifiably rely on the third-party opinion even though his own attorney reviewed the transaction. Yet, compelling arguments can be made for the opposite position, as voiced by the dissent in *Kline*. The courts would probably consider the appropriateness of reliance on particular facts to be highly factual. Underscoring all of that should be the principle that the author of the tax opinion may have access to information and a duty to disseminate it, but he is not a guarantor of the success of the transaction.

One may suggest infinite variations in such fact patterns. For example, should the situation change if the nonclient's attorney reviews the opinion and advises the nonclient he is skeptical that the transaction is viable? Again, there may be a continuum of advice offered by the nonclient's own lawyer. The advice he offers may not be skepticism but may instead be a firm view that the transaction lacks merit.

That latter fact pattern suggests an implicit assumption of risk defense for the author of the opinion. After all, how could the nonclient claim to have justifiably relied on the tax opinion if his *own* counsel has advised him that he should *not* rely on it? I suspect that a deciding factor in the determination could revolve around attorney-client privilege. If the communications between the nonclient and his attorney are privileged, a court might have difficulty in determining the precise nature of the nonclient's reliance on it. However, perhaps the plaintiff's act of placing that advice in controversy, a subject going to the very heart of the matter, would waive the privilege.

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 reliance. With no counsel of his own on which to rely, the plaintiff may argue that the opinion provides support for his reliance. Conversely, an argument could be made that anyone would be foolish to enter into a sophisticated transaction without counsel. Although the lack of one's own counsel may strengthen a finding of justifiable reliance, 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.'' Although such a disclaimer seems counterintuitive in an opinion that accompanies an offering document, opinions sometimes weave in such advice, particularly as to specific issues. The disclaimer should reduce the appropriateness of reliance in at least some cases.

Conclusions

Attorney liability to clients is not terribly hard to understand and is fairly straightforward in application. Like any other type of liability, one tries to avoid it. 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, state law may have adopted some or all of those 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, particularly given the amorphous nature of the rules. Common sense, however, can go a long way here.

Even so, the myriad rules are unlikely to prevent attorneys from issuing opinion letters to nonclients, particularly using a broad notion for what constitutes an

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[85]*Id*. at 161.
[86]*Id*. at 161.
[87]*Supra* note 31.

opinion. The existence of potential liability should remind attorneys that providing opinion letters to nonclients may either create or modify a duty to nonclients. Underscoring all that is a nettlesome lack of precision about what may constitute an opinion. Sometimes what looks and sounds like an opinion to one attorney, client, adversary, or judge may be something that appears to be innocuous to another.

Clearly, something need not be labeled as an opinion letter to be so considered. Particularly in that new era, it is not farfetched to wonder about the status of e-mails too. Many forms of communication may import or enhance liability. Indeed, e-mails may well represent the black hole of the future. Many seem to regard e-mails as oral communications, characterized by casual banter, a lack of formality, and lack of signature. Yet, their import in lawsuits is anything but casual.[88]

Be careful out there.

[88]*See generally* "Another Giant Falls in Quattrone," http://www.thestreet.com, May 3, 2004 (the case against Frank Quattrone, a former Credit Suisse First Boston banker, stemmed from a single e-mail in which Quattrone recommended that his staff clean out their files).