

T.E. Johnston: Reliance on Advice of Counsel Defense Leads to Implied Waiver of the Attorney-Client Privilege (If You Wield It As a Sword, You May Lose the Shield)

By Jeffrey B. Frishman and James M. Lynch*

Jeffrey Frishman and James Lynch examine how a taxpayer's reliance on the advice of counsel defense resulted in an implied waiver of the attorney-client privilege.

Introduction

The attorney-client privilege is relied on regularly and with confidence by clients and attorneys in their dealings. Its operative principle is well known: where the privilege applies, it generally protects communications between attorney and client from being discovered by parties outside the privileged relationship. Case law sometimes reminds us, however, that while the attorney-client privilege is durable, it may be lost when a court perceives that the privilege is being abused.

The U.S. Tax Court issued such a reminder in its recent decision in *T.E. Johnston*,¹ where the IRS successfully argued that a taxpayer impliedly waived the attorney-client privilege during pre-trial litigation by affirmatively asserting good faith reliance on the advice of counsel as a defense to a civil fraud penalty asserted by the IRS under Section 6663 of the Internal

Jeffrey B. Frishman, J.D., LL.M., is a Partner in the Chicago office of Winston & Strawn.

James M. Lynch, J.D., LL.M., is a Partner in the Chicago office of Winston & Strawn.

Revenue Code (“the Code”).² In *Johnston*, the Tax Court concluded that allowing the taxpayer to retain the privilege over legal advice on

erwise distribute Estrella’s assets. These assets included stock in Shorecliffs Golf Course, Inc. (“Shorecliffs,” which held title to a golf course of the same name) and 22 property lots (“the Equestrian lots”). The Shorecliffs stock and the Equestrian lots were distributed to Sea-Aire, Shannon and Fitzsimon in varying interests.

On May 11, 1989, Shannon,

Sea-Aire and Fitzsimon entered into an option agreement whereby Shannon obtained the right to purchase the Shorecliffs shares held by Sea-Aire and Fitzsimon. Shortly thereafter, Shannon acquired Fitzsimon’s Shorecliffs shares. However, under an apparent side agreement between Shannon and Johnston, Sea-Aire was allowed to retain its Shorecliffs shares. On June 28, 1989, Spence and Johnston met with an attorney, Thomas O’Keefe, regarding the sale of Shorecliffs. O’Keefe had represented Johnston and his related entities for many years and was his longstanding tax counsel. On June 30, 1989, the golf course was sold to a third party for somewhere between \$5 million and \$6 million.

With regard to the Equestrian lots, Shannon apparently sold its interest to Sea-Aire after the lots were distributed from Estrella, and the 22 lots were later contributed to the formation of a new limited partnership in 1989, SCE, in which Sea-Aire, Johnston and Fitzsimon were partners. In 1992, another entity related to Johnston, Uppaway Investments, Inc. (“Uppaway”), became a substituted partner in SCE, replacing Sea-Aire.

At the end of the day, Fitzsimon apparently was unhappy missing out on the sale of the Shorecliffs golf course and also with the manner in which SCE was being operated. In 1993, he brought a state court suit in California against Shannon, Spence, Sea-Aire, Johnston, Uppaway and Shorecliffs. Among other allegations, the lawsuit complained that:

- Johnston and Spence fraudulently induced Fitzsimon to sell his interest in Shorecliffs shortly before the golf course was sold; and
- Fitzsimon was deprived of profits in SCE through self-dealing transactions and the diversion of profits by other partners.

With regard to Shorecliffs, a resulting trial found that Fitzsimon was defrauded in connection with the sale of the golf course. With regard to SCE, it was stipulated in settlement that the partnership be dissolved with an ensuing final accounting. In the end, Fitzsimon was awarded compensatory and punitive damages as judgment in connection with the Shorecliffs/SCE lawsuit, for which judgment was upheld on appeal.⁴

Apparently not quite satisfied, Fitzsimon subsequently brought suit against O’Keefe and his law firm for malpractice, fraud and spoliation of evidence in connection with the Shorecliffs transactions. In that suit, Fitzsimon sought the notes O’Keefe made at the June 28, 1989, meeting with Spence and Johnston. Fitzsimon argued that any privilege protecting the notes had been waived as a result of O’Keefe’s participation in the proceedings regarding Shorecliffs, in which O’Keefe provided deposition and trial testimony. Fitzsimon further argued that the crime-fraud exception to the attorney-client privilege would allow for discov-

Implied waiver is a more complicated matter. The implied waiver doctrine broadly refers to the situation where privilege waiver is not intended by the client, but nonetheless is deemed to have occurred ... by a court.

which he intended to rely as a defense to the fraud penalty would improperly deny the government the ability to seek vital evidence it needed to challenge the taxpayer’s affirmative defense. This article examines the implied waiver doctrine as applied in *Johnston*.

*T.E. Johnston— Background Facts*³

In the mid-1970s, Thomas E. Johnston (“Johnston”) participated in real estate development ventures through a wholly-owned corporation named Sea-Aire Properties, Inc. (“Sea-Aire”). In one venture, Sea-Aire became a partner in a limited partnership named Estrella Properties, Ltd. (“Estrella”), established to develop property in California. From June 30, 1978, through March 30, 1989, Estrella had three other partners: Shannon Developers, Inc. (“Shannon”), wholly-owned by an individual, Darrel S. Spence; Leo A. Fitzsimon (“Fitzsimon”); and Borg-Warner Equity Corporation (“Borg”). On March 30, 1989, as a result of Borg’s apparent disappointment with Estrella’s operations, the four partners agreed to dispose of or oth-

ery of the notes, on the ground that O'Keefe participated in a scheme to defraud Fitzsimon of his interest in Shorecliffs.⁵ However, the California trial court rejected these arguments and held that the notes were protected from discovery by the attorney-client privilege, a ruling upheld by the California appellate court.⁶

Johnston's Tax Court Privilege Dispute

The above events set the background for *Johnston's* Tax Court dispute. Johnston apparently failed to report the Shorecliffs sale on his 1989 return, either original or as amended, and the IRS issued a statutory notice of deficiency determining that his failure to report the transaction (with the attendant underpayment of tax) was fraudulent and subject to penalty under Code Sec. 6663.⁷ Johnston filed a Tax Court petition challenging the notice of deficiency and the IRS, in its answer, set forth facts supporting its fraud determination.⁸

In replying to the IRS's fraud allegation, Johnston claimed in pleadings and other papers before the court that his 1989 return positions were prepared in good faith based upon the advice of qualified experts. This is an understandable affirmative defense. The fraud penalty is not imposed with respect to an underpayment of tax (or portion thereof) if a taxpayer can show that there was reasonable cause for such underpayment and that he acted in good faith with regard to the return position.⁹ Thus, a taxpayer's good faith reliance on the advice of his attorney, accountant or other professional may be a defense to fraud.¹⁰

In developing its fraud case against Johnston, the IRS, like

Fitzsimon, wanted to obtain evidence from O'Keefe, including O'Keefe's attorney notes from the June 28, 1989, meeting among O'Keefe, Spence and Johnston dealing with the sale of the Shorecliffs golf course. The IRS filed a pre-trial motion in limine, arguing that Johnston should not be entitled to assert the attorney-client privilege to prevent disclosure of the notes or testimony about the notes at trial. The IRS raised three grounds as to why privilege should not apply to O'Keefe's notes. Two of the arguments were identical to Fitzsimon's positions in his California law suit against O'Keefe and his law firm, *i.e.*, that O'Keefe's deposition and trial testimony in the state court proceedings regarding Shorecliffs resulted in privilege waiver or that the crime-fraud exception negated any privilege protection. The Tax Court never addressed those arguments, however, because the IRS succeeded with a different position.

Applying the doctrine of implied waiver, the Tax Court held that Johnston waived the attorney-client privilege over his communications with O'Keefe, including the notes, by asserting good faith reliance on qualified experts (one of whom was O'Keefe, the court concluded)¹¹ as an affirmative defense to the IRS's fraud penalty determination. In reaching this conclusion, the Tax Court identified several approaches used by courts in examining the implied waiver of privilege, and followed the approach set forth in *J. Hearn v. B.J. Rhay*,¹² a leading case on implied privilege waiver. As dis-

cussed below, the court's analysis in *Johnston* is consistent with case law admonishing that privilege claims seeking to wield the privilege as both a sword and a shield are not favored.¹³

Attorney-Client Privilege Basics

The attorney-client privilege generally protects from compelled disclosure communications between attorneys and their clients made for the purpose of obtaining or imparting legal advice or assistance.¹⁴ The privilege is intended to foster "full and frank communication between attorneys and their clients and thereby

As one might expect from a facts-and-circumstances-based doctrine, courts have not established a uniform standard for determining whether the attorney-client privilege should be lost through implied waiver.

promote broader public interests in the observance of law and the administration of justice."¹⁵ A classic formulation of the privilege provides that:

(1) Where legal advice of any kind is sought (2) from a professional legal advisor in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal advisor, (8) except the protection be waived.¹⁶

The attorney-client privilege recognizes that a lawyer's first step in resolving a legal problem "is ascertaining the factual background

its officers and directors."²³ The power to assert (or waive) privilege passes to new management and former management is un-

Although the automatic waiver approach has been adopted by other courts, it is understandably criticized as being too rigid in its approach to resolving implied waiver issues.

able to assert (or waive) the privilege against the wishes of new management.²⁴ Waiver of the attorney-client privilege may be express or implied. The privilege is expressly waived when the client knowingly provides privileged information to a party outside the privileged relationship.²⁵ The privilege "evaporates upon any voluntary disclosure of confidential information."²⁶ Voluntary disclosure may result in waiver of not just the communications disclosed, but of all privileged communications on the same subject matter.²⁷

and sifting through the facts with an eye to the legally relevant."¹⁷ When the client sits down with the lawyer for the purpose of seeking legal representation and the lawyer takes notes, those notes may be protected from disclosure by the attorney-client privilege.¹⁸ Of course, it is well established that "the privilege only protects disclosure of communications [and] does not protect disclosure of the underlying facts by those who communicated with the attorney."¹⁹

Implied waiver is a more complicated matter. The implied waiver doctrine broadly refers to the situation where privilege waiver is not intended by the client, but nonetheless is deemed to have occurred (is "implied") by a court. The doctrine is an application of a "fairness" principle to privilege claims.²⁸ That is, where the facts and circumstances of a case suggest that the party claiming the attorney-client privilege may be claiming it in a manner inconsistent with the traditional purposes underlying the attorney-client privilege, waiver may be deemed.²⁹ For example, waiver may be implied where a privilege holder selectively discloses privileged information in an effort to obtain gain an advantage in litigation.³⁰ Waiver also may be implied, as the discussion below of the Tax Court's

opinion in *Johnston* shows, where the privilege holder asserts a claim which requires an examination of privileged communications in order for the opposing party to be able to prove or disprove the claim.³¹

As one might expect from a facts-and-circumstances-based doctrine, courts have not established a uniform standard for determining whether the attorney-client privilege should be lost through implied waiver. Indeed, case law identifies several approaches to the implied waiver question, including:

- an automatic waiver rule;
- a balancing test;
- the three-pronged test set forth in *Hearn v. Rhay*; and
- the restrictive test set forth in *Rhone-Poulenc Rorer, Inc. v. Home Indemnity Co.*³²

Each of these approaches to applying the implied waiver doctrine is discussed in turn below.

The Automatic Waiver Rule

Under the so-called automatic waiver rule, a litigant's mere assertion of a claim, counterclaim or affirmative defense raising an issue in litigation results in the waiver of privilege over communications related to the issue.³³ The party seeking relief, in effect, "waives whatever privilege he has" when he brings his position to court.³⁴ The underlying rationale for the automatic waiver approach seems to be the view that it provides a level playing field for litigants. In *Independent Productions Corp. v. Loew's, Inc.*, a leading case on automatic waiver, the court explained that "[i]t would be uneven justice" to allow litigants to come into court seeking redress, yet withhold information which may lead to or materially aid in a valid defense

The attorney-client privilege applies whether the client is an individual or a corporation.²⁰ Within a corporate structure, the attorney-client privilege applies to protect privileged communications shared among a parent corporation, subsidiaries and affiliates; all such entities are considered to be the "client" for privilege purposes.²¹

Privilege Waiver

When the privilege attaches to an attorney-client communication, it belongs solely to the client and may only be waived by the client.²² In the case of a solvent corporation, the authority to waive the attorney-client privilege "rests with the corporation's management and is normally exercised by

CCH INCORPORATED

on the basis of privilege.³⁵ In that case, the plaintiffs brought a private anti-trust lawsuit and subsequently refused to answer questions posed by the defendants in pre-trial depositions on the grounds of First Amendment testimonial privilege. Analogizing to attorney-client privilege principles, the court expressed its view that, regardless of the plaintiffs' intention, they must be deemed to have waived their assumed privilege, since they "initiated the action and forced defendants into court."³⁶ Although the automatic waiver approach has been adopted by other courts,³⁷ it is understandably criticized as being too rigid in its approach to resolving implied waiver issues. Privilege issues "involve subtle and sensitive questions that should not be summarily ignored without a more penetrating analysis."³⁸ The automatic waiver rule, which precludes any consideration of the parties' relative interests involved in the privilege dispute, may "lead to needlessly harsh results."³⁹ The Tax Court has effectively acknowledged the harshness of the automatic waiver approach; it is the court's settled position that the mere filing of a petition raising a claim, without more, does not result in the waiver of privilege.⁴⁰

Balancing Test

This approach to implied waiver weighs a litigant's privilege claim against an opposing party's need for discovery of the privileged communication in order to present its case. This approach begins with a presumption in favor of preserving privilege, but acknowledges that "privilege ends" where the opposing party can show that the claims he must

defend against are entwined with important evidence that will be unavailable if privilege is maintained.⁴¹ The balancing test has been explained as requiring the party seeking the privileged information to show both (1) that the communications sought are relevant to his case; and (2) that it would be "unreasonably difficult" to obtain the information contained in the communications elsewhere or that duplicative evidence will be helpful to the case.⁴² The balancing test has been criticized as having a "lack of concreteness" or for being applied without an adequately articulated standard.⁴³

Hearn v. Rhay

Under the approach of *Hearn v. Rhay*, implied waiver of the attorney-client privilege occurs when, after examining the facts and circumstances, a court is satisfied that each of the following three conditions exists:

- A party asserted privilege as a result of some affirmative act it took, such as filing a law suit.
- As a result of the affirmative act (such as filing the law suit) the party claiming privilege put the privilege communications in issue by making them relevant to the case.
- Maintaining the privilege would deny the opposing party access to information vital to its defense in the case.⁴⁴

Thus, the *Hearn v. Rhay* approach focuses on action taken by a litigant that placed the privileged communications in issue in the case and whether the opposing party can defend its position without the privileged information. The mere fact that a privileged communication is relevant to issues raised in a case does not make a privileged communication discov-

erable.⁴⁵ Similarly, if privileged information is only one of multiple sources of indirect evidence available to an opposing party, then the privileged information may not be "vital" to the opposing party's ability to present its case.⁴⁶ There is no specific test for determining whether information is considered vital, but case law strongly suggests that information is vital if the opposing party has no alternative to obtain it but from the privileged communication.⁴⁷ The overarching consideration of the *Hearn v. Rhay* approach to implied waiver is whether it would be "manifestly unfair" to the opposing party to sustain the privilege under the facts and circumstances.⁴⁸

Rhone-Poulenc Restrictive Test

The restrictive approach to implied waiver set forth in *Rhone-Poulenc Rorer, Inc. v. Home Indemnity Co.*⁴⁹ is a rejection of the other three approaches.

As described above, the other approaches to applying implied waiver focus on whether a position involving privileged information has been raised in litigation, the relevancy of the privileged information to the case, and the opposing party's need for such information to prepare its case. In *Rhone-Poulenc*, the court set forth a more restrictive standard, concluding that a privileged communication's relevance to a claim should not be a factor in determining whether the privilege should be waived, even if the communication is vital, highly probative, directly relevant or even goes to the core of an issue.⁵⁰ The court's rationale was that focusing on relevance or an opposing party's need for information misapprehends and undermines the traditional purpose of privilege, *i.e.*, "to assure a

client that he or she can consult with counsel in confidence.”⁵¹ Under *Rhone-Poulenc’s* restrictive test, implied waiver may result if, and only if, a party injects a privileged communication into the case which is an essential element bearing on the claim in issue.⁵²

In *Rhone-Poulenc*, the plaintiff (Rhone) filed an action for declaratory judgment seeking to establish insurance coverage for claims being made against it related to the transmission of HIV through one of its products. A seminal issue in the case was whether Rhone knew that a particular blood product was causing the transmission of HIV before it acquired the insurance regarding the product.

Pursuing an affirmative defense in litigation of good faith, reliance on the advice of counsel may well result in the implied waiver of the attorney-client privilege over the legal advice given.

Although Rhone had gathered facts about the issue prior to acquiring insurance and sought legal advice regarding the facts, the court concluded that Rhone was not relying on the legal advice it received to support its declaratory judgment action, and had not injected the advice of its counsel as an essential element of its case. Accordingly, the court held that the attorney-client privilege was not impliedly waived. In rejecting implied waiver in *Rhone-Poulenc*, the Third Circuit thus explained that “[a]dvice is not in issue merely because it is relevant, and does not necessarily become at issue merely because the attorney’s advice might affect the client’s state of mind in a relevant

manner. The advice of counsel is placed in issue where the client asserts a claim or defense, and attempts to prove that claim or defense by disclosing or describing an attorney-client communication.”⁵³

The Tax Court’s Application of Implied Waiver in *Johnston*

In ruling that the implied waiver doctrine negated privilege protection over O’Keefe’s attorney noted in *Johnston*, the Tax Court applied the three-pronged approach of *Hearn v. Rhay*. The court explained that *Hearn v. Rhay* had been discussed with approval by the United States District Court for the District of Columbia⁵⁴ and had been expressly adopted by the United States Court of

Appeals for the Ninth Circuit, the venue for any appeal of Johnston’s Tax Court case.⁵⁵ The court also noted that it had previously favorably cited *Hearn v. Rhay*.⁵⁶

In *Hearn v. Rhay*, a prisoner (Hearn) sued prison officials for allegedly violating his civil rights for twice placing him in solitary confinement in the mental ward of a state penitentiary without first holding a hearing or other form of due process review. In response to the suit, the prison officials pleaded an affirmative defense of qualified immunity, contending that they acted in good faith by obtaining legal counsel before acting upon the prisoner.⁵⁷ The prison officials also claimed that

the legal advice they received was protected from disclosure by the attorney-client privilege. In those circumstances, the court in *Hearn v. Rhay* concluded that each of the three elements of implied waiver existed, and, therefore, the prison officials waived their right to assert the attorney-client privilege. First, the court found that the prison officials’ assertion of privilege was related to their claimed defense of good faith reliance on counsel, and therefore occurred as a result of their own affirmative act in the case. The court further concluded that since the substance of the legal advice the prison guards received was germane to their affirmative defense, claiming the affirmative defense had the effect of placing the privileged information at issue. Finally, the court concluded that the privileged information was vital to the plaintiff’s case, since it impacted the plaintiff’s ability to meet his burden of proof of establishing that the prison officials acted with malice or otherwise unreasonably disregarded his constitutional rights.⁵⁸

In applying the implied waiver approach of *Hearn v. Rhay* in *Johnston*, the Tax Court concluded that Johnston clearly claimed and argued in filings before the court that he relied on the “advice of qualified experts” in connection with the positions taken on his 1989 tax return. Although Mr. Johnston tried to persuade the court that his references to “qualified experts” referred to an accountant who assisted him with filing his tax returns and not O’Keefe, the court found Johnston’s argument unavailing. The Tax Court concluded that O’Keefe was one of the experts Johnston relied upon in support of his 1989 return. The court pointed

to statements Johnston made in filings before the court referring to O'Keefe as his tax counsel rendering advice over many years, and in particular in 1989 when the Shorecliffs matters later at issue in the Fitzsimon trial were ongoing.⁵⁹ The court also focused on the text of a legal fees billing entry prepared by Mr. O'Keefe for June 28, 1989, the precise date of the notes subject to the privilege claim. That billing entry described a meeting among Johnston, Spence and O'Keefe regarding Shorecliffs and referencing various items, including tax research and strategy planning regarding basis, installment and exchange issues.⁶⁰ These facts persuaded the Tax Court that Johnston had asserted privilege in furtherance of an affirmative defense he raised (relying on advice he received from O'Keefe), satisfying the first element of implied waiver under *Hearn v. Rhay*.⁶¹

The Tax Court further found that by asserting privilege over O'Keefe's June 28, 1989, notes as an affirmative act, Johnston placed the privileged communications with O'Keefe at issue by making the communications relevant to the case.⁶² In reaching this conclusion, the Tax Court noted that Johnston admitted that he received tax advice from O'Keefe in 1989, and further noted that the California appellate court found substantial evidence that O'Keefe was hired to render tax advice and research tax liability issues for Johnston. The Tax Court thus concluded that since Johnston was relying on legal advice he received from O'Keefe as a defense to fraud, that legal advice was at issue in the case.⁶³

Finally, the Tax Court concluded that it would be manifestly unfair to the IRS to allow Johnston to maintain privilege over O'Keefe's

attorney notes after Johnston placed the privileged communications in issue by claiming good faith reliance on experts as a defense to the alleged fraud penalties. The court explained that in order for the IRS to refute Johnston's affirmative defense, it must show that such reliance was unreasonable or did not actually occur. The court concluded that the IRS could satisfy its burden of proof "only through knowledge of what tax advice Mr. Johnston received," which included communications from O'Keefe.⁶⁴ The court further admonished that maintaining privilege over O'Keefe's communications would unfairly allow Johnston to selectively disclose information from particular experts, since the court previously had concluded that Johnston's affirmative defense contemplated good faith reliance on other experts besides O'Keefe. The court observed that the IRS would be prejudiced if Johnston were allowed to disclose only some of the expert advice he received regarding his 1989 tax return (which the court presumed would not be advice detrimental to Johnston's position).⁶⁵

In denying Johnston the opportunity to maintain his privilege claim, the Tax Court acted consistent with an established body of case law holding that an affirmative defense premised on reasonable or good faith reliance on the advice of counsel results in the implied waiver of privilege.

A good case illustration cited in *Johnston* is *Chevron Corp. v. Pennzoil*.⁶⁶ Pennzoil had been acquiring significant amounts of Chevron stock as part of a strategy to take advantage of the tax deferral provisions of Code Sec. 1033. Although Pennzoil disclaimed in an SEC filing any intent to exert control over Chevron management through its stock

purchases, Chevron sued Pennzoil to enjoin it from acquiring additional stock on the basis that Pennzoil's SEC disclaimer was misleading or not made in good faith. In response, Pennzoil argued that its SEC filing was submitted in good faith based on tax advice it received from its legal counsel that control of Chevron management was not necessary for Pennzoil to achieve Code Sec. 1033 tax deferral.⁶⁷ In challenging Pennzoil's affirmative defense, Chevron intended to argue that Pennzoil could not secure its tax deferral without representation on Chevron's board. In discovery, Chevron sought written materials from Pennzoil supporting Pennzoil's belief that its Code Sec. 1033 position was reasonable and sound. Pennzoil refused to provide any such documents, arguing that its tax position was protected from disclosure by the attorney-client privilege.⁶⁸ Chevron defeated Pennzoil's privilege claim. The Ninth Circuit held that Pennzoil waived the privilege by using the advice of counsel both as a "sword" to defeat Chevron's tax arguments and as a "shield" to protect the advice from disclosure. The court explained that by claiming that its tax position was reasonable because it was based on the advice of counsel, Pennzoil put the advice at issue in the case, and that privilege over the advice must be deemed waived because Chevron needed access to that very advice in order to demonstrate that Pennzoil's SEC filing was misleading.⁶⁹

In another example, the Second Circuit similarly analyzed the implied waiver doctrine in the context of the defense of good faith reliance on the advice of counsel in *P.A. Bilzerian*.⁷⁰ In that case, the defendant in a securities

fraud prosecution intended to argue at trial that he lacked criminal intent because he discussed his alleged fraudulent securities transactions with his attorney prior to engaging in them, and believed that the transactions were legal. In a motion in limine at trial, the defendant asked the court to rule that he could testify as to his belief in the lawfulness of his transactions without waiving his privileged attorney-client communications. The trial court denied the defendant's motion, holding that the privilege application would depend upon the substance of the defendant's testimony. The defendant refused to testify. On appeal, the Second Circuit explained that

testimony from the defendant that he believed his actions were legal "would have put his knowledge of the law and the basis for his understanding of what the law required in issue. His conversations with counsel regarding the legality of his schemes would have been directly relevant in determining the extent of his knowledge and, as a result, his intent."⁷¹

Conclusion

Johnston highlights an important practice point: Pursuing an affirmative defense in litigation of good faith, reliance on the advice of counsel may well result in the implied

waiver of the attorney-client privilege over the legal advice given. Tax advisors and clients both emphasize the importance of privilege in their dealings. It is important, however, to keep in mind that the privilege is not intended to be used as both a sword and a shield. For strategic reasons, a client may be faced with the situation of asserting a claim or defense that injects privileged advice into litigation. Tax advisors and clients need to understand that if the claim or defense is raised that "can only be effectively disproven through the discovery of attorney-client communications,"⁷² the cost of pursuing that claim or defense is likely to be the privileged communications.

ENDNOTES

* The authors thank their associate, Alfonso Canela, for his thoughtful research assistance in the preparation of this article.

¹ *T.E. Johnston*, 119 TC —, No. 3, (Aug. 8, 2002). Specific page cites to *Johnston* in this article are to the Tax Court's slip opinion, which is available on the court's Web site at www.ustaxcourt.gov/InOpHistoric/Johnston.TC.WPD.pdf.

² All references to "Code" or "section" refer to the Internal Revenue Code of 1986 as amended, unless otherwise specified.

³ Since the Tax Court's opinion in *Johnston* addressed pre-trial motions, the facts stated in the court's opinion were not factual findings for purposes of adjudicating the substantive tax issues before the court. Rather, the stated facts were intended to provide context for the court's analysis of the motions before it, taken from pleadings, moving papers, responses and attachments filed with the court. The court noted that none of the stated facts appeared to be in dispute. *Johnston*, *supra* note 1, at 3.

⁴ See *L.A. Fitzsimon v. S.C. Equestrian Lots, Ltd.*, No. G018290 (Cal. Ct. App. filed May 25, 1999), *aff'g*, No. 704870 (Cal. Super. Ct.). The appellate court opinion is unpublished.

⁵ Under the crime-fraud exception to the attorney-client privilege, the privilege does not apply to any communications "made for the purpose of getting advice for the commission of a fraud or crime." *F.S. Zolin*, SCt, 89-1 USTC ¶9380, 491 US 554, 109 SCt 2619.

⁶ See *L.A. Fitzsimon v. Good, Wildman, Hegness & Walley*, No. G020125 (Cal. Ct. App. filed Aug. 24, 1999), *aff'g*, No. 733226

(Cal. Super. Ct.). The appellate court opinion is unpublished and the Supreme Court of California denied Fitzsimon's petition for review. *L.A. Fitzsimon v. Good, Wildman, Hegness & Walley*, No. S082444, 1999 Cal. LEXIS 7950 (S.Ct. Cal. filed Nov. 10, 1999).

⁷ The civil fraud penalty is imposed on any part of any underpayment of tax attributable to fraud. Code Sec. 6663(a). The IRS bears the burden of establishing a taxpayer's fraudulent intent by clear and convincing evidence. Code Sec. 7454(a); Rule 142(b), Tax Court Rules of Practice and Procedure. In *Johnston*, at 17, the IRS also determined that Johnston fraudulently understated taxable income related to understatements of tax in 1991 and 1992, although it is unclear from the opinion what the determination relates to for those years.

⁸ Rule 36(b), Tax Court Rules of Practice and Procedure, specifies that "the answer shall contain a clear and concise statement of every ground, together with the facts in support thereof on which the Commissioner relies and has the burden of proof."

⁹ Code Sec. 6664(c).

¹⁰ See *R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 250-51, 105 SCt 687; *E.S. Spruill Est.*, 88 TC 1197, 1245, Dec. 43,904 (1987); *J. Marinzulich*, 31 TC 487, 490, Dec. 23,261 (1958).

¹¹ *Johnston*, *supra* note 1, at 17-23.

¹² *J. Hearn v. B.J. Rhay*, DC Wash., 68 FRD 574 (1975).

¹³ *Columbia Pictures Ind., Inc. v. Krypton Broadcasting of Birmingham, Inc.*, CA-9, 259 F3d 1186, 1196 (2001); *Chevron Corp. v. Pennzoil*

Co., CA-9, 974 F2d 1156, 1162 (1992); *P.A. Bilzerian*, CA-2, 926 F2d 1285, 1292 (1991).

¹⁴ *Upjohn Co.*, SCt, 81-1 USTC ¶9138, 449 US 383, 389, 101 SCt 677.

¹⁵ *Upjohn*, 449 US, at 389. These policy considerations are so significant that the attorney-client privilege generally continues after death. *Swidler & Berlin*, SCt, 524 US 399, 407, 118 SCt 2081 (1998). ("Knowing that communications will remain confidential even after death encourages the client to communicate fully and frankly with counsel.")

¹⁶ *J.J. Evans*, CA-7, 113 F3d 1457, 1461 (1997) (quoting JOHN H. WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW, §2292 (§§ 2175-2396, Vol. VIII) (Rev. Ed. 1961)). While there is no federal common law accountant-client privilege, recently enacted Code Sec. 7525 established a statutory privilege protecting certain communications made on or after July 22, 1998, between taxpayers and tax advisors authorized to practice before the IRS under Circular 230. Since the statutory tax advisor privilege exists only "to the extent" of the attorney-client privilege (Code Sec. 7525(a)(1)), the common law doctrine of implied waiver addressed herein presumably applies equally to the statutory privilege.

¹⁷ *Upjohn*, *supra* note 14, 449 US, at 390-91.

¹⁸ *Swidler & Berlin*, *supra* note 15 (attorney's handwritten notes taken during a two-hour meeting with client were privileged).

¹⁹ *Upjohn*, *supra* note 14, 449 US, at 395-96 ("The client cannot be compelled to answer

ENDNOTES

- the question “What did you say or write to the attorney?” but may not refuse to disclose any relevant fact within his knowledge merely because he incorporated a statement of such fact into his communication to his attorney”) (quoting *City of Philadelphia Pa. v. Westinghouse Elec. Corp.*, DC Pa., 205 FSupp 830, 831 (1962)); *Saba Partnership*, 78 TCM 684, Dec. 53,604(M), TC Memo. 1999-359, *vac’d and rem’d on other grounds*, CA-DC, 2002-1 USTC ¶50,145, 273 F3d 1135.
- ²⁰ *Commodity Futures Trading Commission v. Weintraub et al.*, S Ct, 471 US 343, 348, 105 S Ct 1986 (1985); *S. Fisher*, S Ct, 76-1 USTC ¶9353, 425 US 391, 403, 96 S Ct 1569.
- ²¹ *Mobil Corp.*, DC Tex., 93-1 USTC ¶50,335, 149 FRD 533, 538; *United Technologies Corp.*, DC Conn., 979 FSupp 108, 112–14 (1997); *Fox v. Massey-Ferguson, Inc.*, DC Mich., 172 FRD 653, 670 (1995); *cf. AT&T, DC D.C.*, 86 FRD 603 (1979) (minority-owned subsidiaries excluded from privileged group of affiliated corporations for privilege purposes).
- ²² *In re C.V. Bulow*, CA-2, 828 F2d 94, 100 (1987); *Cox v. Administrator United States Steel & Carnegie*, CA-11, 17 F3d 1386, 1417 (1994). However, while the attorney may not waive privilege without the client’s authority, that authority may be implied by the client’s actions. In *C.V. Bulow*, the court concluded that Bulow implicitly consented to his attorney’s disclosure of confidential communications by acquiescing in and encouraging the publication of the book *REVERSAL OF FORTUNE*, written by his attorney. 828 F2d, at 100–102. *But see S. Schnall v. M.E. Schnall*, DC N.Y., 550 FSupp 650, 653 (1982), where the court held that privilege was not waived when the client’s attorney testified at an SEC hearing without his client’s authorization.
- ²³ *Weintraub*, *supra* note 20, 471 US, at 338–49. It is possible, however, for a corporate officer testifying before a grand jury to be deemed to waive privilege on behalf of the company even though the company expressly asserted privilege to government counsel. *See In re Grand Jury Proceedings*, CA-2, 219 F3d 175 (2000). For a corporation in bankruptcy proceedings where a trustee has been appointed, *Weintraub* held that the power to exercise or waive the attorney-client privilege passes to the trustee, whose function closely relates to the role management exercises outside bankruptcy. 471 US, at 354.
- ²⁴ Former officers retain no control over privilege even as to statements made to counsel on matters within the scope of their corporate functions. *Weintraub*, *supra* note 20, 471 US, at 349; *Diversified Industries, Inc. v. Meredith*, CA-8, 572 F2d 596, 611, note 5 (1978).
- ²⁵ *In re Sealed Case*, CA-DC, 82-1 USTC ¶9335, 676 F2d 793, 818; *AT&T*, CA-DC, 206 U.S. App. D.C. 317, 642 F2d 1285, 1299 (1980).
- ²⁶ *Carter v. Gibbs*, CA-FC, 909 F2d 1452, 1458 (1990), *cert. denied*, S Ct, 498 US 811 (1990); *see also B.C. Bernardo*, 104 TC 677, 684, Dec. 50,705 (1995); *Hartz Mountain Ind.*, 93 TC 521, 526, Dec. 46,126 (1989).
- ²⁷ *Chevron Corp. v. Pennzoil Co.*, *supra* note 13, at 1162–1163; *R.V. Jones, Jr.*, CA-4, 696 F2d 1069, 1072 (1982); *Weil v. Investment Indicators, Research Management*, CA-9, 647 F2d 18, 25 (1981); *Hartz Mountain Ind.*, *id.*, 93 TC, at 521.
- ²⁸ WIGMORE, *supra* note 16, §2327, at 636.
- ²⁹ *In re Sealed Case*, *supra* note 25, 676 F2d, at 818.
- ³⁰ *Id.*
- ³¹ *See, e.g., Ideal Elec. Sec. Co. v. Int’l Fid. Ins. Co.*, CA-DC, 129 F3d 143 (1997), where implied waiver resulted when the plaintiff sued the defendant for reimbursement of attorneys fees under an indemnification agreement and submitted attorney-redacted billing statements as proof of fees incurred, asserting attorney-client privilege. The court held that the redacted portions of the fee statements had to be disclosed in order for the defendant to be able to fairly challenge the reasonableness of the fees incurred.
- ³² *Rhone-Poulenc Rorer, Inc. v. Home Indemnity Co.*, CA-3, 32 F3d 851 (1994).
- ³³ *Independent Productions Corp. v. Loew’s, Inc.*, DC N.Y., 22 FRD 266 (1958).
- ³⁴ *Zenith Radio Corp.*, CA-FC, 764 F2d 1577, 1579 (1985).
- ³⁵ *Independent Productions Corp.*, *supra* note 33, 22 FRD, at 276.
- ³⁶ *Id.*, at 276–77.
- ³⁷ *See J.A. Lyons v. W.R. Johnson*, CA-9, 415 F2d 540, 542 (1969), *cert. denied*, S Ct, 397 US 1027 (1970); *Ghana Supply Comm’n v. New England Power Co.*, DC Mass., 83 FRD 586, 593–94 (1979).
- ³⁸ *FDIC v. Wise*, DC Colo., 139 FRD 168, 171 (1991).
- ³⁹ *Id.*
- ⁴⁰ *Bernardo*, *supra* note 26, 104 TC 677, 691 (1995) (implied waiver did not occur where the taxpayers had not affirmatively raised a claim “that can only be effectively disproven through the discovery of attorney-client communications”).
- ⁴¹ *Greater Newburyport Clamshell Alliance v. Public Service Co. of N.H.*, CA-1, 838 F2d 13, 20 (1994); *see Black Panther Party v. Smith*, CA-DC, 661 F2d 1243, 1266–68 (1981), *vac’d without opinion*, S Ct, 458 US 1118 (1982).
- ⁴² *Greater Newburyport Clamshell, id.*, 838 F2d, at 22.
- ⁴³ *FDIC v. Wise*, *supra* note 38, 139 FRD, at 171.
- ⁴⁴ *J. Hearn*, *supra* note 12.
- ⁴⁵ *Amlani*, CA-9, 169 F3d 1189, 1195 (1999); *Zenith Radio Corp.*, CA-FC, 764 F2d 1577, 1580–81 (1985).
- ⁴⁶ *Amlani, id.*, 169 F3d, at 1195.
- ⁴⁷ *Frontier Refining, Inc. v. Commercial Union Assurance Co.*, CA-10, 136 F3d 695, 701–702 (1998); *Amlani, id.*, 169 F3d, at 1195; *Home Indemnity Co. v. Lane Powell Moss and Miller*, CA-9, 43 F3d 1322, 1326–27 (1995); *Exxon Corp.*, DC D.C., 94 FRD 246, 249 (1981); *Johnston*, *supra* note 1, at 22–3. *But see Koppers Co., Inc. v. Aetna Casualty and Sur. Co.*, DC Pa., 847 FSupp 360, 363 (1994), arguing that *J. Hearn*’s third factor is vague and overbroad since “reasonable minds” may differ over what is vital information.
- ⁴⁸ *Home Indemnity Co. v. Lane Powell Moss and Miller, id.* (privilege maintained; implied waiver not warranted).
- ⁴⁹ *Rhone-Poulenc Rorer, Inc. v. Home Indemnity Co.*, *supra* note 32.
- ⁵⁰ *Id.*, at 863–64.
- ⁵¹ *Id.*
- ⁵² *Id. See Frontier Refining, Inc. v. Gorman-Rupp Co.*, CA-10, 136 F3d 695, 699–700 (1998). The approach of *Rhone-Poulenc* has been followed in other jurisdictions. *See, e.g., Cincinnati Insurance Co. v. Zurich Insurance Co.*, DC N.C., 198 FRD 81 (2000).
- ⁵³ *Rhone-Poulenc*, *supra* note 32, 32 F3d, at 863.
- ⁵⁴ *See* Code Sec. 7453 and Rule 143(a), Tax Court Rules of Practice and Procedure, which direct that Tax Court proceedings are to be conducted pursuant to evidentiary rules applicable in nonjury trials in the U.S. District Court for the District of Columbia, *i.e.*, the Federal Rules of Evidence (FRE). Rule 501 of the FRE addresses attorney-client privilege issues. *See also Clarke v. Am. Commerce Nat’l Bank*, CA-9, 974 F2d 127, 129 (1992); *Mass. Inst. of Technology*, CA-1, 97-2 USTC ¶50,955, 129 F3d 681.
- ⁵⁵ *See Amlani*, *supra* note 45, at 1195.
- ⁵⁶ *A.B. Karne*, 73 TC 1163, 1184, Dec. 36,843 (1980), *aff’d*, CA-9, 82-1 USTC ¶9316, 673 F2d 1062. Without discussion, the court also stated that, in its view of the facts in *Johnston*, the implied waiver doctrine also would apply to force disclosure of O’Keefe’s attorney notes under the automatic waiver rule, the balancing test or the more restrictive approach of *Rhone-Poulenc*. *Johnston*, *supra* note 1, at 15. Presumably this is so because the Tax Court’s conclusions that *Johnston* injected the privileged communications from O’Keefe into the case and that the substance of the communications are an essential element bearing on *Johnston*’s affirmative defense would seem to satisfy the restrictive ap-

proach to implied waiver set forth in *Rhone-Poulenc*.

⁵⁷ *J. Hearn, supra* note 12, at 577–78.

⁵⁸ *Id.*, at 581.

⁵⁹ *Johnston, supra* note 1, at 18–19.

⁶⁰ *Id.*, at 19.

⁶¹ *Id.*, at 19–20.

⁶² *Id.*, at 20.

⁶³ *Id.*, at 20–21.

⁶⁴ *Id.*, at 22.

⁶⁵ *Id.*, at 23.

⁶⁶ *Chevron Corp. v. Pennzoil, supra* note 13.

⁶⁷ *Id.*, at 1157.

⁶⁸ *Id.*, at 1162.

⁶⁹ *Id.* See also *A.J. Mierzwicki*, DC Md., 500 FSupp 1331, 1335 (1980) (Fairness de-

manded treating defendant's argument that he filed amended returns based on the advice of counsel as a waiver of the attorney-client privilege with regard to that advice).

⁷⁰ *Bilzerian, supra* note 13.

⁷¹ *Id.*

⁷² *Johnston, supra* note 1, at 16.

This article is reprinted with the publisher's permission from the JOURNAL OF TAXATION OF CORPORATE TRANSACTIONS, a bi-monthly journal published by **CCH INCORPORATED**. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF TAXATION OF CORPORATE TRANSACTIONS or other **CCH** Journals please call 800-449-8114 or visit www.tax.cchgroup.com.

