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Transactional Planning and Advice

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Chapter 3

TRANSACTIONAL PLANNING AND ADVICE

I. CLIENT CONFLICTS

Circular 230 §§ 10.20 and 10.29
Tax Court Rule 24(g) (Appendix F)
Model Rules 1.7, 1.8, 1.9, and 1.13(a)
AICPA Code of Professional Conduct ET § 1.100.001 and Interpretation 1.110 (Appendix H)

A. Introduction

The point of conflicts of interest rules is to protect clients' reasonable expectations that legal advisors and representatives will act on their behalf free from compromising loyalties and influences. Thus, the basic principle embodied in the Model Rules' conflict provisions is that a lawyer may not represent anyone where the interests of another person—a current or former client, perhaps, or the lawyer's own interests—could impair the lawyer's ability to zealously and impartially act on a client's behalf. Resolution of a conflict might entail declining to undertake representation, withdrawing from an existing representation, or obtaining a client or clients' written consent to proceed despite a conflict.

Model Rule 1.7 sets out the general conflicts of interest principles on which all other conflicts rules rely. Model Rule 1.7(a) provides that a lawyer may not represent a client if that representation involves a concurrent conflict, meaning that either:

1. the representation of one client will be directly adverse to another client, or
2. there is a significant risk that representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client, or a third person, or by the lawyer's own personal interest.

Notwithstanding a concurrent conflict, however, Model Rule 1.7(b) permits a lawyer to represent a client if:

1. the lawyer believes that she will be able to competently and diligently represent each affected client,
2. the representation is not prohibited by law,
3. the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding, and

4. each affected client gives informed consent, confirmed in writing.

AICPA conflicts of interest rules are set forth at AICPA Code of Professional Conduct ET section 1.100.001 and Interpretation 1.110, which are reproduced at Appendix H. Conflicts of interest for accountants are defined in terms of relationships that could be viewed by a client, employer, or another party as impairing a CPA's objectivity. If a CPA believes that a professional service can be performed with objectivity, however, and the relationship is disclosed to and consent is obtained from the client, employer, or other appropriate party, then the CPA is permitted to perform the professional service. Conflicts cannot be waived with respect to engagements that require independence, *e.g.*, audits, reviews, and other attest services.

B. Differences Among the Guiding Principles

Circular 230 also includes conflicts of interest rules in section 10.29. While it follows from *Ridgely v. Lew*, discussed in Chapter 2, that OPR does not have authority to apply these rules to tax return preparation activity, the conflicts rules may apply in other contexts. Section 10.29's provisions are very similar to those in Model Rule 1.7.[1] Circular 230 § 10.29, however, imposes three additional requirements. First, while both the Model Rules and Circular 230 require that conflict waivers be confirmed in writing, Circular 230 mandates that confirmation be obtained within a reasonable period of time, but in no event later than 30 days after the client has consented to the representation. Second, unlike Model Rule 1.7, which permits affected clients to provide informed consent verbally if the consent is contemporaneously documented by the practitioner in writing, a verbal consent followed by a confirmatory letter authored by the practitioner will not satisfy Circular 230 § 10.29 unless the confirmatory letter is countersigned by the client. Finally, under Circular 230, practitioners are required to retain copies of written consents for at least 36 months from the date on which representation of the client concludes. While AICPA standards do not require written consent, they do state that members should abide by Circular 230's more restrictive requirements concerning written consent when practicing before the IRS. AICPA Code of Prof'l Conduct Interpretation 1.110.010.18.

Practitioners must provide copies of written consents to IRS officers or employees, including those from OPR, upon request. Although the requirement to turn over copies of written consents is explicitly stated in Circular 230 § 10.29(c), it is consistent with the practitioner's duty, as a general matter under Circular 230 § 10.20, to provide documents and information to the IRS upon proper and lawful request. Unlike Circular 230 § 10.29(c), however, Circular 230 § 10.20 explicitly provides that information and documents need not be turned over if the practitioner believes in good faith and on reasonable grounds that the records or information are privileged. Perhaps the very fact that Circular 230 § 10.29 requires that written consents be obtained and held for 36 months should the IRS or OPR

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[1] As a practical matter, this may mean that attorneys are better than other tax professionals at identifying and resolving conflicts of interest because attorneys generally are accustomed to the rules and procedures. Jeremiah Coder, *Recusal Not Always Required In Conflicts, Hawkins Says*, 139 TAX NOTES 35 (2013).

request them is meant to negate privilege as to such written consents because there could be no realistic expectation of privacy. Of course, this argument presumes that the client understands at the time of signing that the consent must be turned over by the practitioner to the IRS upon request. It is the client's expectation of privacy, and not the attorney's or tax adviser's, that matters for privilege purposes.

Alternatively, it is possible that OPR regards written consents as ineligible for protection by the attorney-client or Section 7525 privilege in the first instance. Such a position may often be incorrect, particularly if a written consent document includes or reflects privileged communications. Therefore, when a practitioner chooses to explain the nature of a conflict to her client in writing, it would be prudent to have the client consent, or confirm consent, in a separate document, which could be turned over to the IRS or OPR without worry. It is generally understood that OPR considers failure to obtain, retain, or turn over a written consent a violation of Circular 230 regardless of the quality of the underlying representation.[2]

Practitioners representing clients in Tax Court proceedings must comply with the Tax Court's own rule on conflicts of interest:[3] Tax Court Rule 24(g) provides that if any counsel of record "represents more than one person with differing interests with respect to any issue in the case," she must secure the clients' informed consent to the representation, withdraw from the case, or take whatever other steps are necessary to obviate the conflict of interest. Tax Court Rule 24(g) imposes the same obligations on any counsel who "was involved in planning or promoting a transaction or operating an entity that is connected to any issue in a case." Counsel who is a potential witness in a case must withdraw or take other steps necessary to obviate a conflict; obtaining the client's informed consent is not an option in this situation.

PROBLEM 3-1

X is the president and chief executive officer of Family-Run Corp., a small, family-run business. Family-Run engages Practitioner to prepare tax returns for the company, its officers, and its shareholders (all family members). As Practitioner prepares Family-Run's return, there is a question as to whether a payment the company made to X is a deductible payment of compensation or a nondeductible distribution. Does Practitioner have a conflict of interest? If so, can it be cured, and how?

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[2] At least one instance of OPR having disciplined an attorney who failed to disclose a conflict of interest to his clients and obtain their written consent to continue the representation has been publicly announced. *See* IR-2012-63 (June 22, 2012), *available at* http://www.irs.gov/uac/Newsroom/Office-of-Professional-Responsibility-Censures-Attorney. The identity of the attorney, who was censured, was separately disclosed. Ann. 2012-33, 2012-35 I.R.B. 325, 327 (Aug. 27, 2012).

[3] Practitioners representing clients in Tax Court must comply with all of the Model Rules, which have been adopted as rules of practice before the court. Tax Court Rule 201(a). Differences between the Model Rules and the rules adopted by one's own state of admission or practice, therefore, should be carefully monitored.

PROBLEM 3-2

Q, A, and B, all individuals, are partners in LP, a limited partnership. Q is the general partner. Q engages Practitioner to prepare LP's return (Form 1065) and the partners' Schedules K-1. Practitioner is separately engaged by Q, A, and B to prepare their individual income tax returns. While preparing LP's return, Practitioner identifies an issue as to the meaning of a provision in the partnership agreement that will affect the allocation of partnership items to the partners. This provision could be interpreted to provide an allocation of certain tax benefits to Q, to the detriment of A and B. Does Practitioner have a conflict of interest? If so, can it be cured, and how?

PROBLEM 3-3

Jon and Michael were married for all of 2015. In June 2015, Michael initiated divorce proceedings. In early 2016, Jon engages Practitioner to prepare the couple's joint tax return for 2015. Not long after, Michael (through his attorney) asks Practitioner to prepare his 2015 tax return as married filing separately. When Practitioner informs Michael's attorney that he was already engaged by Jon to prepare a joint return for the couple, the attorney informs Practitioner that Michael has no intention of signing a joint return. Does Practitioner have a conflict of interest? If so, can it be cured, and how?

PROBLEM 3-4

Accounting Firm offers to discuss with June Cash a package of ideas the Firm says could significantly reduce June's taxes. Accounting Firm will share the package with June, however, only if June pays Accounting Firm an upfront fee for the information and June and her lawyer, Rocky, each enter into a confidentiality agreement pursuant to which June and Rocky agree never to divulge the ideas in the package. If Rocky signed the confidentiality agreement, would he have a conflict of interest in representing other clients who could benefit from the ideas that Rocky might obtain from Accounting Firm but agreed not to disclose?

C. Business Planning

Most Corporate Tax classes begin with a study of the tax consequences of corporate formation, "Section 351 exchanges." Inevitably, students are asked to consider a hypothetical set of facts involving several unrelated persons who, together, desire to incorporate a new entity, with each person transferring previously-owned property, cash and/or services to the newly-formed entity in exchange for stock and, perhaps, other property ("boot"). Students are routinely asked to consider whether each transferor recognizes gain or loss, and what each transferor's basis in her newly acquired stock and boot will be. On the corporate side, students learn that the corporation itself recognizes no gain or loss on the issuance of shares, and master the increasingly complicated rules governing a corporation's basis in property received from transferors. Professors go to great lengths to assist students in divining those situations in which nonrecognition is a benefit and those in which it is not. Students brainstorm solutions to assist the various players in, *e.g.*, recognizing losses but not gains, preserving or protecting unrecognized losses, and maximizing corporate basis in depreciable assets. Corresponding concepts are covered in Partnership Tax classes in connection with formation of partnerships and limited liability companies.

What typically is omitted from such instruction, however, is an examination of the ethical situation in which an attorney hired by all of the transferors finds herself. While individuals entering into a new business venture might view their interests as common, that is not necessarily so.[4] Particularly in the case of small businesses founded by individuals, one attorney is often hired by the entire group to handle the corporate formation.

If a lawyer agrees to accept representation, who is the client, the individual transferors (separately or as a group), or the corporation that results from the representation? Does the answer depend upon whether the attorney will continue to work professionally with the corporation?

State Bar of Arizona Opinion No. 02-06

(Sept. 2002)[5]

Summary

A lawyer may form a business entity for various individuals and be counsel only for the yet-to-be-formed entity, if appropriate disclosures and consents occur. Alternatively, a lawyer may represent all of the incorporators, collectively, with appropriate disclosures.

Facts

Lawyer is a business law practitioner who currently represents several businessmen in various matters. The existing clients ask the lawyer to form a new entity corporation for them and to be counsel only for the entity.

Questions Presented

1. May a lawyer represent a yet-to-be-formed entity during formation?

2. Can a lawyer represent the prospective entity without being deemed to also represent the incorporators?

3. If so, what disclosures must the lawyer make to the constituents to clarify who is the client?

* * *

[4] Individuals who form businesses often have inconsistent non-tax objectives as well, for example, voting control or veto power over certain acts, priority return on investments or security for loans. Conflicts also may present themselves in choosing the form of entity (corporation, partnership, limited liability company), establishing rules for internal governance, structuring financing, agreeing on how to resolve disputes and negotiating exit strategies.

[5] Used with State Bar of Arizona permission.

Opinion

1. Can a lawyer represent an entity that does not yet exist?

Yes, as long as the incorporators understand that they are retaining counsel on behalf of the yet-to-be-formed entity and will need to ratify this corporate action, *nunc pro tunc*, once the entity is formed. According to [Rule] 1.13(a), a lawyer may represent an "organization." The Comments to the Rule explain that an "organizational client is a legal entity, but it cannot act except through its officers, directors, employees, shareholders and other constituents. . . . The duties defined in this comment apply equally to unincorporated associations."

An "organizational client" or "entity" can be a separate client. For purposes of the ethical analysis, this Opinion will refer to "corporations" as the entity at issue, but the analysis also is applicable to other legal entities.

To determine whether a lawyer ethically may represent a yet-to-be-formed corporation, the analysis must include a review of Arizona corporate and partnership statutes. A.R.S. § 10-203 provides:

> A. Unless a delayed effective date is specified in the articles of incorporation, incorporation occurs and the corporate existence begins when the articles of incorporation and certificate of disclosure are delivered to the commission for filing.

Under this statute, a corporation does not exist as a separate legal entity until its articles of incorporation are filed with the Corporation Commission.[6] Section 10-204 of the Arizona Revised Statutes further cautions that individuals who attempt to transact business as a corporation, knowing that no corporation exists, will be jointly liable for their actions. Presumably, however, a newly formed corporation may ratify pre-incorporation acts of the corporation, *nunc pro tunc*.

A decision from Wisconsin specifically holds that a lawyer hired to form an entity can represent the to-be-formed entity, not the incorporators, and the "entity" rule applies retroactively. *Jesse v. Danforth*, 485 N.W.2d 63 (Wis. 1992). This view would be consistent with the "entity" theory of representation, under [Rule] 1.13(a). The "entity" theory holds that a lawyer may represent the corporation and does not, necessarily, represent any of the constituents that act on behalf of the entity—even if it is a closely held corporation. *See, e.g., Skarbrevik v. Cohen, England & Whitfield*, 282 Cal. Rptr. 627 (Cal. App. 1991); *Bowen v. Smith*, 838 P.2d 186 (Wyo. 1992).

An alternative view is the "aggregate" theory in which the lawyer is found to represent the incorporators/constituents collectively as joint clients. *See Griva v. Davison*, 637 A.2d 830 (D.C. 1994). Under the aggregate theory, a lawyer represents multiple co-clients during formation of the corporation and then once the entity is formed, the clients must determine whether the lawyer will continue to

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[6] [1] Partnerships, however, are not required to make a filing to establish their existence; a partnership exists once there is an "association of two or more persons to carry on as co-owners [of] a business for profit . . . whether or not the persons intend to form a partnership." A.R.S. § 29-1013.A.

represent all of the constituents and the entity, or just the entity. Who a lawyer may represent depends upon whether the lawyer's independent professional judgment would be materially limited because of the lawyer's duties to another client or third person. *See* [Rule] 1.7(b); *Matter of Shannon*, 179 Ariz. 52, 876 P.2d 548 (1994). As discussed below in Section 3, there are specific disclosures that a lawyer must make to co-clients, in order for them to consent to a joint representation.

Thus, a lawyer may represent an entity during the formation process, as long as the constituents who are acting on behalf of the yet-to-be-formed entity understand and agree to the entity being the client.

2. Can a lawyer represent *only* the yet-to-be-formed entity and not the constituents?

Who a lawyer represents depends upon the reasonable perceptions of those who have consulted with the lawyer. *In re Petrie*, 154 Ariz. 295 (1987). When two or more individuals consult with a lawyer about forming an entity, it is the responsibility of the lawyer at that initial meeting to clarify who the lawyer will represent. [Rule] 1.13 provides that a lawyer may represent an entity and the Rule suggests that the lawyer will not automatically be considered counsel for the constituents because paragraph (e) of the Rule provides:

> A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of [Rule] 1.7. If the organization's consent to the dual representation is required by [Rule] 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

In *Samaritan v. Goodfarb*, 176 Ariz. 497, 508, 862 P.2d 870 (1993), the Arizona Supreme Court confirmed that a lawyer representing an entity does not automatically represent the constituents. Therefore, unless a lawyer wants to be counsel to all of the incorporators and the entity, the lawyer should specify that the lawyer does not represent the constituents collectively—the lawyer only represents the entity. If an engagement letter or oral representation by the lawyer suggests that the constituents are represented as an aggregate, then the lawyer will have ethical obligations to each constituent. Aggregate representation also is ethically proper if the disclosure to each client includes an explanation that the lawyer may have to withdraw from representing each client if a conflict arises among the clients.

3. What disclosures should a lawyer make to the incorporating constituents to obtain their informed consent to the limited representation of the entity?

The underlying premise of the conflict Rules is loyalty to clients. Where a lawyer's independent professional judgment for a client is materially limited due to anything or anyone, a conflict may exist. Thus, in order to avoid inadvertent conflicts caused by misunderstandings of constituents in corporate representations, it is crucial for lawyers to specify exactly who they represent, who they do not represent, and how information conveyed to the lawyer by constituents of an entity client will be treated, for confidentiality purposes. The Restatement Third, The Law

Governing Lawyers, Comment b to § 14 provides in part: "A lawyer may be held to responsibility of representation when the client reasonably relies on the existence of the relationship. . . . "

See also Comment f: "[A] lawyer's failure to clarify whom the lawyer represents in circumstances calling for such a result might lead a lawyer to have entered into client-lawyer representations not intended by the lawyer."

Therefore, it is crucial that a lawyer specify in the engagement agreement if the lawyer is not representing the constituents of an entity client.

Even if the engagement letter specifies that the constituents are not clients, lawyers still should regularly caution constituents that they are not clients—particularly when they consult with counsel. Lawyers who represent entities also must be aware of the entity's potential fiduciary duties to the constituents, so that the lawyer does not run afoul of those statutory or common law obligations. For instance, there are cases that have held that lawyers may have fiduciary duties to non-clients, depending upon whether the entity represented had fiduciary duties to the third parties. *See Fickett v. Superior Ct. of Pima Cty.*, 27 Ariz. App. 793, 558 P.2d 988 (1976); *Matter of Estate of Shano*, 177 Ariz. 550, 869 P.2d 1203 (App. 1993) (lawyer disqualified as counsel to administrator for an estate because of prior representation of one beneficiary and derivative duty of neutrality to all beneficiaries). Accordingly, lawyers for entities should be mindful of this potential responsibility and that a derivative fiduciary duty to constituents may cause a conflict of interest for the lawyer.

The engagement letter also should explain that once the entity is created, the constituents agree to ratify the lawyer's services, *nunc pro tunc* on behalf of the entity.

With respect to confidentiality obligations, lawyers should specify how information conveyed to the lawyer will be treated for confidentiality purposes. If the firm is representing only the entity, constituents must be advised that their communications to the lawyer will be conveyed to the other decision-makers for the entity and are not confidential as to the entity. The information is confidential, however, according to Rule 1.6(a), to the "outside world." Similarly, information shared by one co-client that is necessary for the representation of the other joint clients will be shared with the other co-clients because there is no individual confidentiality when a joint representation exists.

Finally, if the lawyer has chosen to represent multiple clients, including the constituents and the entity, the lawyer should explain, at the beginning of the joint representation, that in the event that a conflict arises among the clients, the lawyer most likely will need to withdraw from representing all of the co-clients. However, some commentators, including the Restatement Third, note that the engagement agreement may provide that in the event of a conflict, the lawyer may withdraw from representing one of the co-clients and continue to represent the remaining clients. The usefulness of such provisions was recently demonstrated in *In re Rite Aid Corp. Securities Litigation v. Grass*, 139 F. Supp. 2d 649 (E.D. Pa. April 17, 2001), where the court permitted the law firm to withdraw as counsel for one of the executives of Rite Aid and continue as counsel for the entity in a class action suit, primarily because the engagement agreement provided for such action.

In *Jesse v. Danforth*, 485 N.W.2d 63 (Wis. 1992), a case referred to in the State Bar of Arizona opinion, *supra*, the Wisconsin Supreme Court held that the client is the corporation, not the corporation's constituents. This is referred to as "the entity theory." The court stated:

> We thus provide the following guideline: where (1) a person retains a lawyer for the purpose of organizing an entity and (2) the lawyer's involvement with that person is directly related to that incorporation and (3) such entity is eventually incorporated, the entity rule applies retroactively such that the lawyer's pre-incorporation involvement with the person is deemed to be representation of the entity, not the person.
>
> In essence, the retroactive application of the entity rule simply gives the person who retained the lawyer the status of being a corporate constituent during the period before actual incorporation, as long as actual incorporation eventually occurred.

Id. at 67. Under the "entity theory" of representation, a corporate lawyer typically is not disqualified from representing the corporation in litigation between the corporation and one or more of its constituents. It also means that the corporate lawyer generally is not liable to shareholders, officers, or directors for malpractice or breach of fiduciary duty. Moreover, as specifically noted by the court in *Jesse v. Danforth*, the identity of the client has implications with respect to the attorney-client privilege. The corporation, and not the constituents, holds the privilege as to communications pertaining to the organization of the entity. Individual constituents who are also being represented personally by the lawyer, however, hold the privilege where a communication does not relate directly to the purpose of organizing the entity.

If the lawyer's dealings with constituent individuals become so extensive and personal that the individuals reasonably believe that the lawyer represents them personally, a court or disciplinary authority might conclude that, despite the "entity theory," a lawyer-client relationship has nonetheless been formed between the lawyer and the individual constituent. Attorneys should be familiar with their own states' corporate laws when evaluating possible conflicts of interest questions in the context of business representation.

Samples of conflicts language for engagement letters often are available on the websites of state bars. For example, the Georgia Bar website includes a lengthy "Report on Engagement Letters in Transactional Practice," at http://www.gabar.org/committeesprogramssections/sections/business/upload/eltp.pdf. The Colorado state bar website also contains an interesting example, at http://www.cobar.org/repository/LPM%20Dept/FeeAgmts/EngageLtrConflictof InterestASparkman.pdf?ID=260. The American College of Trust and Estate Counsel offers samples, as well, at http://www.actec.org/publications/engagement-letters/.

PROBLEM 3-5

Three prospective clients meet with Lawyer to discuss a new business venture. A, who has experience in the business, would contribute his management skills, B would contribute a substantial amount of cash, and C would contribute assets that could be used in the business. Each person would receive one-third of the stock in a newly formed corporation. A, B, and C have asked Lawyer to create the corporation and to advise them with respect to tax and other issues related to forming and operating the business.

a. May Lawyer represent all three individuals seeking to form the business? Whom should Lawyer represent in the case? How would you advise Lawyer to proceed?

b. Would your answer to (a), above, change if A, B, and C brought in another "partner," D, who would contribute property with an adjusted basis in excess of value?

c. If a dispute were to arise among the three "partners," and one of them decided to hire her own lawyer, could Lawyer continue to represent the remaining "partners?"

d. Suppose that you accept the representation in full compliance with your ethical obligations and that several years later, A calls you to discuss renegotiating her salary. How should you handle her call?

PROBLEM 3-6

You recently filed a letter ruling request with the IRS on behalf of Smithco, Inc. to the effect that a series of contemplated transactions should, with application of the step transaction doctrine, be treated as a tax-free reorganization. Jonesco, Inc. has asked you to represent it in Tax Court litigation in which its position will be that a similar series of transactions should not to be stepped together, but should instead be treated as separate steps, with the result that there is no reorganization. Can you take the case? Would your answer be different if you are representing Smithco in Tax Court rather than in the ruling process? What is the answer if you are representing Smithco in connection with an audit, after the transaction has already been reported as a reorganization on a filed tax return? *See* Model Rule 1.7, Comment [24].

D. When Business or Personal Relationships Fail

Human nature being what it is, disputes often develop between or among business "partners" once business operations have commenced. Whether a lawyer previously worked with all of the co-venturers or merely represented the entity, questions arise as to whether the attorney may continue in the representation and whom the attorney may represent. Among the concerns is the possibility that the attorney received confidential information that may not be used against a former client. While the case below arose out of a personal, not a business, relationship, the ethical considerations are well exemplified.

DEVORE v. COMMISSIONER

United States Court of Appeals, Ninth Circuit
963 F.2d 280 (1992)

Per Curiam:

Gary Devore appeals from the United States Tax Court's denials of his motions to vacate deficiency judgments for the tax years 1970–1975. Devore contends that dual representation of himself and his ex-wife in the tax proceedings resulted in a conflict of interest that prevented their joint counsel from raising defenses on his behalf. We have jurisdiction under 26 U.S.C. §§ 7482(a), 7483. We reverse the orders of the tax court and remand for an evidentiary hearing to determine whether Devore was prejudiced by his former counsel's conflict of interest and whether Devore had reasonable grounds for failing to seek independent counsel.

Background

For many years, Maria Cole and her former husband, Nat King Cole, had been represented by attorney Harry Margolis. Margolis continued to represent Maria Cole after Nat King Cole's death. Maria Cole and Gary Devore were married in 1969. For the year 1970, Devore filed an individual return. Joint returns were prepared for all other years during the marriage. Until June 1987, Harry Margolis was the sole counsel of Cole and Devore. Leo Branton, Jr., became co-counsel with Margolis in June 1987. Margolis died on or about July 15, 1987 and Branton became the sole counsel of record on behalf of Cole and Devore in connection with the instant actions. The tax proceedings culminated in the entry of two judgments against Devore.

Cole and Devore were separated in 1976, and were divorced in 1978. The tax court did not render judgments in the instant cases until 1989. Despite their divorce, joint counsel continued to represent Cole and Devore throughout the tax proceedings.

After a four day trial, the tax court determined that [for 1970] Devore was individually liable for a federal tax deficiency of $135,302, and for a negligent return penalty of $6,765. The tax court found that Devore failed to carry his burden of proof in establishing that certain checks totaling $210,000 did not constitute reportable income to him. Two checks had been issued to Devore by a company controlled by Margolis. These checks were received by Devore, but were immediately endorsed over to Margolis. Devore alleges that these funds were then used to purchase a home in the name of Maria Cole. The tax court found that the $210,000 represented by the two checks was income attributable to Devore.

In a second judgment entered pursuant to stipulations of settlement, Devore and Cole were held jointly and severally liable for deficiencies totaling over $300,000 for the years 1971–1975.

Devore states that he entered and left his marriage to Cole with a net worth of less than $10,000 and that he lacks the money to satisfy the judgments. He further states that he was unsophisticated in tax matters and that he was continually excluded from the financial affairs of Maria Cole.

Devore moved, through new counsel, to vacate the tax court's deficiency judgments. He asserted that when counsel represented him and Cole jointly, a conflict of interest resulted. This conflict, argues Devore, prevented joint counsel from bringing innocent spouse and agency defenses which would have diminished his tax liability. The tax court denied these motions.

Discussion

A tax court's decision not to reopen a record for the submission of new evidence "is not subject to review except upon a demonstration of extraordinary circumstances which reveal a clear abuse of discretion." *Nor-Cal Adjusters v. Commissioner*, 503 F.2d 359, 363 (9th Cir. 1974).

The facts of Devore's case constitute "extraordinary circumstances." One spouse was in a substantially weaker position with reference to the other. Devore earned a negligible income while his wife controlled a significant sum of money. Devore was unsophisticated in tax matters and was excluded from the financial affairs of his wife.

Our research uncovered only one case that is directly on point. In *Wilson v. Commissioner*, 500 F.2d 645 (2nd Cir. 1974), a husband and wife had filed joint tax returns. The husband earned a much larger income than his wife. A deficiency judgment was entered against the couple. Throughout the tax proceedings, they were jointly represented by the same attorney. However, they were also engaged in a simultaneous annulment action. In the annulment action, the husband was represented by the same attorney who represented the couple in the tax proceedings.

The Second Circuit held that it could "reverse a discretionary denial by the Tax Court of post-opinion motions only if there are shown to be 'extraordinary circumstances.' " *Wilson*[,] 500 F.2d at 648, quoting *Pepi, Inc. v. C.I.R.*, 448 F.2d 141, 148 (2nd Cir. 1971). The court held that the facts in Wilson were sufficiently compelling to constitute "extraordinary circumstances." The attorney could not competently advance the interests of the wife in the tax proceedings while representing the husband in a separate annulment action. It thus reversed the tax court's denial of Mrs. Wilson's post-opinion motions. It remanded the case to the tax court, allowing Mrs. Wilson to present evidence explaining her failure to seek the advice of independent counsel and to raise the annulment issue.

The facts supporting Devore's claim of "extraordinary circumstances" are at least as compelling as those of Wilson. In Wilson, the attorney represented both the husband and wife in tax proceedings while representing the husband in a simultaneous annulment litigation. However, the couple was still married at the time of the tax proceedings. In the instant case, the parties were separated in 1976 and divorced in 1978. The trial did not take place until 1989. By this time, the marriage was clearly over. Arguably, Devore's interests were compromised by counsel's simultaneous representation of Devore and Cole.

Accordingly, we remand to the tax court for an evidentiary hearing to determine if Devore was prejudiced by his former counsel's conflict of interest and to establish the reasonableness of his failure to retain independent counsel. If Devore satisfies these burdens, he should be granted a new trial at which innocent spouse and agency defenses may be asserted.

The *Devore* case is somewhat unique in that the aggrieved spouse was the ex-husband.[7] Most often, innocent spouse claims are made by an ex-wife. Why? What special responsibilities does this impose on a lawyer who perhaps has a preexisting professional relationship with the ex-husband?

Many law firms are loathe to provide legal services at the same time to individuals (*e.g.*, estate planning) and business entities in which those individuals own interests because disagreements often arise between or among the individuals, creating painful conflicts of interest problems for lawyers. For an example of such a conflict, see *Pascale v. Pascale*, 549 A.2d 782 (N.J. 1988), *infra*, Section I.F.

PROBLEM 3-7

You have represented Mr. and Mrs. Mildew in connection with an audit of their joint federal income tax return. Following the audit, the IRS issues them a joint notice of deficiency. You prepare a petition, which they both sign, and which is then filed in the Tax Court. Two weeks before the case is scheduled to go to trial, Mrs. Mildew calls, says they are getting divorced and tells you that her divorce lawyer has discovered that her husband was skimming cash receipts out of their jointly owned restaurant without reporting them on the couple's tax returns. What are your ethical and other obligations to each of the Mildews, IRS counsel, and the Tax Court?

PROBLEM 3-8

Practitioner prepared a joint return filed by a married couple. The couple later divorced. May Practitioner represent both spouses in connection with an IRS challenge to expenses that were claimed on the joint return? Note that Section 6013(e) (innocent spouse relief provision that applied at the time *Devore* was decided) has been replaced by Section 6015. Does your analysis change because of the statutory change? What must Practitioner do if she decides to accept representation?

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[7] A more recent case in which the "innocent spouse" was the husband is *Harbin v. Commissioner*, 137 T.C. 93 (2011). A lawyer had represented both spouses at audit and in Tax Court litigation without raising a viable innocent spouse claim. *See* Section 6015. He had also represented both spouses in a contentious divorce during the pendency of the Tax Court proceedings! The husband clearly blamed his wife for their tax problems, which resulted from her substantial gambling activities. The court found that the attorney had a conflict of interest, which he had neither disclosed to the couple nor sought to have them waive. The husband was later permitted to request innocent spouse relief.

PROBLEM 3-9

Several years ago, before Husband married Wife, Lawyer represented Husband in connection with the formation of a business venture. Recently, Wife approached Lawyer to request representation in divorce proceedings against Husband. Can Lawyer accept the representation? What are Lawyer's ethical obligations? *See* Model Rule 1.9, Comment [3].

E. Tax Shelters

For many years, taxpayers and the IRS have litigated over the tax consequences of transactions that the IRS has labeled "tax shelters." For tax benefits generated from a purported tax shelter transaction to be upheld, courts have consistently held that the transaction or series of transactions at issue must have economic substance. In an often-quoted articulation of the economic substance doctrine, the Court of Appeals for the Fourth Circuit stated:

> To treat a transaction as a sham, the court must find [1] that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and [2] that the transaction has no economic substance because no reasonable possibility of a profit exists.

Rice's Toyota World v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985).

The Circuit Courts of Appeals that have considered the economic substance doctrine agree generally on the articulation of its two parts as set forth in *Rice's Toyota*, but differ on how to apply the test. Some circuits have required that a transaction satisfy both the business purpose and economic profit standards to validate a transaction (conjunctive test). Other circuits have required satisfaction of only one of the standards to validate a transaction (disjunctive test). Some courts have given more weight to one prong than the other, in some cases disregarding one or the other of the two prongs altogether. In some cases, courts have considered both prongs as merely factors, among others, in determining whether a transaction has any practical economic effects other than the creation of tax benefits.

In 2010, Congress codified the economic substance doctrine for penalty purposes, endorsing the conjunctive approach (i.e., a transaction has economic substance only if it satisfies both parts of the test). Under Section 6662(b)(6), a 20 percent accuracy-related penalty may be imposed on an understatement of tax resulting from a transaction that lacked economic substance or failed to meet the requirements of any similar rule of law. The penalty increases to 40 percent if relevant facts are not adequately disclosed on the taxpayer's return. Section 6662(i). For penalty purposes, a transaction is treated as having economic substance only if:

> (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
>
> (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

Section 7701(o)(1). The potential for profit from a transaction is taken into account in determining whether the requirements in (A) and (B) are met only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would have been allowed if the transaction had been respected. Section 7701(o)(2)(A).

The following problems exemplify conflicts of interest issues arising in the context of the economic substance doctrine.

PROBLEM 3-10

Your law firm represents 18 different clients who invested in a transaction sold by the same accounting firm. For each client, you must prove that the client had a profit motive for investing in the transaction, which the IRS has called a tax shelter. Can you offer the same profit motive for each client (*e.g.*, expectation of a specific return on a series of hedging transactions)?

PROBLEM 3-11

If profit motive or business purpose is an essential element of proof to obtain a deduction from a tax shelter investment, does representation of multiple clients who invested in essentially the same transaction (1) dilute any single client's chances of obtaining a favorable settlement or (2) impose ethical constraints on the lawyer when additional clients are added to the representation roster?

PROBLEM 3-12

With the informed consent of the parties, your law firm has undertaken representation of investors in a tax shelter in proceedings before the Tax Court in which the tax benefits of the shelter are being challenged. During the pendency of the proceeding, a separate class action is brought against the shelter promoters on behalf of a putative class consisting of the investors in the shelter, including some of your firm's clients. Your firm does not anticipate participating as counsel in the class action on behalf of either side. Can your firm continue in the Tax Court representation? *See* D.C. Opinion No. 165 (Jan. 21, 1986). Would it matter whether the promoters have agreed to pay all of your professional fees incurred by the investors in the Tax Court proceeding?

PROBLEM 3-13

An accounting firm developed and promoted a tax shelter in which your firm's client invested. Can your firm represent that client at the same time that it represents the accounting firm in malpractice cases that do not involve tax shelters? Can your firm represent that client at the same time that it represents the accounting firm in malpractice cases that do involve tax shelters?

PROBLEM 3-14

Your law firm's banking department does loan documentation work for a bank that provided financing for a tax shelter transaction. A tax department client invested in one such tax shelter transaction. Can the firm represent both the bank and the investor?

PROBLEM 3-15

Your law firm represents a large insurance company on general corporate and regulatory matters. The insurance company sold a transaction, which the IRS alleges is substantially similar to a listed transaction but which the insurance company claims was substantially different from the listed transaction, to Investor. Can you represent Investor in connection with an IRS audit?

F. Estate Planning

Conflicts of interest generally arise in estate planning in one of four situations.

1. Spouses. First, and most commonly thought of, are conflicts involving concurrent representation of spouses. (Many, but not all, of the same issues arise, as well, when representing unmarried cohabitants.) Children from prior marriages or large disparities in wealth between spouses might be a reason to suggest separate representation. Spouses of substantially different ages may have conflicts in their planning goals. In addition, when one spouse dies, the surviving spouse and the estate could have differing interests. For example, the surviving spouse may wish to make an election against the estate or the executor may wish to make an election that increases the surviving spouse's share of the estate while decreasing the interests of other beneficiaries.

Nonetheless, and despite all of the possible conflicts, spouses frequently visit attorneys together for the purpose of preparing their wills. Often, these are reciprocal wills—wills that are essentially mirror images of each other, in which each spouse leaves his or her residuary estate to the other. Under Model Rule 1.7, a lawyer should, in most cases, be able to represent and plan for both spouses jointly. However, the lawyer should require each spouse to sign a written waiver of confidentiality as to the other so that any information provided to the lawyer by either spouse must be revealed to the other spouse. All information provided to the lawyer, of course, would still be protected against disclosure to third parties. The reluctance of a spouse to sign a waiver should alert the lawyer to the possible existence of a nonwaivable conflict of interest.

The lawyer must explain to both spouses that their interests could conflict, particularly where they do not agree on the identity of beneficiaries or fiduciaries. Under Model Rule 1.7, each spouse must sign this statement, agreeing to allow the lawyer to use his or her best efforts and judgment to represent each of them, despite these possible conflicts. It would be wise for the lawyer and spouses to agree that both spouses must be present whenever either wishes to change any of his or her estate planning documents.

The American College of Trust and Estate Counsel offers samples of conflicts language for engagement letters in estate planning, at http://www.actec.org/publications/engagement-letters/. The Colorado Bar Association web site also contains a good example, at https://www.cobar.org/repository/Inside_Bar/TrustEstate/OrangeBook_Dec2007_EngagementLetter.pdf?ID=2841.

2. Families. Second, conflicts may arise where parents and children seek representation or advice. A parent and child might have different ideas about the

use or disposition of a trust fund benefitting the child, or an adult child and an infirm parent might disagree about transfers of the parent's property. Conflicts also often arise when adult children are involved in a family-owned business, which forms a substantial portion of a parent's estate.

Particularly where the lawyer is approached by an adult child or children in connection with estate planning for a parent, care should be given to the question of who is the client — the adult child(ren) or the parent? Surprisingly, intentions in this regard are often unclear: is the purpose of the representation to plan for the disposition of the parent's assets as he or she intends or to protect the interests of a particular beneficiary? If the attorney previously represented either the parent or the child, the attorney might possess confidential information, gained through the course of that representation that would be inconsistent with representing the other.[8]

Once it is determined who the client is, it is important to make sure that everyone understands and agrees. Even where such an understanding is reached, however, maintaining confidentiality between lawyer and client often presents challenges. For example, elderly clients may feel more comfortable meeting with the lawyer in the company of their children. Significant decisions are made at these meetings and it is the attorney's responsibility to establish a clear and confidential line of communication without the presence or undue influence of family members. Attorneys are strongly advised to talk to the client alone to make sure that problems of conflicts of interest and undue influence do not exist, and to explain confidentiality concerns.

3. Businesses and their Constituents. Third, a conflict may arise when a lawyer represents a business entity and a majority or controlling owner, as was discussed earlier in this chapter. Additional issues arise where business and estate planning overlap. For example, an estate plan of a majority shareholder of a closely-held corporation could affect the business plans or ownership of the corporation as well as the relationship between the corporation and other shareholders.

PASCALE v. PASCALE
New Jersey Supreme Court
549 A.2d 782 (1988)

POLLOCK, J.

Plaintiff, John J. Pascale (Pascale), seeks to set aside a transfer of stock and real estate to his son David P. Pascale (David). Pascale contends that a confidential relationship existed between him and David and that the same attorney advised both of them in connection with the transfer. The issue is whether the transfers are invalid because David exercised undue influence over Pascale.

* * *

[8] Moreover, if the parent is incapacitated or appears to suffer from a diminished capacity, particular issues pertaining to such a representation must be considered. Discussion of such matters is beyond the scope of this book. *See* Model Rule 1.14.

Nearly fifty years ago, in 1939, Pascale founded a machine tool and die business, which was later incorporated under the name Quality Tool & Die Company Inc. (Quality). In 1952, plaintiff established a second, smaller machine tool company, Majoda Tool and Die Company (Majoda), which operated out of Quality's premises in Hoboken. By 1960, both businesses had become quite profitable.

In the 1960s, Pascale introduced his older son, John, Jr., into the businesses, and six years later, Pascale gave all the stock in Majoda to John, Jr. David began full-time employment with Quality in 1971. Sometime before 1972, John, Jr. left Majoda and assigned all of his stock to Pascale and David.

In March 1972, Pascale's wife instituted a divorce action, and the two sons chose sides: John, Jr. sided with his mother, and David with Pascale. Consequently, Pascale did not see John, Jr. again until their apparent reconciliation in 1978. In 1973, to minimize his net worth and thereby to reduce his wife's share in an equitable distribution of his assets, Pascale signed a stock certificate, which purported to transfer ownership of his Quality shares to David. The certificate, however, was backdated to 1968, four years before the institution of the divorce action.

Initially, the fraud worked. An accounting firm, which was appointed by the matrimonial court to investigate Pascale's assets, reported on June 7, 1973, that Pascale was "essentially responsible" for the operations of Quality and Majoda, but that he had transferred his stock in both corporations to David on October 16, 1968. The matrimonial court approved the property settlement based on this false information. Although Pascale claims that the stock certificate and corporate books are lost, David produced at the trial of the within matter a photocopy of a signed copy of the backdated October 16, 1968, stock certificate.

Consistent with the certificate, David claimed in his deposition that Pascale transferred all the Quality stock to him in 1968. David denied that any transfer of stock from his father to him occurred between 1970 and 1976. When asked at trial who owned the Quality stock in 1976, however, David testified, "my father did." The foregoing facts led the trial court to find that Pascale signed the backdated certificate in 1973 as part of "a scheme to defraud [Pascale's] wife and the matrimonial court."

Following the transfer, Pascale and David continued in their respective roles at Quality. Until 1979, Pascale remained in control, with David managing accounts and performing other office work. From 1971 until late 1981, Pascale and David enjoyed a close personal relationship. Pascale lavished expensive gifts on David and his wife, including cars, real estate, a sable coat, jewelry, and large amounts of cash. David handled Pascale's personal financial affairs, such as check writing, personal bills, safe deposit boxes, and securities.

Late in 1975, however, the Internal Revenue Service asserted a tax deficiency claim against Pascale personally and also against Quality. On the advice of his personal and business accountant, J. Bennett Schwartz, Pascale retained a tax attorney, Bernard Berkowitz, who resolved the IRS matter in January 1979. In the interim, Pascale asked Berkowitz to prepare an estate plan for him.

Early in his representation on both matters, Berkowitz communicated exclusively with Pascale. Pascale, however, directed Berkowitz to "deal directly with David Pascale or Ben Schwartz, but primarily David." According to Berkowitz, Pascale instructed him to develop an estate plan that left "everything to David" while incurring as little tax liability as possible. David confirmed Berkowitz's testimony by acknowledging that he served as an agent for Pascale in dealing with Berkowitz.

As early as 1977, Berkowitz and his associate, Stephen C. Levitt, discussed with David and Schwartz an estate plan that would have left Pascale in control of Quality. For tax purposes, Berkowitz recommended that Pascale transfer to Quality land he owned in Hoboken and that Pascale convert his common stock in Quality into three classes: preferred stock, voting common stock, and nonvoting common stock. The then-existing value of Quality would be ascribed to the preferred stock, which Pascale would retain along with all the voting common stock. David would receive the nonvoting common stock to which all future growth would be attributed.

In May 1978, Berkowitz worked out the details of the recapitalization with David and Schwartz, who in turn informed Pascale of the plan. Although Pascale approved the recapitalization, the plan was never executed.

A year later, on May 9, 1979, Berkowitz, Levitt, and Schwartz met with David. At this meeting, while reading the 1973 accountant's report from the matrimonial action, Berkowitz first learned that Pascale apparently had transferred the Quality shares to David in 1968. It became apparent to Berkowitz that there was a conflict between David and Pascale about the ownership of the Quality stock. As Berkowitz testified, "David Pascale thought he owned the stock; John Pascale thought that he owned the stock." Because the recapitalization plan was premised on Pascale's ownership of the Quality stock, the confusion about stock ownership caused Berkowitz to abandon this plan.

Berkowitz also ascertained that no gift tax had been paid on the backdated transaction. Confronted with this information, Berkowitz devised an alternate plan to fulfill Pascale's intention of leaving, with a minimal tax impact, all of his business assets to David. The plan was for Pascale to give the Hoboken properties and the Quality stock to David, with David paying the gift taxes of $54,947. That proposal was consistent with the will prepared by a different attorney and executed by Pascale on December 10, 1975, in which Pascale left his entire estate to David. Berkowitz further believed that the gift to David would reduce the problems inherent in the fraudulent matrimonial scheme, which was evidenced by the backdated stock certificate.

The trial court found that Berkowitz discussed the alternate plan with David and Schwartz, and that each of them in turn discussed it with Pascale. Both David and Schwartz claimed that Pascale understood that by agreeing with this plan, he would be yielding control of Quality to David. Indeed, Schwartz testified that he spoke with Pascale on May 24, 1979, the day Pascale executed the alternate plan, and specifically admonished him that by executing the plan, "he was giving the company away, he could be thrown out in a week."

On that date, Berkowitz, David, and Pascale met at Pascale's office in Hoboken to execute the plan. According to Levitt, with the exception of several letters that his law firm had mailed to Pascale, this meeting was the first time since January 11, 1978, that the firm "had any contact or has any records that reflect any contact with John Pascale." At the meeting, Pascale signed various documents, including two stock certificates of Quality: one that described Pascale as the owner of 310 shares, and the other that described David as the owner of 310 shares. Pascale also signed an assignment transferring his 310 shares of Quality to David, a deed from Pascale and Quality conveying the Quality premises in Hoboken to David, and an affidavit of consideration.

The main dispute in this case is whether Pascale understood that these documents effected an outright transfer of the Quality stock and real estate to David. On this point, as on others, the testimony at trial was in sharp conflict.

According to Pascale, before the May 24, 1979, meeting, he had not received any of the documents. He contends that he had no opportunity to read the documents before signing them, that neither Berkowitz nor David explained the documents to him, and that he relied on them in signing the documents. Pascale testified that he thought he "was to have control [of Quality] to the day I died or was incapable of handling the business."

David and Berkowitz testified, however, that Berkowitz reviewed the documents in detail with Pascale before he signed them. Berkowitz did not remember whether he discussed with Pascale the implications of transferring the Quality stock and the Hoboken properties to David, but he believed that the implications were so obvious that such a discussion was unnecessary. David, however, testified that Berkowitz explained to Pascale that the effect of signing the documents would be to relinquish control of Quality to David. Pascale signed the documents.

On the same day, David executed a will prepared by Berkowitz, in which David bequeathed all his Quality stock to a testamentary stock trust, of which Pascale was the trustee. The beneficiaries of the trust were Pascale and David's wife, and all income was payable to Pascale during his lifetime. In the following year, on October 7, 1980, however, David executed another will, which eliminated the trust and provided that the Quality stock and land would pass to his wife, if she survived, and if she predeceased him, to his mother-in-law.

After the May 24, 1979, meeting, David assumed greater responsibility in managing Quality. Pascale remained active in the business, and continued to receive his \$3,500 weekly salary, plus approximately \$700 in travel and entertainment expenses. In January 1980, however, David attempted to reduce Pascale's salary to \$3,000 per week, but Pascale responded by retroactively reinstating his salary to \$3,500.

Relations between David and Pascale cooled when David learned that Pascale was helping John, Jr. in a competing machine and tool business. According to Pascale, he first learned that he was no longer in control of Quality in October 1981 following a dispute with David over Pascale's assistance to John, Jr. David ordered Pascale to leave the Quality premises and to consult with a lawyer to confirm that David now controlled Quality and had the right to terminate Pascale's employment. Notwithstanding their dispute, Pascale remained on Quality's payroll until October 1982, two months after he filed the within action. In the interim, during the spring of 1982, Pascale consulted with Levitt, who told him that the effect of the May 24, 1979, transfers was to place David in control of Quality.

* * *

[T]he trial court found that Pascale's attorney, Berkowitz, was not in a position of conflict when he prepared Pascale's estate plan and advised him to execute it, stating, "[a]t all times Berkowitz was Pascale's rather than David's attorney."

The Appellate Division reversed. 216 N.J. Super. 133. It found that a confidential relationship existed between Pascale and David, and that Berkowitz was in a position of conflict when he advised Pascale to execute the transfers.

* * *

We now turn to the question of the conflict of interest on the part of the attorney, Berkowitz, in representing both David and Pascale at the time of the challenged transfer. Here, we also agree with the Appellate Division's assessment that Berkowitz was in a position of conflict in representing both parties. Berkowitz and his associate, Levitt, admitted that there was a conflict in the positions of David and Pascale concerning the ownership of the Quality stock prior to May 24, 1979. Moreover, David admitted Pascale was never informed of the services rendered by Berkowitz in preparing David's estate plan. Despite the fact that David told Berkowitz that he, not Pascale, owned the Quality stock on May 9, 1979, Berkowitz simultaneously represented David and Pascale. Neither Berkowitz nor David ever informed Pascale, however, of David's claim to the stock or that Berkowitz was now representing David. Nonetheless, the trial court found that "[a]t all times Berkowitz was Pascale's rather than David's attorney." The Appellate Division rejected that finding and found that Berkowitz was in a position of conflict because of his simultaneous representation of the parties. 216 N.J. Super. at 142. We agree.

As we have previously stated, "[a] lawyer cannot serve two masters in the same subject matter if their interests are or may became *[sic]* actually or potentially in conflict." *In re Chase*, 68 N.J. 392, 396 (1975). Disciplinary Rule 5-105(A), which was in effect at the time of the transaction, like present Rule of Professional Conduct 1.7, prohibited a lawyer from accepting or continuing employment "if the exercise of his professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of" or continuance of the employment.

A conflict arises when an attorney represents in separate matters multiple clients who have adverse interests in at least one of those matters. "Developments in the Law—Conflicts of Interest in the Legal Profession," 94 Harv. L. Rev. 1244, 1296–1306 (1981). The attorney has divided loyalties that can prevent faithful representation of both clients in the matter in which the conflict arises. *Ibid.* For example, an attorney may not, without making appropriate disclosure, simultaneously represent the testator and the beneficiaries of a will. *Haynes, supra*, 87 N.J. at 181–85. Similarly, here, Berkowitz should not have represented Pascale on the transfer of real estate and stock to David without disclosing that he was simultaneously representing David on an independent matter. Even if Berkowitz believed he could adequately represent the interests of both Pascale and David, he failed to comply with the requirement of Disciplinary Rule 5-105(C) that he fully disclose the conflict.

Consequently, we agree with the Appellate Division that the conflicting claims to ownership of the Quality stock placed Berkowitz in a position of conflict arising from his dual representation of David and Pascale. On the same day, Berkowitz represented Pascale in the transfer of substantial assets to David and also represented David in the drafting and execution of his will. The conflicting claims of stock ownership, as the Appellate Division found, "raised an immediate conflict having the clear potential to raise in the mind of legal counsel the question as to which of the two masters was to be served and protected." 216 N.J. Super. at 142.

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4. Referrals. Finally, an attorney is often asked to recommend a particular bank, trust company, or person to serve as a trustee or executor knowing that the company or person will hire the attorney who drafted the will as attorney for the estate. Because this situation potentially creates a conflict between the client and the lawyer's own interest, it should be analyzed under Model Rule 1.7(a)(2) and Circular 230 § 10.29(a)(2).

Illinois State Bar Association Advisory Opinion 99-06

(Nov. 1999)[9]

Facts

An Illinois trust company has developed a lawyer/trust administrator program in which licensed Illinois lawyers, who practice substantially in the area of estate planning, enter into an agency relationship with the trust company. The agency agreement provides that the lawyers will furnish trust administrator services for trusts in which the trust company has been named trustee. The lawyers perform the administrative services for the trust from their law offices and may continue to render legal services to the clients in matters related to the trust or otherwise, for which they bill separately. Once accepted as a trust administrator, the lawyers may refer clients and other persons as potential customers for the trust company's services. The lawyer will bill his clients for legal services in preparing trust instruments and other documents. The trust company does not prepare the trust documents or otherwise practice law.

Assets of the trusts are deposited with the trust company and administered by the trust company's investment advisors or, at the option of the client, in self-directed accounts. Services of the trust company personnel are paid from the trust assets pursuant to an established fee schedule, and the lawyer/trust administrator is paid a fee by the trust company, again under a published fee schedule,

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from the fee paid to the trust company from the client's trust.

The lawyer/trust administrator acts as a conduit of information between the trust company and its customers, directs payments from the trust, forwards customer investment directives, and responds on behalf of the trust company to customer inquiries. The lawyer/trust administrator offers no investment advice with respect to the trusts. The lawyer's relationship with the trust company, his compensation as trust administrator, and other relevant information are set out in an extensive written disclosure and consent form which the client must sign as a part of the trust agreement.

Inquiry is made as to whether the arrangement described violates any provision of the Rules of Professional Conduct.

Opinion

A variety of issues created by relationships involving lawyers, their clients and fiduciary institutions have been considered by this Committee.

We have stated, for example, that a lawyer who is both a director and lawyer for a bank may not insist that his client designate the bank as a fiduciary, even where the relationship is disclosed to the client. See Opinion No. 90-02 (1990).

We have also opined that it is professionally improper for a lawyer employed by an institution marketing revocable living trusts to prepare or review such documents for possible use by his clients. Such an arrangement, we felt, posed significant conflict of interest problems that would prevent the lawyer from fairly representing the consumer/client and acting in his best interests. In addition, the lawyer violated Rule 5.5(b) by aiding the unauthorized practice of law by the institution in connection with its preparation of the trust documents. See Opinion No. 90-20 (1991).

Finally, we have held that the referral of clients to an investment advisor or securities broker, whereby the referring lawyer is paid a fee from the funds being managed for the client, may be permissible provided that appropriate disclosures are made. See Opinion No. 97-04 (1998).

The Committee considers the arrangement outlined above sufficient to satisfy the concerns expressed in our prior opinions, provided that appropriate safeguards are employed to satisfy the rules regarding conflicts of interest.

Where a lawyer's representation of a client may be limited by the lawyer's responsibilities to a third person or by the lawyer's own interests, the lawyer may undertake or continue the representation only if he reasonably believes that the representation will not be adversely affected and the client consents after disclosure. Rule 1.7(b) states the general rule:

> A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interest, unless:
>
> (1) the lawyer reasonably believes the representation will not be adversely affected; and

(2) the client consents after disclosure.

Here, the lawyer as an agent of the trust company is expected to develop business for the trust company by recommending the trust company's services to the lawyer's clients and others. Where the trust company is selected by the client, the lawyer is paid a fee for his services as trust administrator by the trust company based upon the fee for trust services paid by the client/customer. The lawyer accordingly has an incentive to recommend the trust company's services over those of a competing fiduciary. The relationship between the lawyer and the trust company, and the compensation generated by that relationship, involve "responsibilities to a third person" and "the lawyer's own interests," as described in the rule.

Nonetheless, the lawyer may, in the Committee's judgment, reasonably believe that his representation of the client may not be adversely affected by his relationship with the trust company. Since the client may disagree, however, it is incumbent upon the lawyer, pursuant to Rule 1.7(b) of the Rules of Professional Conduct, to disclose his relationship with the trust company, the fee arrangement and method of calculation (including the source of payment to him), and all other aspects of the relationship. Although the rule does not by its terms require that the disclosure be in writing, the Committee has noted that that is the more prudent practice.

In our Opinion No. 97-04, *supra*, the Committee had occasion to consider two slightly different referral arrangements involving lawyers, their clients, and an investment adviser and securities broker. In each case, the referring lawyer was paid a portion of the management fee generated by the investment of the client's funds. We pointed out that such an arrangement constituted a business transaction with a client, governed by Rule 1.8 of the Rules of Professional Conduct, which provides:

> Unless the client has consented after disclosure, a lawyer shall not enter into a transaction with the client if:
>
> (1) the lawyer knows or reasonably should know that the lawyer and client have or may have conflicting interests therein; or
>
> (2) the client expects the lawyer to exercise the lawyer's professional judgment therein for the protection of the client.

We stated that, under pertinent Illinois case law, a presumption of undue influence arises where a lawyer benefits from a business transaction with a client. The presumption may be rebutted only by clear and convincing evidence. Generally, this requires a showing of full disclosure of all relevant information, a transaction that was fair and reasonable, and that the client had the advice of independent counsel, or the opportunity for such advice, before entering into the transaction. *In re Anderson*, 52 Ill. 2d 202, 287 N.E.2d 682, 682 (1972); *In re Schuyler*, 91 Ill. 2d 6, 61 Ill. Dec. 540, 424 N.E.2d 1137 (1982); *Franciscan Sisters Health Care v. Dean*, 95 Ill. 2d 452, 448 N.E.2d 872, 69 Ill. Dec. 960 (1982).

As in Opinion No. 97-04, the investment of the client's trust assets in the case at hand is clearly a business transaction. The profits realized from the investment program are the basis for the trust company's fees from which, in turn, the lawyer/trust administrator's fees are paid. As in Opinion No. 97-04, these fees are not for legal services performed; they emanate from a business transaction in which the lawyer and the client are jointly interested.

Since the amount of the lawyer/trust administrator's fee is affected by the performance of the trust being administered, there is at least the potential for a conflict of interest between the lawyer and his client. The client's objectives with respect to the trust program may dictate a relatively conservative investment approach, which may generate lesser fees to the trust administrator (and the trust company) than would a more aggressive approach. Disclosure must therefore be made and the client's consent obtained in the same manner as prescribed with respect to Rule 1.7(b). It should also be remembered that a conflict of interest problem, although initially addressed by appropriate disclosure and consent, imposes a continuing duty on the part of the lawyer to make supplemental disclosures as developing circumstances warrant.

For the reasons given, the Committee believes that the arrangement described is not professionally improper.

Illinois' version of Rule 1.8(a) is based on the Model Code DR 5-104 rather than the Model Rule. The case law relied on in the Opinion, however, is more or less consistent with Model Rule 1.8(a): the transaction must be fair and reasonable to the client, the lawyer must fully disclose all relevant information, and the client must obtain the advice of independent counsel or have opportunity to obtain such advice before entering into the transaction. Moreover, the Opinion notes that prudent practice entails obtaining the client's written consent to the essential terms of, and the lawyer's role in, the transaction, as is required by Model Rule 1.8(a). An Oregon ethics opinion concludes that the type of referral arrangement described in the Illinois opinion is per se unethical. The opinion, Oregon Formal Op. 2005-2 (revised June 2014), never mentions the possibility of a conflict of interest, and is based solely on Oregon's version of Model Rule 7.2(b) and an Oregon-specific addition to Model Rule 5.4, which states:

> (e) A lawyer shall not refer a client to a nonlawyer with the understanding that the lawyer will receive a fee, commission or anything of value in exchange for the referral, but a lawyer may accept gifts in the ordinary course of social or business hospitality.

PROBLEM 3-16

You are asked to do estate planning and will drafting for Beth, the majority shareholder and CEO of Widgets, Inc. (a regular firm client), and Beth's wife, Mary.

a. What must you initially advise Beth and Mary before agreeing to take on their estate planning?

b. Assume that after having heard your initial advice, Beth and Mary still prefer to have you handle all of their estate planning. They provide you with the appropriate informed consent. What would that be?

c. You do the planning and draft the wills which Beth and Mary execute, but you notice that Widgets does not have a buy-sell agreement with Fred, the CFO of Widgets, who is also the minority shareholder. What should you do now?

d. The buy-sell agreement is drafted to provide that on the occurrence of certain events (death, divorce, or bankruptcy of a shareholder), the company will buy back the shareholder's shares in the company, with the valuation determined on a formula basis. When the agreement is ready, Beth offers to set up a meeting for the two of you and Fred in order to get the agreement signed. At that meeting, you ask how Widgets will fund the share repurchase, particularly in the case of Beth's death. Beth says, "Don't worry. It won't be a problem." Fred is concerned, but doesn't pursue the issue. Are you ready to let Beth and Fred sign the agreement?

e. The buy-sell agreement is signed. As you sit at your son's soccer game two years later, you hear from another parent (who works for Widgets) that Beth has been having an affair with Widgets' sales manager, Melody, for "months." What should you do?

f. Mary calls you later that fall, notes that she and Beth are getting a divorce, and asks you to draft a new will for her. Can you do this? Can your firm continue to represent Widgets?

PROBLEM 3-17

Lawyer has represented Husband and Wife for many years in a range of personal matters, including estate planning. Husband and Wife have substantial individual assets, and they also own substantial jointly-held property. Recently, Lawyer prepared new updated wills that Husband and Wife signed. Like their previous wills, the new wills primarily benefit the surviving spouse for his or her life, with beneficial disposition at the death of the survivor being made equally to their children (none of whom were from a prior marriage).

Husband, Wife, and Lawyer have always shared all relevant asset and financial information. Consistent with previous practice, Lawyer met with Husband and Wife together to confer regarding the changes to be made in updating their wills.

Several months after the execution of the new wills, Husband confers separately with Lawyer. Husband reveals to Lawyer that he has just executed a codicil (prepared by another law firm) that makes a substantial beneficial disposition to a woman with whom Husband has been having an extra-marital relationship. Husband tells Lawyer that Wife does not know about the relationship or the new codicil, as to which Husband asks Lawyer to advise him regarding Wife's rights of election in the event she were to survive Husband. What are Lawyer's ethical obligations?

Suppose that Lawyer tells Husband that Lawyer cannot advise him regarding Wife's rights and that Lawyer is withdrawing from representation of both Husband and Wife. What are Lawyer's obligations with respect to informing or not informing Wife of the substance of Husband's revelation if Husband does not do so himself? *See* Florida Bar Op. 95-4 (May 30, 1997, *revised*, June 23, 2009).

PROBLEM 3-18

Your law firm regularly engages an appraisal firm to prepare appraisal reports for use in family limited partnership transactions and as litigation support for valuation issues. The appraisal firm did a valuation of corporate stock that was an integral part of a tax shelter. Can you represent an investor in the tax shelter in connection with an IRS audit or Tax Court litigation?

II. CONFLICTS BETWEEN LAWYERS AND CLIENTS

Circular 230 §§ 10.27 and 10.29
Internal Revenue Manual ¶ 4.11.55.4.2 (Appendix I)
Model Rules 1.5, 1.7, and 1.8
AICPA Code of Professional Conduct ET § 1.510.001 and Interpretation 1.510.010 (Appendix J)

Among the circumstances described in the general rule governing conflicts of interest, Model Rule 1.7, is one that bans a lawyer from representing a client if there is a significant risk that the representation will be materially limited by a personal interest of the lawyer. Circular 230 § 10.29(a)(2) contains a similar rule. Model Rule 1.8 identifies specific instances of such conflicts and prescribes rules and procedures for dealing with them; in some instances, the client may waive a conflict while, in others, representation is strictly prohibited. (Situations that are not specifically addressed in Model Rule 1.8. remain subject to the more general strictures of Model Rule 1.7.)

PROBLEM 3-19

Lawyer has a number of estate planning clients who could benefit from financial planning advice. She is considering establishing a relationship with Financial Planner, who would pay her a referral fee for each client she refers to him. Can Lawyer accept the referral fee?

Suppose that Lawyer and Financial Planner wish to enter into a reciprocal arrangement under which Lawyer would refer clients to Financial Planner for financial planning services and Financial Planner would refer clients to Lawyer for legal services. *See* Model Rule 7.2(b)(4); Philadelphia and Pennsylvania Bar Associations Joint Opinion 2000-100 (May 2000); Supreme Court of Ohio Opinion 2000-1 (Feb. 11, 2000).

PROBLEM 3-20

Lawyer has provided tax and other legal advice to a limited liability company (LLC) in a traditional fee-for-service relationship. LLC's business has grown over time and its members believe that it should have a general counsel. They have asked Lawyer to take on this responsibility, on a part-time basis. In lieu of fees for this work, the LLC members have proposed to give Lawyer a 20 percent ownership interest in LLC and a percentage of the company's profits, if any. If Lawyer accepts this position, she would continue her private practice representing other clients. Under what circumstances is Lawyer ethically permitted to enter into the proposed arrangement?

A. Contingent Fees

Circular 230 § 10.27 contains a general rule barring unconscionable fees in matters before the IRS. No guidance is provided on what unconscionability means in this context; presumably, the principles in Model Rule 1.5 would govern. Under Model Rule 1.5, factors considered in determining the reasonableness of a fee include:

1. the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
2. the likelihood, if apparent to the client, that acceptance of the particular employment will preclude other employment by the lawyer;
3. the fee customarily charged in the locality for similar legal services;
4. the amount involved and the results obtained;
5. the time limitations imposed by the client or by the circumstances;
6. the nature and length of the professional relationship with the client;
7. the experience, reputation, and ability of the lawyer or lawyers performing the services; and
8. whether the fee is fixed or contingent.

Model Rule 1.5(c) permits contingent fee arrangements — except in domestic relations and criminal matters — so long as they are documented in a writing signed by the client and stating the method by which the fee will be calculated.

The AICPA prohibits contingent fee arrangements in connection with the preparation of an original or amended tax return, or a claim for refund. AICPA Code of Prof'l Conduct ET section 1.510.001 (together with Interpretation 1.510.010, reproduced at Appendix J). Interpretation 1.510.010 provides several examples of circumstances in which contingent fees are permitted in connection with tax matters:

1. representing a client in an examination by a revenue agent of the client's federal or state income tax return;
2. filing an amended federal or state income tax return claiming a tax refund based on a tax issue that is either the subject of a test case (involving a different taxpayer) or with respect to which the taxing authority is developing a position;
3. filing an amended federal or state income tax return (or refund claim) claiming a tax refund in an amount greater than the threshold for review by the Joint Committee on Internal Revenue Taxation ($2 million) or state taxing authority;
4. requesting a refund of either overpayments of interest or penalties charged to a client's account or deposits of taxes improperly accounted for by the federal or state taxing authority in circumstances where the taxing

authority has established procedures for the substantive review of such refund requests;

5. requesting, by means of "protest" or similar document, consideration by the state or local taxing authority of a reduction in the "assessed value" of property under an established taxing authority review process for hearing all taxpayer arguments relating to assessed value; and
6. representing a client in connection with obtaining a private letter ruling or influencing the drafting of a regulation or statute.

Circular 230's rules on the use of contingent fees in tax matters are similar, but not identical, to the AICPA rules. A contingent fee is defined for Circular 230 purposes as:

> any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved, or that otherwise depends on the specific result attained. A contingent fee also includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.

Circular 230 § 10.27(c)(1). Circular 230 § 10.27(b) prohibits contingent fees for services rendered in connection with any matter before the IRS, with four exceptions. Thus, Circular 230 purports to prohibit practitioners from charging contingent fees in connection with preparing or filing an original tax return, amended tax return, or claim for refund. Restricting contingent fees in this context is thought to discourage return positions that exploit the "audit lottery." *Ridgely v. Lew*, 55 F. Supp. 3d 89, 90 (D.D.C. 2014), casts serious doubt on Treasury's authority to regulate or limit contingent fee arrangements in these contexts. Although the challenge in *Ridgely* was only to the bar on contingent fees in the preparation of refund claims, consider whether *Ridgely*, when coupled with *Loving* (discussed in Chapter 1 and excerpted in Chapter 2), is broad enough to effectively invalidate any regulation of contingent fees for services rendered "before the commencement of any adversarial proceedings with the IRS or any formal legal representation" by the practitioner. *Ridgely v. Lew*, 55 F. Supp. 3d at 91.

RIDGELY v. LEW

United States District Court, District of Columbia
55 F. Supp. 3d 89 (2014)

MEMORANDUM OPINION

To prevent "exploit[ation of] the audit selection process," the Internal Revenue Service ("IRS") in 2007 prohibited a broad range of tax practitioners from charging contingent fees for certain services relating to preparing, filing, or presenting tax returns or refund claims. 31 C.F.R. § 10.27. Plaintiff Gerald Lee Ridgely, Jr., a practicing CPA, brought suit against the Secretary of the Treasury and the Commissioner of the IRS in their official capacities, arguing that the IRS exceeded the scope of its statutory authority in regulating the preparation and filing of "Ordinary Refund Claims"—refund claims that practitioners file after a taxpayer has filed his original tax return but before the IRS has initiated an audit of the return. Ridgely and the IRS cross-moved for summary judgment. Concluding that the IRS lacks statutory authority to regulate the preparation and filing of Ordinary Refund Claims, the Court grants Ridgely's Motion.

I. Background

As most taxpayers know, the process of preparing, filing, and (in some cases) adjudicating tax returns can be complicated. So before examining the merits of this case, the Court will provide some background on how taxpayers interact with the IRS and how the IRS treats the "Ordinary Refund Claims" at issue in this case.

A. Process for Preparing and Filing Refund Claims

Taxpayers proceed through three stages of interaction with the IRS: assessment and collection, examination, and appeals. "Assessment" refers to the "calculation of a recording of a tax liability" following a taxpayer's submission of his return. Although the IRS accepts most taxpayers' returns as filed, it selects some returns for examination, or audit. 26 C.F.R. § 601.103(b). During the examination stage, which may take place by mail or in-person, "a taxpayer may be represented before the examiner by an attorney, certified public accountant, or other representative." 26 C.F.R. § 601.105(b)(1). After the examination, the IRS may determine that the taxpayer owes additional tax or that the IRS owes a refund to the taxpayer. Finally, if the taxpayer and IRS disagree over the IRS's disposition, the taxpayer may request an in-person conference with the IRS's appeals office, during which he may designate a representative to act on his behalf. 26 C.F.R. §§ 601.103(b), (c)(1)–(3); 601.106(c). A taxpayer may then seek review in court. 26 C.F.R. § 601.103(c).

This case concerns the preparation and filing of the so-called "Ordinary Refund Claim," a procedure that a taxpayer may undertake if he determines that he has overpaid his taxes. A taxpayer may file this type of claim after he has filed his tax return or during the course of an examination, but prior to filing suit in court for a refund. I.R.C. § 7422(a). In his claim, a taxpayer must detail the exact basis for the refund. Treas. Reg. 301.6402-2(b)(1). Should the IRS disallow his claim, the taxpayer may appeal. I.R.C. § 6532(a). Particularly if the refund claim is complex, a taxpayer may elect to hire a CPA to help prepare and file his claim.

Before proceeding any further, the Court must explain exactly what actions constitute "preparing and filing" an Ordinary Refund Claim. As Ridgely's counsel made clear during the hearing on the parties' summary judgment motions, a CPA may assist a taxpayer in preparing and filing a refund claim and, in doing so, would not be legally representing the taxpayer until the IRS responds to the claim and the CPA submits a power-of-attorney form to the IRS. Thus, what Ridgley challenges here is the IRS's proclaimed authority to regulate fee arrangements entered into by CPAs for preparing and filing Ordinary Refund Claims *before* the commencement of any adversarial proceedings with the IRS or any formal legal representation by the CPA.

B. Statutory and Regulatory Framework

This case concerns the breadth of the IRS's authority to regulate CPAs, which is found in 31 U.S.C. § 330, a statute originally enacted in 1884. Pursuant to Section 330, the Treasury Secretary has authority to regulate "persons" who practice before the Treasury Department. In relevant part, Section 330 states:

(a) Subject to section 500 of title 5, the Secretary of the Treasury may—

(1) regulate the practice of representatives of persons before the Department of the Treasury; and

(2) before admitting a representative to practice, require that the representative demonstrate—

(A) good character;

(B) good reputation;

(C) necessary qualifications to enable the representative to provide to persons valuable service; and

(D) competency to advise and assist persons in presenting their cases.

(b) After notice and opportunity for a proceeding, the Secretary may suspend or disbar from practice before the Department, or censure, a representative who—

(1) is incompetent;

(2) is disreputable;

(3) violates regulations prescribed under this section; or

(4) with intent to defraud, willfully and knowingly misleads or threatens the person being represented or a prospective person to be represented.

. . . .

(d) Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.

Pursuant to this statutory authority, the Secretary of the Treasury publishes regulations governing "practice" before the IRS in the Code of Federal Regulations, Title 31, part 10. These regulations are commonly known as "Circular 230." Most of Circular 230 outlines duties and restrictions concerning "practice" before the IRS as they relate to practitioner character, reputation, and competency. See 31

C.F.R. §§ 10.20–.38. The IRS has applied these regulations to attorneys, CPAs, and other specified tax professionals. See 31 C.F.R. § 10.3 (2009). Beginning in 1994, Circular 230 prohibited the use of contingent fee arrangements for preparing original income tax returns, but allowed such arrangements in the context of preparing an amended return or a claim for a refund.

In 2007, after a period of notice and comment, the IRS promulgated regulations prohibiting the charging of contingent fees except in limited circumstances. Specifically, Section 10.27(a)–(b) of Circular 230 provides:

(a) *In general.* A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service.

(b) *Contingent fees*—

(1) Except as provided in paragraphs (b)(2), (3), and (4) of this section, a practitioner may not charge a contingent fee for services rendered in connection with any matter before the Internal Revenue Service.

(2) A practitioner may charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to—

(i) An original tax return; or

(ii) An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return.

(3) A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.

(4) A practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

Section 10.27 defines "matter before the Internal Revenue Service" to include "tax planning and advice, preparing or filing or assisting in preparing or filing returns or claims for refund or credit, and all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities." Circular 230 § 10.27. The provision therefore encompasses preparers of refund claims who "appear" before the IRS only when they prepare and/or file refund claims. With this statutory and regulatory framework in mind, the Court now turns to the particular facts of this case.

C. Factual and Procedural History

The IRS promulgated the contingent fee restrictions at issue in this case out of concern about auditor independence. IRS Reply [Dkt. No. 40] at 15 (arguing that CPA practice of "taking lucrative contingent fees from companies whose books they review . . . jeopardizes auditor independence because it leads accountants and their clients to share financial interests"). The plaintiff in this case, Gerald Ridgely, is a practicing CPA. Required to comply with 10.27's restrictions on contingent fee arrangements, Ridgely argues that he has suffered a "loss of clients and significant revenue," and that his "ability to represent and assist clients in the preparation and filing of Ordinary Refund Claims and to practice before the IRS has been severely restricted." Seeking injunctive and declaratory relief, Ridgely sued the Secretary of the Treasury and the Commissioner of the IRS under the Administrative Procedure Act, 5 U.S.C. §§ 701–706, and the Declaratory Judgment Act, 28 U.S.C. §§ 2201–2202. This Court previously determined that Ridgely has standing. Both parties now move for summary judgment.

II. Legal Standard

* * *

The court reviews APA claims under the familiar two-step *Chevron* standard. *Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (1984). The court first uses the traditional tools of statutory interpretation to determine "whether Congress has directly spoken to the precise question at issue." *Chevron*, 467 U.S. at 842, 104 S. Ct. 2778. "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Id.* at 842–43, 104 S. Ct. 2778. "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Id.* at 842–43, 104 S. Ct. 2778. "[I]f the statute is silent or ambiguous with respect to the specific issue," the court proceeds to step two, asking whether the agency's interpretation "is based on a permissible construction of the statute." *Id.* at 843, 104 S. Ct. 2778. The agency's construction at step two is permissible "unless it is arbitrary or capricious in substance, or manifestly contrary to the statute." *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704, 711, 178 L. Ed. 2d 588 (2011).

III. Analysis

Section 330(a) authorizes the Secretary of the Treasury to "regulate the practice of representatives of persons before the Department of the Treasury." 31 U.S.C. § 330(a)(1). As both parties recognize, however, Congress "nowhere defined the meaning or scope of the term 'practice' before the Treasury Department."

* * *

This Court, however, is not the first to venture down this particular rabbit hole. Earlier this year, in *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), the D.C. Circuit grappled with the question of "whether the IRS's authority to 'regulate the practice of representatives of persons before the Department of the Treasury' encompasses authority to regulate *tax-return preparers*," *Loving*, 742 F.3d at 1016 (emphasis added), whom the Court in turn defined as persons who " 'prepare[] for compensation, or who employ[] one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code,' " *id.* (quoting 26 C.F.R. § 301.7701-15(a)). The Court held that the text, history, structure, and context of Section 330 "foreclose[d] and render[ed] unreasonable" the IRS's interpretation of Section 330. *Id.* at 1022. In other words, the IRS's interpretation failed at both *Chevron* step 1 and *Chevron* step 2. *Id.*

As the IRS is quick to point out, though, *Loving* involved a different set of plaintiffs—non-CPA tax-return preparers—and different provisions of Circular 230—Sections 10.3-10.6, which imposed requirements to pay a fee, pass a qualifying exam, and complete continuing education classes. But *Loving* also expressly addressed two key questions that the Court faces here: who are "representatives" and what is "practice" under Section 330? In the Court's view, *Loving* is controlling precedent that must guide the Court's examination of Section 330's text, context, and history with respect to the claims at issue in this case.

A. Text of Section 330

The plain text of Section 330(a) limits the regulatory authority of the Secretary of the Treasury to "the practice of representatives of persons before the Department of the Treasury." 31 U.S.C. § 330(a)(1). As the *Loving* court explained, two terms in this provision are key: "representative" and "practice." To fall under Section 330's purview, the regulated conduct must be "practice" and must be undertaken by a "representative."

As to the meaning of the term "representative," *Loving* is clear: a "representative" is traditionally one "with authority to bind others." Tax-return preparers neither "possess legal authority to act on the taxpayer's behalf" nor can they "legally bind the taxpayer by acting on the taxpayer's behalf." They are, as a result, "not agents." As mentioned earlier, the *Loving* court defined "tax return preparers" to expressly *include* those preparing refund claims, but even if the court's holding fails to directly cover CPAs preparing and filing Ordinary Refund Claims, the court's reasoning applies straightforwardly. CPAs preparing and filing such claims before possessing any power of attorney possesses no "legal authority to act on behalf of taxpayers." In *Loving*'s words, these individuals merely "assist[]" the taxpayer. Thus, Section 330's use of the term "representative" excludes refund claim preparers, just as it did tax-return preparers in *Loving.*

Loving also sheds light on the meaning of the term "practice" in Section 330. As the Court explained, "practice . . . before the Department of the Treasury," like practice before any agency or court, "ordinarily refers to practice during an investigation, adversarial hearing, or other adjudicative proceeding." The process of filing an Ordinary Refund Claim—again, before any back-and-forth with the IRS—is similar to the process of filing a tax return in that both take place prior to any type of adversarial assessment of the taxpayer's liability. If a "tax-return preparer do[es] not practice *before the IRS* when [he] simply assist[s] in the preparation of someone else's tax return," then a CPA hardly "practices" before the IRS when he simply prepares and files a taxpayer's refund claim, before being designated as the taxpayer's representative and before the commencement of an audit or appeal. Following *Loving*, the Court therefore concludes that the plain text of Section 330 excludes preparers and filers of Ordinary Refund Claims from the ambit of the IRS's regulatory authority.

B. Context of Section 330

Like its plain text, Section 330's broader statutory context leads the Court to conclude that the IRS's regulatory authority does not extend to those preparing and filing Ordinary Refund Claims. "It is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme." But heeding the IRS's interpretation of Section 330 would "effectively gut" Congress's "carefully articulated" framework for regulating those preparing and filing tax returns and tax refund claims. *Loving*, 742 F.3d at 1020. This framework includes a number of statutes that deal particularly with individuals preparing tax returns or refund claims. To start, 26 U.S.C. § 7701 expressly defines "tax return preparer" to include individuals who prepare tax returns or tax refund claims. 26 U.S.C. § 7701(a)(36). Beyond grouping tax-return preparers and tax-refund preparers in the same statutory definition, Congress enacted a comprehensive scheme of penalties to curb the potential for abuse in the preparation and filing of *both* original returns and refund claims. See 26 U.S.C. §§ 6662, 6663, 6676, 6694, 6701, 7206, and 7207 (penalizing filing frivolous claims for refunds, inaccurate reporting, fraud, understatements due to unreasonable positions, willful or reckless conduct, aiding and abetting understatements of tax liabilities, willfully aiding or assisting in the preparation of fraudulent or false claims, and willfully delivering fraudulent or false returns to the IRS). These provisions reveal that Congress conceived of tax-return preparation and tax-refund preparation as similar activities that qualitatively differ from the "practice" of presenting or adjudicating cases. But under the IRS's view, these specific provisions would serve no purpose, for Section 330 itself would have given the IRS liberal authority to impose various penalties on tax-return preparers who behave unethically. See *Loving*, 742 F.3d at 1020. The definition of "tax return preparer" and the need to avoid surplusage support the conclusion that Congress differentiated between the preparation and filing of refund claims on the one hand and their subsequent adjudication on the other. Congress clearly intended to allow the IRS to regulate these two categories of activity differently, and the grant of authority in Section 330 is limited to the latter.

C. History of Section 330

The history of Section 330 also indicates that the statute's scope never encompassed the mere preparation and filing of refund claims. The original language of Section 330 stated:

> [T]he Secretary of the Treasury may prescribe rules and regulations governing the recognition *of agents, attorneys, or other persons representing claimants before his Department*, and may require of such persons, agents and attorneys, before being recognized as representatives of claimants, that they shall show that they are of good character and in good repute, possessed of the necessary qualifications to enable them to render such claimants valuable service, and *otherwise* competent to advise and assist such claimants *in the presentation of their cases.*

Act of July 7, 1884, ch. 334, sec. 3, 23 Stat. 258, 258–59 (emphasis added). As *Loving* noted, Congress's use of "the words 'agents,' 'attorneys,' 'claimants,' 'otherwise,' and 'presentation of their cases' in the original version of the statute" and Congress's statement "in the statute itself that it intended no change in meaning when it streamlined the statute in 1982" demonstrates that "the statute contemplates representation in a contested proceeding." 742 F.3d at 1020. Because a CPA prepares and files an Ordinary Refund Claim before becoming a legal representative and presenting his case, preparing and filing such claims is not within the scope of the actions originally targeted by Section 330.

D. IRS's Counter-Arguments

The IRS offers only one non-conclusory argument in response to the Court's statutory interpretation as guided by Loving: that because Ridgely is a CPA, he "is a representative who practices before the Department and is therefore subject to the terms of Circular 230." In other words, according to the IRS, it has authority to regulate *all* actions of CPAs who—at some point—"practice" before it, regardless of "whether they're acting in a representational or nonrepresentational capacity." This argument, however, poses three problems. First, it is inconsistent with the use of the word "practice" in Section 330. The statute does not regulate "practitioners" generally; it regulates a specific kind of activity they may undertake: "practice . . . before the [IRS]." 31 U.S.C. § 330(a)(1). Second, the IRS's position would read the word "representative" out of Section 330. As *Loving* made clear, Section 330 only applies to individuals when they *represent* taxpayers. Third, adhering to the IRS's position would lead to absurd results. According to the IRS, it could broadly regulate the actions of CPAs no matter what they were doing—even if their conduct was nowhere close to "practicing" before IRS—simply because, say, the CPAs "practiced" before the IRS once a year. Meanwhile, the IRS would impose no contingent fee restrictions on the preparation and filing of Ordinary Refund Claims by non-CPAs and those who never "practice" before the IRS. Nothing in the statutory text (or, for that matter, the context and history of Section 330) gives the IRS this kind of authority over CPAs specifically. Further, nothing in Section 10.27 indicates that the IRS was concerned with CPA conduct in particular instead of with the ethics of fee arrangements for preparation and filing generally. The Court therefore disagrees with the IRS that simply because CPAs may *at times* practice before the IRS, the IRS has authority to regulate their conduct without limit.

The IRS's remaining arguments have been foreclosed by *Loving*. For example, the IRS argues that it has "inherent authority" to regulate those that practice before it. But as *Loving* held, the IRS's regulatory authority is expressly circumscribed by Section 330. The IRS also argued for the first time at the hearing that Section 330(d) broadly authorizes the IRS to regulate those preparing and filing Ordinary Refund Claims regardless of the capacity in which they act. But the IRS never explained how Section 330(d), which concerns "the rendering of written advice," encompasses preparing or filing refund claims prior to formal legal representation. 31 U.S.C. § 330(d). If "written advice" included such acts, it would also include preparing and filing tax returns, a possibility foreclosed by *Loving*. In any event, as the Court has explained, the plain text, context, and history of Section 330 paint a clear picture of the scope of the IRS's authority with respect to the preparation and filing of Ordinary Refund Claims. That clarity cannot be eclipsed by brief, thinly supported references to ambiguous statutory language, the relevance of which the IRS never really explains.

* * *

IV. Conclusion

For the foregoing reasons, the Court will grant Ridgely's Motion for Summary Judgment and deny the IRS's Motion for Summary Judgment. The Court will issue a separate Order consistent with this Opinion.

Despite the outcome with respect to the IRS, it is worth considering whether Mr. Ridgely nonetheless may have a problem with his state licensing board or the AICPA. According to court filings, Mr. Ridgely is a CPA, licensed in Texas. Thus, he could be disciplined for violating AICPA guidelines (AICPA Code of Prof'l Conduct ET § 1.510.001 and Interpretation 301.01) that prohibit contingent fees for preparing refund claims in most instances. (As in many states, the Texas Society of Certified Public Accountants has incorporated the AICPA standards into its own Code of Professional Conduct.) Moreover, because the AICPA standard explicitly bans contingent fees for preparing original returns, that standard should deter contingent fee arrangements as to original returns, as a general matter, regardless of the validity of Circular 230 § 10.27 (i.e., if *Ridgely* were given a broad reading). Query whether OPR will step up its referrals to the AICPA and state boards of accountancy where contingent fees are utilized. Interestingly, attorneys may be able to take more advantage of the *Ridgely* case than CPAs since the ethical rules governing attorneys do not generally prohibit the charging of such contingent fees. *See* Model Rule 1.5(c) and (d).

Circular 230 does permit contingent fee arrangements in four specific situations.[10]

First, a practitioner may charge a contingent fee for services rendered in connection with an IRS examination of, or challenge to, an original tax return, amended return, or claim for refund where the amended return or claim for refund is filed (1) before the taxpayer receives a written notice of examination of, or a written challenge to, the original tax return or (2) no later than 120 days after receipt of such written notice or challenge. Contingent fees are permitted in this situation because unlike, *e.g.*, an original return, substantive review by the IRS of the taxpayer's position here is a certainty. Therefore, the rule does not encourage

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[10] Circular 230 § 10.27(b) itself permits practitioners to collect contingent fees in three specific situations (which are discussed in the text). On March 26, 2008, the IRS issued Notice 2008-43, 2008-1 C.B. 748, adding a fourth situation in which contingent fees are permitted and announcing its intention to amend certain language in Circular 230 § 10.27(b). Notice 2008-43 also announced a substantive change to Circular 230 § 10.27(b)(2). Treasury began the process of amending Circular 230 § 10.27(b) to incorporate the substance of Notice 2008-43 by issuing proposed regulations in July 2009. 74 Fed. Reg. 37183-01. The Preamble states that Notice 2008-43 will become obsolete when the regulations become final. However, Treasury has taken no action with respect to the proposed changes. (Circular 230 itself has been amended twice since 2008.) The text assumes that the changes announced in Notice 2008-43 have been incorporated into Circular 230. Students should make sure to consider the status of the proposed regulations and Notice 2008-43 until such time as Circular 230 § 10.27(b) is formally amended.

practitioners to encourage frivolous positions that exploit the audit lottery. The 120-day limit addresses governmental concerns over the use of contingent fee arrangements in connection with claims for refund or amended returns that are filed very late in the process of an examination (audit) in the hope that an IRS officer or employee will not look closely at the claims.

Second, a practitioner is permitted to charge a contingent fee for services rendered in connection with a claim for refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS. This exception is meant to address services provided by "account review practitioners" who retroactively evaluate corporate taxpayers' IRS accounts to determine whether they have overpaid interest or penalties. Typically, account review practitioners' fees are based on a percentage of the savings uncovered. Because the interest or penalties have already been paid, a claim for refund is necessary, assuring substantive review by an IRS employee or officer.

Third, a practitioner may charge a contingent fee for services rendered in connection with a whistleblower claim under Section 7623.[11] That section establishes a program under which the IRS may pay rewards to persons who report underpayments of tax by others. Such persons ("whistleblowers") may be entitled to receive a percentage of the taxes recovered by the IRS.

Fourth, a practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Code.

PROBLEM 3-21

Lawyer has been asked by Client for advice in connection with Client's investment in a series of financial transactions, which Client hopes will result in substantial tax savings to Client. Among the services to be provided by Lawyer, Lawyer will issue an opinion letter describing the tax consequences of the investment. May Lawyer's fee reflect a portion of the projected tax savings? Would it matter if Lawyer agreed to (perhaps retroactively) reduce her fee if the tax savings did not hold up under audit or litigation?

B. Tax Return Accuracy Standards

Differences between the income tax return accuracy standards for taxpayers and for the professionals who advise them could result in conflicts of interest. Specifically, with respect to the same position on a taxpayer's return, a tax adviser might face the imposition of a penalty if such position is not disclosed (i.e., flagged) on the return while, at the same time, the taxpayer might face no penalty risk for nondisclosure. In other words, it could be in the adviser's interest, but not in the taxpayer/client's interest, to disclose a position. Thankfully, Congress significantly reduced the potential for such conflicts by amending Section 6694 (the preparer penalty rules) in 2008 to conform the preparer and taxpayer standards. As is discussed in Chapter 2, the basic standard is now "substantial authority" for both

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[11] This category was added by Notice 2008-43. Query whether contingent fee arrangements in connection with whistleblower claims violate the Model Rules. *See* discussion, *infra* at III.D.

groups: return positions that are supported by substantial authority generally will not subject anyone to penalties; positions that lack substantial authority could subject both the taxpayer and her professional adviser to penalties unless the positions are disclosed on the return. *See* Sections 6694(a)(2), 6662(d)(2)(B).

The professional standard articulated in ABA Formal Op. 85-352 differs from the taxpayer standard. That difference creates the potential for conflicts of interest. *See* ABA Section of Taxation Committee on Standards of Tax Practice, Standards of Tax Practice Statement 2000-1, 54 TAX LAW. 185 (2000). ABA Formal Op. 85-352 concludes that "[a] lawyer may advise reporting a position on a tax return so long as the lawyer believes in good faith that the position is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law and there is some realistic possibility of success if the matter is litigated" (the "realistic possibility of success" standard). A "realistic possibility of success" has been quantified as a likelihood of success approximating one-third. The realistic possibility of success standard also applies to CPAs, but only where the applicable taxing authority has no written standards or if its standards are lower than the AICPA standards. *See* AICPA SSTS No. 1 (in Appendix C) & Interpretation No. 1-1, "Reporting and Disclosure Standards" (in Appendix D). The realistic possibility of success standard is inconsistent with Section 6694, as amended, and should be revised or withdrawn.[12] Until revision, however, attorneys are strongly advised to follow the higher standard in Section 6694.

C. Referrals to OPR

The Internal Revenue Manual lists circumstances in which a Revenue Agent *must* or *may* refer a practitioner to OPR. Referral is mandatory in the following situations:

1. when cases in which understatements due to willful or reckless conduct (Section 6694(b)) are closed;
2. when a penalty for aiding and abetting (Section 6701) is assessed (Revenue Agents should consider referrals to OPR where the Section 6701 penalty was considered but not imposed);
3. when a penalty for promoting abusive tax shelters (Section 6700) is assessed against an attorney, CPA or enrolled agent;
4. when an injunctive action (Section 7407 or Section 7408) is taken against promoters of abusive tax shelters; and
5. when injunctive action (Section 7408) is taken against an attorney, CPA or enrolled agent.

IRM ¶ 4.11.55.4.2.2.1 (2010).

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[12] No efforts have ever been undertaken to revise ABA Formal Op. 85-352. The AICPA revised its SSTSs effective January 1, 2010. The new standard retains the realistic possibility of success standard but requires CPAs to follow a higher standard if one is adopted by the relevant taxing authority. Therefore, CPAs are subject to the higher substantial authority standard in preparing federal returns. *See also* AICPA Interpretation No. 1-1, "Reporting and Disclosure Standards."

The following situations *may* warrant a referral to OPR:

1. when penalties are asserted due to "unreasonable positions" (Section 6694(a)) or for failing to furnish a copy of a return to the taxpayer, failing to sign a return, failing to furnish an identifying number (PTIN), failing to retain a copy or list, failing to file correct information returns for tax return preparers, negotiating taxpayer refund checks, or failing to be diligent in determining eligibility for earned income credit (Section 6695);
2. when return preparer referrals are made to the IRS Criminal Investigation Division (Section 7206);
3. when an appraiser who aids or assists in the preparation or presentation of an appraisal in connection with the tax laws will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person;
4. when a by-pass of representative letter was issued to a tax practitioner;
5. when a practitioner engages in disreputable conduct or incompetence as described in Circular 230 § 10.51;
6. when a tax practitioner is implicated in a frivolous tax return matter (Section 6702);
7. when an accuracy-related penalty (Section 6662(d)) for a substantial understatement is asserted and the facts of the case suggest the practitioner did not exercise due diligence in the preparation of the return;
8. when an erroneous claim for refund or credit penalty (Section 6676) is asserted because there is no reasonable basis for the refund claim and the facts suggest that the practitioner did not exercise due diligence in the preparation of the return;
9. when a practitioner fails to comply with the tax shelter registration requirement (Section 6111) or characterizes such registration as an IRS endorsement of the shelter and takes a position on a tax return that reflects the purported endorsement;
10. when opinions rendered by tax practitioners are used or referred to in the marketing of tax shelters (abusive or otherwise); and
11. when an examination report is written with respect to any tax return of an attorney, CPA, or enrolled agent, or a return prepared by an attorney, CPA or enrolled agent where a Pre-filing Notification Letter was issued in connection with a tax shelter and the loss and/or credit from the promotion was nevertheless claimed on the tax return.

IRM ¶ 4.11.55.4.2.2.2 (2010). Some of the circumstances listed above involve acts that are or may be outside of OPR's statutory authority, following *Loving* and *Ridgely*. It will be interesting to see if the IRS amends the IRM. Perhaps OPR would like to hear about the various situations nonetheless, for data gathering or other purposes.

PROBLEM 3-22

Several years ago, Lawyer gave tax advice to a long-time client (Client) with respect to an investment that Client was then considering. Client made the investment. Client's income tax return for the year in which the investment was made is now under audit by the IRS. Because Lawyer is Client's regular tax counsel, Lawyer is representing Client in the proceeding. From comments made by the IRS Revenue Agent during the course of discussions, Lawyer has the impression that the Revenue Agent believes that Lawyer gave Client bad advice at the time of the investment. What, if anything, should Lawyer do? What, if anything, must Lawyer do?

PROBLEM 3-23

Lawyer represents Client during what Lawyer originally thought was a routine audit. During the course of the proceeding, Lawyer realizes that the Revenue Agent may have grounds for referring her to OPR. Is there automatically a conflict of interest? How should Lawyer decide whether or not to withdraw from the representation?

D. Whistleblower Claims

The IRS maintains two whistleblower programs under the authority of Section 7623. Claims involving individuals with more than $200,000 of gross income and/or an amount in dispute in excess of $2 million are eligible for awards ranging from 15 to 30 percent of the amount collected (including additional taxes, interest, penalties, and fines) by the IRS as a result of the whistleblower's information. Section 7623(b). Claims that do not meet the thresholds are eligible for discretionary awards determined by the Director of the IRS Whistleblower Office. Section 7623(a). The possibility of collecting a bounty by blowing the whistle on one's own client or on another party raises significant ethical issues, primarily in (but not limited to) the area of conflicts of interest.

The following ethics opinion concerns another whistleblower program, established by the Dodd-Frank legislation. The ethical position of lawyers wishing to participate in the IRS whistleblower programs should be the same as that of lawyers wishing to blow the whistle to the Securities and Exchange Commission under Dodd-Frank, although in the latter case there is some evidence that federal preemption of state bar ethical rules may have been intended. In reviewing the opinion, students should be aware that New York, the jurisdiction in which the opinion was written, has not adopted Model Rule 1.6(b)(2) and (b)(3) (discussed in Chapter 4). While the confidentiality analysis might differ under the Model Rule, the conclusion would be the same because, even under the Model Rule, disclosure is permitted only to the extent that it is "reasonably necessary." It is difficult to envision a circumstance in which it would be reasonably necessary within the meaning of Model Rule 1.6 for a lawyer to pursue the steps necessary to collect a bounty or reward for revealing confidential information. *See United States v. Quest Diagnostics*, 734 F.3d 154 (2d Cir. 2013), *aff'g*, *United States ex rel. Fair Lab. Practices Assocs. v. Quest Diagnostics*, 2011 U.S. Dist. LEXIS 37014 (S.D.N.Y. Mar. 24, 2011); *New York ex. rel. Danon v. Vanguard Group, Inc.*, 2015 N.Y. Misc.

LEXIS 4239 (Sup. Ct. 2015) (dismissing whistleblower claim by attorney relying on former employer's confidential information).

New York County Lawyers Association Formal Opinion 746 (Oct. 2013)[13]

Question

May a New York lawyer ethically participate in the whistleblower bounty program under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 by revealing confidential information about the lawyer's client and then seeking a bounty?

Opinion

I. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) authorizes the payment of bounties to whistleblowers who report corporate wrongdoing to the U.S. Securities and Exchange Commission (SEC), Department of Justice, or the Commodity Futures Trading Commission (CFTC). The question arises as to the ethical implications under the New York Rules of Professional Conduct (RPC) if a New York lawyer were to accept a whistleblower bounty in exchange for furnishing information to the SEC or other government agency. This opinion analyzes the duties of New York lawyers under the New York RPC.

In 2002, the Sarbanes-Oxley Act (Sarbanes-Oxley), overwhelmingly passed by both houses, became law. It was a response to major corporate and accounting scandals, such as those involving Enron, Tyco International, Adelphia and World-Com, that cost investors billions of dollars when the share prices of affected companies collapsed. The SEC adopted Rule 205 as an attorney conduct regulation to implement portions of Sarbanes-Oxley. Rule 205 requires lawyers and others who deal with the SEC to report corporate misdeeds up the corporate ladder and permits, but does not require, reporting outside the corporation if the internal reporting does not solve the problem.[14]

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[14] [1] As relevant to attorneys, SEC Rule 205 provides:

> An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:
>
> (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
>
> (ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

In an attempt to regulate the financial markets in order to prevent a recurrence of the financial crisis of 2008–2009, Dodd-Frank was signed into law on July 21, 2010. Building onto Sarbanes-Oxley, section 922 of Dodd-Frank creates a whistle-blower bounty program under which individuals, who voluntarily provide original information leading to successful SEC enforcement actions, may receive bounty payments based on penalties assessed against respondents.[15] Whistleblowers whose "original information"[16] results in successful prosecutions netting monetary penalties in excess of $1 million are entitled, with some exceptions, to bounties of 10% to 30% of the amount recovered in the government enforcement actions. Thus, the minimum whistleblower bounty is $100,000. While, as explained below, lawyers subject to SEC jurisdiction are required to report serious corporate wrongdoing up the corporate ladder, reporting out—and collecting a bounty—is permissible under SEC rules. There are two sets of relevant SEC rules: attorney conduct regulations under Rule 205 (17 C.F.R. § 205); and Rules 240 and 249 (17 C.F.R. §§ 240, 249), promulgated under Dodd-Frank, concerning whistleblowing provisions.

II. Attorneys as Whistleblowers and Bounty Seekers under SEC Rules

SEC whistleblower rules exclude from the definition of "original information" most material that lawyers, in-house or retained, are likely to gain in the course of their professional representation of clients, and thus generally preclude attorneys, in most instances, from receiving a bounty for revealing such information.[17] SEC Rule 21F-4(b) acknowledges the importance of the attorney-client privilege, as well as state ethics rules, and presumptively excludes the use of privileged or confidential information from the definition of eligible original information under the whistleblower rule.[18] Indeed, the SEC warns lawyers that there will be no financial benefit to lawyers who disclose such information in violation of the attorney-client privilege or their ethical requirements.[19]

> (iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

17 C.F.R. § 205.3(d)(2).

[15] [2] Bounties are also available to whistleblowers who provide original information to the CFTC and the Department of Justice.

[16] [3] "Original information" is defined at 17 C.F.R. § 240.21F-4(b) as deriving from the whistleblower's "independent knowledge or independent analysis," and not available from a court or administrative record or the news media, or otherwise known to the Commission.

[17] [4] The categories excluded from whistleblower bounty include: (a) confidential communications subject to the attorney-client privilege; (b) information that came from the legal representation of a client, whatever its source; (c) information that came from persons in a compliance, legal, audit, supervisory or governance role for the entity; and (d) information from the entity's legal, compliance, audit, or related functions for dealing with violations, unless the entity did not disclose the information to the SEC or CFTC within a reasonable time or acted in bad faith. 17 C.F.R. § 240.21F-4(b)(4), *available at* http://www.law.cornell.edu/cfr/text/17/240.21F-4.

[18] [5] See Implementation of the Whistleblower Provisions of Section 21F, Exchange Act Release No. 34-64545, at 50–52, 60–66, 249–50 (Aug. 12, 2011) [hereinafter SEC Release No. 34-64545], *available at* http://www.sec.gov/rules/final/2011/34-64545.pdf.

[19] [6] at 60–61, 249–50.

However, the SEC permits attorneys to reveal information obtained as a result of legal representation of a client when such disclosure is permitted by either state ethics rules or SEC Rule 205.3(d)(2), which Rule, as noted above, was promulgated under Sarbanes-Oxley.[20] Rule 205 allows attorneys practicing before the SEC in the representation of an issuer to reveal confidential information related to the representation when the attorney reasonably believes disclosure is necessary: (a) to prevent the issuer from committing a material violation of securities laws that is likely to cause substantial financial injury to the interests or property of the issuer or investors, (b) to rectify the consequences of a material violation of securities laws in which the attorney's services have been used, or (c) to prevent the issuer from committing or suborning perjury in an SEC proceeding.

Under SEC Rule 205, the disclosure of client confidences outside the organization is a last resort, not a first step. The rule requires lawyers practicing before the Commission to report evidence of material violations of the securities laws to the company's chief legal officer (CLO), who is required to investigate the claim and report back to the lawyer who originally made the report.[21] In the event that the CLO finds credible evidence of a material violation, she must report the wrongdoing up the corporate ladder, including, if necessary, to the audit committee, qualified legal compliance committee or full board of directors. If all else fails, and if necessary to prevent further harm to the corporation or to investors, the CLO is authorized to disclose client confidences outside the company.[22] A junior reporting lawyer may report disclosures outside the organization if the CLO fails to act. Thus, under SEC Rule 205, reporting up the corporate ladder is mandatory; reporting out is permissible. However, to the extent that there is an independent violation of the securities laws, a lawyer may be subject to an enforcement action by the SEC for failing to correct or prevent the wrongdoing of a client in which the lawyer was complicit.[23]

The prospect of government-rewarded lawyer whistleblowers poses two ethical questions for New York lawyers: (1) In those limited circumstances in which the New York Rules and SEC Rule 205 diverge, would a New York attorney violate the RPC if she makes a disclosure not authorized by the confidentiality provisions of RPC 1.6 in order to seek a bounty? (2) Would a New York attorney who is representing a client violate the conflict of interest provisions of NY RPC 1.7 by seeking a bounty as a whistleblower with respect to that client by using that client's confidential information?

III. Disclosure of Confidential Information

In addressing the foregoing questions, the Committee begins from the obvious premise that its jurisdiction is limited to interpreting the New York Rules of Professional Conduct, and does not extend to the rules of other states or questions

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[20] [7] 17 C.F.R. § 240.21F-4(b)(4)(i), *available at* http://www.law.cornell.edu/cfr/text/17/240.21F-4.

[21] [8] *Id.* at § 205.3(b), *available at* http://www.law.cornell.edu/cfr/text/17/205.3.

[22] [9] *Id.* at § 205.3(d), *available at* http://www.law.cornell.edu/cfr/text/17/205.3.

[23] [10] *See In re Don Hershman*, Securities Act Release No. 33-9180 (Feb. 2, 2011), *available at* http://www.sec.gov/litigation/admin/2011/33-9180.pdf.

of substantive law. Nor can the Committee anticipate the myriad choice-of-law issues that may arise in different contexts under RPC 8.5, particularly in matters involving nationwide practices and administrative procedure. In addition, there are some circumstances in which state regulations may be preempted by inconsistent federal law.[24] Preemption is a question of substantive law, to be applied by the courts to the specific facts of each case, and is beyond this committee's jurisdiction.[25] However, SEC whistleblower rules explicitly reference "attorney-client privilege" and "applicable state attorney conduct rules," and thereby implicitly assume a side-by-side coexistence of the RPC and Rule 205.[26] Moreover, the SEC itself has acknowledged the applicability of state ethics rules in its own proceedings.[27]

The New York RPC prevent a lawyer generally from disclosing confidential information, but present six categories of exceptions to the general rule in RPC 1.6(b) if the circumstances are such that "the lawyer reasonably believes [disclosure is] necessary." Of these six exceptions, three are relevant to this discussion: RPC 1.6(b)(2), RPC 1.6(b)(3), and RPC 1.6(b)(6). [*Eds. Note*—New York has not adopted Model Rules 1.6(b)(2) and (b)(3), which could change the opinion's analysis on the confidentiality issues, depending on whether the lawyer's services were used.]

RPC 1.6(b)(2) permits an attorney to disclose confidential information to prevent a client from "committing a crime." This exception has some overlap with the "material violation" of the securities laws described in SEC Rule 205; however, not all securities violations rise to the level of a crime. Lawyers have been civilly or administratively sued for registration and record-keeping violations that do not amount to fraud or a crime. For example, in *In re Isselmann*, a general counsel improperly failed to correct his client's misperception of foreign law.[28] In *In re Drummond*, the SEC civilly prosecuted the general counsel of Google for failing to

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[24] [11] *See, e.g.*, Giovanni P. Prezioso, *Public Statement by SEC Official: Letter Regarding Washington State Bar Association's Proposed Opinion on the Effect of the SEC's Attorney Conduct Rules* (July 23, 2013), *available at* http://www.sec.gov/news/speech/spch072303gpp.htm.

[25] [12] *Compare Grievance Comm. v. Simels*, 48 F.3d 640, 646 (2d Cir. 1995) (reversing imposition of discipline against attorney who violated state "no-contact" rule in federal criminal proceeding; finding that "[i]f a particular interpretation of a state ethics rule is inconsistent with or antithetical to federal interests, a federal court interpreting that rule must do so in a way that balances the varying federal interests at stake"), *with Gadda v. Ashcroft*, 377 F.3d 934, 945 (9th Cir. 2004) (state bar has authority to discipline attorney for neglect of federal immigration matters) ("We apply a presumption against federal preemption unless the state attempts to regulate an area in which there is a history of significant federal regulation."), *and Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119 (9th Cir. 2005) (California arbitrator ethics rules preempted in FINRA proceedings by FINRA rules approved by SEC), *and Sperry v. State of Florida*, 373 U.S. 379 (1963) (IRS regulations for practice before federal agency preempt inconsistent state rules).

[26] [13] *See* 17 C.F.R. § 240.21F-4(b)(4); SEC Release No. 34-64545, *supra* note 5, at 50–52, 250–51.

[27] [14] *See, e.g.*, SEC v. Steven Altman, Securities Act Release No. 34-63306 (Nov. 10, 2010); *Steven Altman v. SEC*, 666 F.3d 1322 (D.C. Cir. 2011) (disciplining lawyer for violations of NY RPC based on extortionate conduct which impeded SEC investigation). *See also* 28 U.S.C. § 530B (2006) (The "McDade Amendment") (binding federal prosecutors to follow state ethics rules to the same extent as state lawyers); Lisa G. Lerman & Philip G. Schrag, Ethical Problems in the Practice of Law 716–17 (Aspen 2008).

[28] [15] Securities Act Release No. 34-50428 (Sept. 23, 2004), *available at* http://www.sec.gov/litigation/admin/34-50428.htm.

report that a grant of stock options would cause the company to cross a reporting threshold.[29] In both *Isselmann* and *Drummond*, general counsels were prosecuted for securities law violations. However, it is at least arguable that the lawyers' conduct in those cases, even if violations of securities law, did not rise to the level of crime or fraud for the purpose of state ethics rules.

To the extent that SEC Rule 205 permits (but does not require) reporting out of client confidences that amount to a material violation of the securities laws, regardless of whether the client's conduct amounts to a crime or whether the lawyer's services were used, it is broader than, and inconsistent with, the New York RPC exceptions to the confidentiality requirement.

Additionally, New York RPC 1.6(b)(3) permits a lawyer to reveal client confidential information where reasonably necessary

> to withdraw a written or oral opinion or representation previously given by the lawyer and reasonably believed by the lawyer still to be relied upon by a third person, where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud.

This exception permits reporting out of client confidences, but only in circumstances in which the lawyer's services have been used, in essence, to perpetrate a crime or fraud. For example, where the lawyer participated in drafting an offering statement that the lawyer later learns to be materially misleading, the New York Rules and SEC Rule 205 are in essential agreement that disclosure is permissible.

The third relevant exception is New York RPC 1.6(b)(6), which permits disclosure of client information "when permitted or required under these Rules or to comply with other law or court order." We do not need to decide here whether or not an administrative regulation, such as SEC Rule 205, is a law or court order within the meaning of the exception of RPC 1.6(b)(6). This is because RPC 1.6(b) explicitly provides that disclosure of client confidential information under its six exceptions—including RPC 1.6(b)(6)—may be made only "to the extent the lawyer reasonably believes necessary." The SEC regulations, as mentioned, only require reporting up the ladder. Reporting out is permissive, not mandatory. Thus, as a general rule, SEC Rule 205, standing by itself, does not require a lawyer to report out corporate wrongdoing and, therefore, such reporting is not reasonably necessary within the meaning of RPC 1.6(b).[30] The whistleblower rule is permissive as well, and does not mandate reporting out.

Other ethics rules also inform the conduct of corporate lawyers. New York RPC 1.13, "Organization as Client," which covers the responsibilities of a corporate attorney, requires an attorney aware of corporate misconduct that constitutes a violation of law or of a legal duty to the corporation to take reasonable measures

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[29] [16] Securities Act Release No. 33-8523 (Jan. 13, 2005), *available at* http://www.sec.gov/litigation/admin/33-8523.htm.

[30] [17] For the same reason, the state and federal regulatory schemes are not mutually antagonistic. SEC whistleblower regulations do not require reporting out; they permit it, within the exceptions set forth in Rule 205. If federal regulations required reporting out, we might be in a different situation.

within the organization to prevent harm to the organization, but does not contain independent support for reporting outside the organization if such reporting might result in disclosure of confidential information in violation of Rule 1.6:

> If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly in violation of law and is likely to result in a substantial injury to the organization, the lawyer may reveal confidential information only if permitted by Rule 1.6, and may resign in accordance with Rule 1.16.[31]

Thus, reporting out is circumscribed under New York law to those instances permitted in RPC 1.6(b).

In addition, in the case of known false evidence, a lawyer is required under RPC 3.3(a) to take reasonable remedial measures, "including, if necessary, disclosure to the tribunal." Disclosing client confidences to a tribunal may also be required when the lawyer knows of criminal or fraudulent conduct related to a proceeding in a tribunal.[32]

In sum, the New York exceptions permitting disclosure of confidential information are different from the SEC exceptions. Under the SEC rules discussed above, an attorney may collect a bounty in exchange for disclosure of confidential information in situations not permitted under the New York Rules. Even when disclosure is permitted under the New York Rules, for example, when clear corporate wrongdoing rising to the level of crime or fraud has been perpetrated through the use of the lawyer's services, preventing wrongdoing is not the same as collecting a bounty. Even in cases of clear criminal conduct or fraud, the lawyer's disclosure must be limited to reasonably necessary information.[33]

As a general principle, there are few circumstances, if any, in which, in the Committee's view, it would be reasonably necessary within the meaning of RPC 1.6(b) for a lawyer to pursue the steps necessary to collect a bounty as a reward for revealing confidential material. This point was acknowledged in a recent federal opinion in a qui tam whistleblower case decided under the False Claims Act.[34]

Thus, in those circumstances in which the New York Rules apply, this Committee

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[31] [18] NY RPC 1.13(c) (emphasis added). By contrast, American Bar Association Model Rule 1.13 permits outside disclosure if the corporation's board fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law and if the lawyer reasonably believes that the violation is "reasonably certain to result in substantial injury to the organization." But disclosure is permitted only to the extent necessary to prevent substantial injury to the organization.

[32] [19] NY RPC 3.3(b).

[33] [20] *See, e.g.*, NYSBA Comm. on Prof'l Ethics, Op. 837 (lawyer must take reasonable remedial measures under RPC 3.3 to correct client perjury, but may only reveal client confidences to the extent reasonably necessary; "[t]herefore, if there are any reasonable remedial measures short of disclosure, that course must be taken").

[34] [21] *See United States Ex Rel. Fair Lab. Practices Assocs. v. Quest Diagnostics Inc.*, No. 05-C5393, 2011 U.S. Dist. LEXIS 37014 (S.D.N.Y. Mar. 24, 2011) (disclosure of client confidences by former general counsel of corporation was not "reasonably necessary" under former Code of Professional Responsibility to rectify client fraud).

opines that disclosure of confidential information in order to collect a whistleblower bounty is unlikely, in most instances, to be ethically justifiable. This is because, under most circumstances, such disclosure is not reasonably necessary, and does not fit within the enumerated exceptions of RPC 1.6(b).[35] RPC 1.6, by its terms, is limited to "information gained during or relating to the representation of a client . . . ." Accordingly, this opinion applies only when a lawyer is acting as a legal representative of a client. Thus, a lawyer functioning in a non-legal capacity would not be within the scope of this opinion.

Accordingly, New York RPC 1.6 does not permit disclosure of confidential information in order to collect a Dodd-Frank whistleblower bounty, even in compliance with the SEC rules, if that disclosure does not fit within an exception under New York RPC 1.6 or is not necessary to correct a fraud, crime or false evidence within the meaning of RPC 3.3.

IV. Conflicts of Interest Under RPC 1.7

An additional and even more significant ethical issue is presented by the bounty provisions of Dodd-Frank: Is a conflict of interest under RPC 1.7 presented when a corporate lawyer, functioning as a lawyer, seeks to collect a whistleblower bounty? Our answer is presumptively yes. A lawyer confronted with potential corporate wrongdoing must evaluate and consider varying requirements under SEC and state ethics rules and then make some difficult decisions: Is the potential violation material? Is the potential violation criminal? Should the lawyer report the wrongdoing up the corporate ladder? Should the lawyer report the wrongdoing to an outside body, and if so, when?

These complex and potentially inconsistent considerations call for the exercise of objective, dispassionate professional judgment. A lawyer who blows the whistle prematurely could harm the client and be professionally responsible for the precipitous disclosure of client confidences. A lawyer who fails to report credible evidence of corporate wrongdoing up the ladder, if it amounts to an independent violation of the securities laws, could potentially be prosecuted by securities regulators, subject to professional discipline by the SEC, and subject to reciprocal discipline by state bar counsel.[36]

Especially under these delicate circumstances, a financial incentive might tend to cloud a lawyer's professional judgment. Yet Dodd-Frank permits the SEC to pay lawyers potential bounties of 10%–30% of collected fines in excess of $1 million. The potential bounties range from $100,000 to literally millions of dollars in larger cases. The prospect of financial benefit could place the attorney's personal interests in potential conflict with those of the client.

RPC 1.7(a)(2) precludes representation of a client, absent waiver, where a reasonable lawyer would conclude that "there is a significant risk that the lawyer's

[35] [22] *See id.*

[36] [23] *See, e.g.*, New York City Bar, Report of the Task Force on the Lawyer's Role in Corporate Governance 46 (Nov. 2006) (collecting seventy-four SEC enforcement actions against lawyers), *available at* http://online.wsj.com/public/resources/documents/WSJ-CORP-GOV-FINAL_REPORT.pdf.

professional judgment on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other personal interests." The prospect of a government payment to a whistleblower poses such a risk. While we cannot anticipate all potential circumstances and situations, and do not wish to paint a bright line rule applicable to all cases, it is the opinion of the Committee that the potential payment of an anticipated whistleblower bounty in excess of $100,000 presumptively gives rise to a conflict of interest between the lawyer's personal interest and that of the client.

We cannot anticipate all potential circumstances and, therefore, our opinion anticipates the overwhelming majority of cases in which the lawyer's professional judgment may be affected by the prospect of a monetary bounty. This opinion is narrowly tailored to an interpretation of permissive whistleblowing, and does not purport to address the rare and exceptional situation in which the lawyer is affirmatively required by law or the rules of professional conduct to report out the client's misconduct, *i.e.*, when reporting out is mandatory.[37] Under those rare circumstances (in which reporting out is mandatory), the financial incentive could be less of a factor in determining the existence of a conflict with the lawyer's personal interest.

Further, although Rule 1.7(b) provides for a waiver by a client of the conflict even if there is a "significant risk" that the lawyer's professional judgment or representation will be adversely affected by the lawyer's personal interest, in some circumstances the whistleblower-bounty conflict may be unwaivable.[38]

Indeed, where an attorney can hope to claim close to a $10 million bounty by reporting a securities fraud of $30 million or more—the same amount that gave rise to an unwaivable conflict in Schwarz—the conflict may be unwaivable. Such large sums of money would tend to cloud lawyers' professional judgment, influencing lawyers to report out a violation regardless of their clients' interests.[39]

V. Former Clients

In our view, some ethical concerns with regard to whistleblower bounties apply to former clients as well. New York RPC 1.9(c) prohibits a lawyer from using client confidential information to the detriment of a former client, unless permitted by Rule 1.6(b). According to RPC 1.9(c):

> A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

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[37] [24] *See, e.g.*, NY RPC 3.3(b).

[38] [25] *See, e.g.*, *United States v. Schwarz*, 283 F.3d 76, 95 (2d Cir. 2002) (unwaivable conflict of interest raised by criminal defense lawyer's $10 million contract with police union where lawyer failed to point finger at union delegates in defense of criminal defendant accused of participating in torture of Abner Louima).

[39] [26] This opinion does not deal with circumstances where the attorney's financial interest is less than $100,000, and is not meant to suggest that no ethical concerns are present in such situations.

(1) use confidential information of the former client protected by Rule 1.6 to the disadvantage of the former client, except as these Rules would permit or require with respect to a current client or when the information has become generally known; or

(2) reveal confidential information of the former client protected by Rule 1.6 except as these Rules would permit or require with respect to a current client.

Thus, Rule 1.9 protects the confidences of former clients, which may not be disclosed to the client's detriment unless pursuant to an exception under RPC 1.6(b). And, as mentioned, the exceptions in Rule 1.6(b) permit disclosure of client confidences only "to the extent the lawyer reasonably believes necessary . . . ." The lawyer's duty to maintain client confidences has been held to survive the termination of the client-lawyer relationship.[40] It is the Committee's view that lawyers of former clients, even those wrongfully discharged in violation of the law, may not seek bounties, although it has been held that they may, under some circumstances, reveal some client confidences in the context of a claim for wrongful termination.[41] This is because the confidentiality provisions of RPC 1.9, which apply to former clients, incorporate those of RPC 1.6. Accordingly, a former lawyer for a client may not reveal information that could not have been revealed in the course of the representation.

Moreover, case law has recognized, more generally, the lawyer's duty not to harm a former client. In *Oasis West Realty, LLC v. Goldman*, the California Supreme Court sustained a breach of fiduciary duty claim against a lawyer who was disloyal to a former client when he publicly protested a development permit that he himself had formerly obtained on behalf of the client, at considerable expense.[42] The lawyer's interest in free speech did not permit his act of disloyalty to his former client regarding the same matter for which he had been retained.

We believe that a similar analysis applies in the case of a lawyer standing to profit from blowing the whistle on a former client in exchange for a monetary bounty. While in some circumstances a lawyer may be required to take remedial action to prevent or correct client fraud or perjury, such actions should be taken because they are required by the law or the RPC—not because the lawyer seeks personal gain at the former client's expense. Additionally, we believe that attorneys owe a fiduciary duty to former clients to maintain confidentiality, and may not violate that fiduciary duty in order to promote a personal interest.[43] Furthermore, there are circumstances in which an attorney may be *permitted* under Rule 1.9 to reveal otherwise confidential information about a former client—for example, when the disclosure is reasonably necessary to prevent the client from committing a crime under Rule 1.6.

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[40] [27] *See Quest Diagnostics*, 2011 U.S. Dist. LEXIS 37014; *Swidler & Berlin v. United States*, 524 U.S. 399 (1998) (notes of Vincent Foster's lawyer are confidential even after his death).

[41] [28] *See, e.g., Van Asdale v. Int'l Game Tech.*, 577 F.3d 989 (9th Cir. 2009).

[42] [29] 51 Cal. 4th 811 (2011).

[43] *See generally Birnbaum v. Birnbaum*, 73 N.Y.2d 461 (1989) (general duty of fidelity requires avoidance of situations in which personal interests conflict with the interests of those owed a fiduciary duty).

However, we believe that undertaking this otherwise permissible disclosure in a manner that results in a bounty for the attorney raises a significant risk that the attorney's judgment in determining whether disclosure is "reasonably necessary" will be adversely affected and presents a conflict of interest that is beyond what Rule 1.9 was intended to allow.

VI. The Attorney's Status

While the RPC apply with equal force to lawyers in private practice and in-house counsel, we note that the conflict provisions of RPC 1.7 (and, as mentioned above, RPC 1.6) do not apply to all lawyers at all times, but only to lawyers who are engaging or have engaged in the representation of a client. RPC 1.7(a) specifically says that "a lawyer shall not represent a client" if the lawyer's professional judgment "on behalf of a client" would be affected by a personal interest of the lawyer. Thus, our opinion would not affect or apply to lawyers who are not representing, or did not represent clients. For example, a corporate officer or compliance officer who happens to be a lawyer may not necessarily be representing a client in the performance of his duties, depending on the facts of the individual case. To the extent that the lawyer is not representing a client, our opinion would not apply to that conduct simply because the lawyer happens to be a licensed attorney.

VII. Conclusion

It is the Committee's opinion that New York lawyers who are acting as attorneys on behalf of clients presumptively may not ethically serve as whistleblowers for a bounty against their clients under the Dodd-Frank Wall Street Reform and Consumer Protection Act, because doing so generally gives rise to a conflict between the lawyers' interests and those of their clients. New York lawyers, in matters governed by the New York RPC, may not disclose confidential information under the Dodd-Frank whistleblower regulations, except to the extent permissible under the Rules of Professional Conduct. This conclusion is the same for current and former lawyers, whether in-house or outside counsel. However, this Opinion is limited to New York lawyers who are acting as attorneys on behalf of clients.

PROBLEM 3-24

Lucy Lawyer regularly assists US persons who own offshore financial accounts to regularize their US reporting and tax obligations. Lucy routinely discusses with these clients the substantial penalties they may face for failing to report income on their tax returns and for failing to report the existence of the accounts on IRS Form 8938 and FinCEN Form 114 (Report Of Foreign Bank And Financial Accounts; referred to as an FBAR). (Willful failure to report an account on an FBAR could result in a penalty of up to 50 percent of the account balance per year!) Some of these clients decide to participate in the IRS's Offshore Voluntary Disclosure Program under Lucy's guidance, while others choose to pursue other approaches. Several wealthy clients with whom Lucy has worked suddenly stop calling Lucy or otherwise indicate that they have decided not to report their foreign accounts to the IRS.

a. Can Lucy contact the IRS Whistleblower Office to report her clients' noncompliance?

b. Can Lucy contact the IRS Whistleblower Office to report the names of the banks in which her clients have held their unreported accounts? (The IRS and Department of Justice might be interested in determining whether these banks assisted US accountholders to evade their US tax obligations.)

III. OPINION LETTERS AND WRITTEN ADVICE

Circular 230 §§ 10.22 and 10.37
Model Rule 2.3
AICPA SSTS No. 1, AICPA SSTS No. 7, and Interpretation No. 1-2 "Tax Planning" (Appendices C and D)

A. Opinion Letters

Clients frequently ask their tax advisors for written opinion letters stating the lawyers' or accountants' views on the tax treatment or consequences of transactions or investments described in the letters. The letters typically begin with a detailed description of the transaction or investment with respect to which opinions are rendered (these are the facts on which the opinions are based), continue with a statement of the relevant legal principles and authorities and an analysis of how those principles and authorities apply to the facts at issue, and conclude by stating opinions on the tax treatment or consequences. For a variety of reasons, many of which are discussed in this section, opinion letters usually contain a variety of embellishments, as well, *e.g.*, the identity of the person or persons from whom the facts were obtained, the extent to which an opinion relies on representations of others, etc.

Tax opinion letters can be useful in a variety of circumstances.[44] Sometimes, a client merely seeks written comfort that her advisors have thought carefully

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[44] According to a recent article, clients are increasingly seeking tax opinion letters for several reasons.

> First, the economy is climbing out of the 2008 depression at an accelerating pace, prompting more deals. Second, the list of no-rule issues in Rev. Proc. 2014-3 continues to grow in response to IRS resource constraints. Third, the revised Circular 230 relieves tax advice of some constraints. Fourth, since the advent of the Sarbanes-Oxley Act of 2002, having a tax opinion from someone other than your financial auditor has become more useful, even for corporate group internal transactions. Fifth, many corporate taxpayers have become more at ease with proceeding on opinions of tax practitioners without rulings, particularly in reorganizations and spinoffs.
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> The last factor is influenced by many considerations, including (1) having no other choice, because the IRS will not rule; (2) the declining number of IRS attacks on what can appear to be real business deals, as contrasted with perceived "tax shelters"; and (3) the replacement of concerns about IRS audits with concerns about the views of the company's external auditors on financial accounting reserves and internal concerns about reporting uncertain tax positions to the IRS.

Jasper L. Cummings, *Tax Opinion Practice Today*, 145 TAX NOTES 1049 (2014).

through the relevant issues and have confidence in their advice. With the adoption and implementation of FASB FIN 48,[45] tax lawyers can anticipate being asked for written opinions to influence auditors in creating tax accruals. Clients seek opinion letters as a means of defending against the possible imposition of tax penalties by the IRS; such opinion letters are casually referred to as "penalty protection." Some clients seek tax opinions in order to influence others to participate or invest in a transaction. Finally, sometimes opinions are required by law. For example, federal securities laws may require that transactions involving issuance of securities to the public include an opinion to support discussions of tax consequences included in the offering materials.

Tax opinion letters predict the likelihood of a position being sustained on its merits if challenged by the IRS. In other words, they predict how a court would rule if called upon to decide the issue or issues opined upon, assuming that the court were familiar with all of the relevant facts. In reality, the likelihood of any particular outcome is difficult to quantify; nonetheless, clients ask for, and receive, greater or lesser degrees of assurance depending on the purpose or context of the letter. Although there are neither formal definitions of relevant terminology nor any real agreement on the strength of the various levels, tax opinion letters typically give assurance at one of five levels.[46]

1. <u>Reasonable basis</u> has been quantified by some to be as low as 5 percent and by others as high as the 20 to 25 percent range. According to Treas. Reg. § 1.6662-3(b)(3):

> The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in the [substantial authority regulations,] the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.

A position having a reasonable basis avoids a negligence penalty. Treas. Reg. § 1.6662-3(b)(1). Moreover, a return position must have at least a reasonable basis in order to avoid, through disclosure,[47] a penalty for substantial understatement of

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[45] Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes." For tax years beginning after December 15, 2006 (with some exceptions), FIN 48 governs the evaluation by CPAs of material positions taken in any income tax return, for purposes of financial accounting. According to the FASB:

> [FIN 48] clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

The full text of FIN 48 is *available at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1175801627860&acceptedDisclaimer=true.

[46] There could be other standards for opinions, *e.g.*, "not frivolous." The text addresses only the standards that are most commonly utilized. For a tongue-in-cheek breakdown of tax opinion standards, see *A Detailed Guide to Tax Opinion Standards*, 106 Tax Notes 1469–71 (2005).

[47] Form 8275 is attached to a return whenever a taxpayer or tax return preparer wishes to disclose

income tax or a preparer penalty under Section 6694(a). Sections 6662(d)(2)(B)(ii), 6694(a)(2)(B).

2. Substantial authority is difficult to quantify numerically but it certainly may be less than 50 percent. "Substantial authority" is more stringent than the reasonable basis standard but less stringent than the more likely than not (i.e., greater than 50 percent) standard. Treas. Reg. § 1.6662-4(d)(2).

> There is substantial authority for the tax treatment of any item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed in [Treas. Reg. § 1.6662-4(d)(3)(ii)].

Treas. Reg. § 1.6662-4(d)(3)(i). (Students should be quite comfortable with the meaning of "substantial authority" after having studied Chapter 2 of this text.)

Because this standard can be satisfied at less than 50 percent certainty, it is possible that there could be substantial authority for more than one position. Moreover, unlike any of the other levels of assurance, substantial authority is not stated in the regulations in terms of how likely a particular outcome will be but focuses instead on the strength, or relative strength, of the authority or authorities supporting a position.

An undisclosed position must have substantial authority in order to avoid the taxpayer penalty for substantial understatement of income tax or the preparer penalty for an unreasonable position under Section 6694(a).[48] Sections 6662(d)(2)(B)(i), 6694(a)(2)(A).

3. More likely than not means having a greater than 50 percent likelihood of being sustained on the merits. Treas. Reg. §§ 1.6662-4(g)(4)(i)(B), 1.6694-2(b)(1).[49] For tax years beginning after December 15, 2006 (with some exceptions), "more likely than not" is the standard or threshold that must be used by CPAs preparing financial statements to assess all material positions taken in an enterprise's income tax return.[50] FIN 48 requires a company to undertake and retain a detailed analysis of tax positions that may be uncertain and to document whether each such position

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items or positions in order to avoid certain penalties. Form 8275 is filed, for example, to avoid the portions of the accuracy-related penalty due to disregard of rules or to a substantial understatement of income tax for nontax shelter items if the return position has a reasonable basis. It can also be used for disclosures relating to preparer penalties for understatements due to unreasonable positions or disregard of rules. (Where disclosure is made of return positions that are contrary to a regulation, Form 8275-R is used.)

[48] In addition, substantial authority is required in order to qualify for the reasonable cause exception to the penalty for reportable transaction understatements. Section 6664(d)(2)(B).

[49] A position must meet the more likely that not standard to avoid certain penalties related to tax shelters and reportable transactions. Sections 6664(d)(3)(C), 6694(a)(2)(C).

[50] The "more likely than not" threshold, for FIN 48 purposes, means that: (1) a benefit related to an uncertain tax position may not be recognized in financial statements unless it is "more likely than not" that the position will be sustained based on its technical merits; and (2) there must be more than a 50

can be recognized as more likely than not. While tax opinions are not required to meet the FIN 48 threshold, companies routinely engage outside tax counsel or advisers to prepare tax opinions on significant positions to determine whether such positions meet the "more likely than not" standard.

4. Should is not quantified or defined in either the Code or the regulations, but is generally considered to mean a likelihood of success of more than 70 percent. Thus, a "should" opinion opines at a level greater than "more likely than not" but less than "will." Although some attorneys use the phrases "weak should" and "strong should" to describe the strength of their opinions, such terminology rarely is reflected in the opinion letters themselves. Because the level of "should" is uncertain, these letters typically include reasoning or analysis so that the reader can assess the degree of certainty or uncertainty for herself. (Not surprisingly, an opinion letter that includes a lengthy analysis is referred to as a "reasoned opinion.").

5. Will means 95 to 100 percent. A "will" opinion is considered a "clean" or "unqualified" opinion of near certainty. "Will" opinions may be subject to exceptions, limitations, and/or assumptions, so long as they are customary and are stated in the letter.

B. Ethical Considerations

1. Ethical Rules

In drafting an opinion, lawyers must be mindful of traditional ethical standards. For example, under ABA Formal Op. 85-352, a lawyer is prohibited from advising tax return positions that fall short of a "realistic possibility of success" standard. The same standard is generally thought to govern any tax advice given to a client to the extent that tax return positions are or will be involved (*e.g.*, advice in the course of structuring transactions that will involve tax return positions), including tax advice in the course of preparing legal documents. Opinion 85-352 states:

> [A] lawyer, in representing a client in the course of the preparation of the client's tax return, may advise the statement of positions most favorable to the client if the lawyer has a good faith belief that those positions are warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. A lawyer can have a good faith belief in this context even if the lawyer believes the client's position probably will not prevail. However, good faith requires that there be some realistic possibility of success if the matter is litigated.
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> * * *
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> Thus, where a lawyer has a good faith belief in the validity of a position in accordance with the standard stated above that a particular transaction does not result in taxable income or that certain expenditures are properly deductible as expenses, the lawyer has no duty to require as a condition of

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percent likelihood that the position would be sustained if challenged and considered by the highest court in the relevant jurisdiction.

> his or her continued representation that riders be attached to the client's tax return explaining the circumstances surrounding the transaction or the expenditures.
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> In the role of advisor, the lawyer should counsel the client as to whether the position is likely to be sustained by a court if challenged by the IRS, as well as of the potential penalty consequences to the client if the position is taken on the tax return without disclosure. Section 6661 [now Section 6662] of the Internal Revenue Code imposes a penalty for substantial understatement of tax liability which can be avoided if the facts are adequately disclosed or if there is or was substantial authority for the position taken by the taxpayer. Competent representation of the client would require the lawyer to advise the client fully as to whether there is or was substantial authority for the position taken in the tax return. If the lawyer is unable to conclude that the position is supported by substantial authority, the lawyer should advise the client of the penalty the client may suffer and of the opportunity to avoid such penalty by adequately disclosing the facts in the return or in a statement attached to the return. If after receiving such advice the client decides to risk the penalty by making no disclosure and to take the position initially advised by the lawyer in accordance with the standard stated above, the lawyer has met his or her ethical responsibility with respect to the advice.
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> In all cases, however, with regard both to the preparation of returns and negotiating administrative settlements, the lawyer is under a duty not to mislead the Internal Revenue Service deliberately, either by misstatements or by silence or by permitting the client to mislead.
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> In summary, a lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no 'substantial authority' in support of the position, and there will be no disclosure of the position in the return. However, the position to be asserted must be one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. *This requires that there is some realistic possibility of success if the matter is litigated.* In addition, in his role as advisor, the lawyer should refer to potential penalties and other legal consequences should the client take the position advised.

The realistic possibility of success standard has been quantified as a one in three, or greater, likelihood of being sustained on the merits. Treas. Reg. § 1.6694-2(b)(1) (as in effect prior to Dec. 15, 2008); Circular 230 § 10.34(d)(1) (as in effect prior to Apr. 4, 2008). Prior to 2008, Circular 230 mandated the same realistic possibility of success standard with respect to tax return positions, and the preparer penalty rule under Section 6694(a) incorporated that standard, as well. The AICPA rule was the same. Thus, all tax professionals were governed by the same reporting standards in all contexts. (The tax professional was governed by a different reporting standard than her client, however—realistic possibility of success versus substantial authority.[51])

In 2008, Section 6694(a) was amended to require that, with respect to tax advice, a return preparer must meet the substantial authority standard (as described in Chapter 2). The realistic possibility of success standard was replaced in Circular 230 § 10.34(a) with a reference to Section 6694(a) (the substantial authority standard). Therefore, while the tax practitioner's statutory reporting (*i.e.*, penalty) standard and her obligations under Circular 230 now conform to the client's, all three are now subject to the substantial authority standard for nondisclosed items. Oddly, the attorney's ethical standard is inconsistent with all of the others. ABA Formal Op. 85-352 has not been revised to reflect the incongruities and no efforts are underway to make the appropriate revisions or to withdraw the Opinion. Most attorneys, thus, take the ethical standard set forth in Opinion 85-352 into account but regard the substantial authority standard as the governing standard.

Opinion letters that may be used or relied upon by third parties (other than the client), *e.g.*, prospective investors in a transaction organized and promoted by a client, must comport with Model Rule 2.3, under which (1) the rendering lawyer must reasonably believe that making an evaluation for the benefit of third parties is compatible with other aspects of the lawyer's relationship with the client and (2) if the lawyer knows or reasonably should know that the evaluation is likely to affect the client's interests materially and adversely, the lawyer may not provide the evaluation unless the client gives informed consent. According to the Comments to Model Rule 2.3, when a question about the legal situation of a client arises at the instance of the client's financial auditor, the lawyer's response may be made in accordance with procedures recognized in the legal profession, such as the so-called "treaty" entered into between the ABA and AICPA. *See* ABA Comm. on Audit Inquiry Responses, *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 31 Bus. Law. 1709 (1975). The ABA's position paper on responding to auditor responses in light of FIN 48 is available at http://apps.americanbar.org/buslaw/tribar/materials/20081017000000.pdf.

2. AICPA Standards

According to the AICPA SSTSs and interpretations (Appendices C and D), the same standard that applies to tax return preparation applies to professional services involving tax planning. Interpretation No. 1-2 to SSTS No. 1. Tax planning, for this purpose, includes any oral or written recommendation or expression of an opinion in a prospective or completed transaction on either a return position or on a specific tax plan by the member, the taxpayer, or a third party.

Under a prior AICPA standard, a member could not recommend that a tax return or tax planning position be taken unless the member had a good faith belief that the position had a realistic possibility of being sustained administratively or judicially on its merits if challenged. That standard was revised in light of Section

[51] Ethical issues arising out of this conflict were addressed by the ABA Section of Taxation Committee on Standards of Tax Practice in its Standards of Tax Practice Statement 2001-1 (Dec. 4, 2000), 54 Tax Law. 185 (2000), which explores whether the benefits of adequately disclosing return positions, which might have affected taxpayers and advisers differently, generated conflicts of interest.

6694(a) and Circular 230. The current standard retains the realistic possibility of success standard in situations where the applicable taxing authority has no written standards or where such written standards are lower than realistic possibility of success. Otherwise, members are required to comply with standards imposed by the applicable taxing authority. Thus, in the case of a federal tax issue, the substantial authority standard (as set forth in Section 6694 and Circular 230 § 10.34(a)) governs.

Interpretation No. 1-2 provides guidelines for issuing opinions and for reviewing opinions given to a client by other tax professionals. In issuing a tax opinion, a member should:

1. establish the relevant background facts;
2. consider the reasonableness of assumptions and representations;
3. consider applicable regulations and standards regarding reliance on information and advice received from a third party;
4. apply the relevant authorities to the facts;
5. consider the business purpose and economic substance of the transaction if they are relevant to the tax consequences of the transaction (relying on a representation that there is a business purpose or economic substance is generally insufficient);
6. consider whether the issue involves a listed transaction or reportable transaction (defined in Section 6707A);
7. consider other regulations and standards applicable to written tax advice promulgated by the applicable taxing authority; and
8. arrive at a conclusion supported by the authorities.

Interpretation No. 1-2 sets forth similar standards for members who are evaluating tax opinions that a client has obtained from another tax advisor. These guidelines are strikingly similar to the Circular 230 opinion standards that are described in the next section and were replaced in 2014. It will be interesting to see if the AICPA retains the standards in Interpretation No. 1-2, which are now substantially stricter than those required by Circular 230, or amends them to conform to the new Circular 230 rules.

C. Circular 230

In 2004, Treasury issued regulations prescribing opinion standards and rules that were aimed primarily at opinions rendered in tax shelter transactions. The regulations, however, were written broadly enough to cover other types of written opinions and advice, as well. Indeed, much written advice, including electronic communications, was covered by the regulations, with the result that even innocuous e-mails covering tax topics were often thought to be covered by the regulations. The regulations effectively required that "covered opinions" be given in the form of reasoned opinions containing lengthy recitals of facts and assumptions. Practitioners could avoid these cumbersome (and often costly) requirements by disclaiming that the advice could be relied upon for certain purposes.[52] Written advice that was not subject to these onerous "covered opinion" rules was subject to a vaguely worded version of Circular 230 § 10.37, covering "other written advice." Neither 2004 Circular 230 § 10.35 nor Circular 230 § 10.37 was ever used by OPR for disciplinary purposes.

The onerous rules governing written opinions were eliminated in 2014. In their place, Treasury adopted a reasonable practitioner standard, which by its terms applies to all written advice. *See* Circular 230 § 10.37. At the same time, Treasury broadened the scope of procedures required of all tax practitioner firms and their managerial and supervisory personnel to ensure compliance with Circular 230 generally and with respect to written advice. *See* Circular 230 § 10.36.

Under the current written advice rules, a practitioner who renders any sort of written advice must:

1. base the written advice on reasonable factual or legal assumptions, including assumptions as to future events;
2. reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know;
3. use reasonable efforts to identify and ascertain the facts relevant to the written advice on each federal tax matter;
4. not rely on representations, statements, findings or agreements (including projections, financial forecasts or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable;
5. relate applicable law and authorities to facts; and
6. not, in evaluating a federal tax issue, take into account the possibility that a tax return will not be audited or that an issue will not be raised on audit.

Circular 230 § 10.37(a)(2). These requirements are essentially procedural. Practitioners are permitted to give written advice regardless of whether the practitioner concludes that any particular issue will be resolved in favor of the taxpayer and regardless of the confidence level the practitioner has with respect to any particular issue's resolution.[53] It seems clear under general ethical principles, however, that a practitioner's reservations about the strength of her advice should be communicated to the client. Furthermore, Circular 230 § 10.35 requires a practitioner to possess the necessary competence to engage in practice before the IRS. An incompetent practitioner's failure to reach a reasonable result despite following the section 10.37 process could, then, result in OPR discipline for a violation of section 10.35.

In evaluating whether a practitioner has failed to comply with Circular 230 § 10.37, OPR will apply a reasonable practitioner standard, considering all facts

[52] This explains the ubiquitous Circular 230 disclaimers that were prominent at the end of e-mails sent from many law and accounting firms. For example: "Any statements regarding federal tax law contained herein are not intended or written to be used, and cannot be used, for the purposes of avoiding penalties that may be imposed under federal tax law or to market any entity, investment plan, or arrangement."

[53] The *Sykes* case, in Chapter 1, illustrates how limited the regulation's approach can be in regulating practitioners who provide overly aggressive advice

and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client. A reasonable practitioner standard also will apply in the case of an opinion which the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting, marketing, or recommending to others an entity, plan, or arrangement with a significant tax avoidance or evasion purpose, but in this case, any review will emphasize the additional risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.