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A TRIBUTE TO PROFESSOR JOSEPH W. M^cKNIGHT: SHADES OF THE HIGHWAYMAN'S CASE IN THE 21ST CENTURY

*Christopher H. Hanna**

I. INTRODUCTION

PROFESSOR Joseph W. M^cKnight has been a wonderful friend and colleague to me over the last several years. I think this is due in large part to our mutual love of restoring old books and visiting England. In fact, we sometimes combine our mutual interests by visiting bookstores in London that specialize in old books and then restoring the books upon our return to Dallas.

When I was in law school, in class one day, one of my professors mentioned an old English case that he referred to as *The Highwayman's Case*. He gave us the details of the case, and I was fascinated by it but doubted whether the case really existed. Knowing of Professor M^cKnight's love of anything (especially history) related to England, I asked him about the case, and he told me he was unfamiliar with it but would check on it and get back to me. A couple of days later he gave me several articles describing the case (apparently, it was a real case). I read the articles, and although still fascinated by the case, did not see how a case like *The Highwayman's Case* could possibly arise in this day and age, particularly in my field of tax law. However, I was proven wrong by a recent case involving corporate tax shelters.

Former Secretary of the Treasury Lawrence Summers stated that “[c]ombating abusive [corporate] tax shelters is perhaps the biggest challenge facing our tax administration today.”¹ One of the primary reasons combating abusive corporate tax shelters is so challenging is the lack of information available to the government in terms of the type of tax shelters that are being sold and the identity of the individuals or entities in-

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1. Nicholas Kulish & Tom Herman, *Treasury to Issue Notice to Eliminate New Tax Shelter*, WALL ST. J., Nov. 17, 2000, at A2.

volved in selling, marketing, and participating in the tax shelters.² On February 28, 2000, the Treasury Department released temporary and proposed regulations generally requiring promoters to register confidential corporate tax shelters and to maintain lists of investors.³

In March 2001, the United States District Court for the Southern District of New York issued an opinion in a case involving corporate tax shelters, *Diversified Group, Inc. v. Daugerdas*,⁴ (Daugerdas), that bears some resemblance to The Highwayman's Case although, *unlike The Highwayman's Case, the parties in the tax case were not charged with any crimes and it appears that no crimes were committed*.⁵ In this brief article, I will discuss The Highwayman's Case and then the recent opinion in *Daugerdas*. I think the reader will quickly identify the similarities.

II. THE HIGHWAYMAN'S CASE

The Highwayman's Case is the name generally given to the case of *Everet v. Williams*. The bill was filed in the Equity side of the Exchequer.⁶ John Everet, of the Parish of St. James's, Clerkenwell, and Joseph Williams of Middlesex were the parties. The bill was apparently filed before 1725 but the orders were given in 1725.

The bill recites an oral partnership between the plaintiff (Everet) and the defendant (Williams). The plaintiff was "skill [sic] in dealing, and in buying and selling several sorts of commodities, such as corn, hay, straw, horses, cows, sheep, oxen, hogs, wool, lambs, butter, cheese, plate, rings, watches, canes, swords, and several other commodities."⁷ Pursuant to the oral partnership, the parties "went on and proceeded jointly in the said

2. See generally Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47 (2001) (disclosure of tax shelters and penalties for non-disclosure and failure on the merits may be the appropriate solution to curbing aggressive tax shelters).

3. T.D. 8877, 65 Fed. Reg. 11205 (Mar. 2, 2000); T.D. 8876, 65 Fed. Reg. 11215 (Mar. 2, 2000); T.D. 8875, 65 Fed. Reg. 11211 (Mar. 2, 2000). These regulations have been amended twice since their issuance.

4. 139 F. Supp. 2d 445 (S.D.N.Y. 2001). The Daugerdas case was filed on February 2, 2000, shortly before the release of the temporary and proposed regulations requiring disclosure.

5. The IRS has raised the possibility of criminal sanctions in certain corporate tax shelters. For example, in I.R.S. Notice 2000-44, 2000-36 I.R.B. 255, the IRS describes a transaction in which a taxpayer purchases and writes options and purports to create positive basis in a partnership interest by transferring the option positions to a partnership. The promoters of this transaction take the position that the taxpayer's basis in the partnership interest is increased by the cost of the purchased call options but is not reduced as a result of the partnership's assumption of the taxpayer's obligation with respect to the written call options. As a result, the taxpayer can dispose of the partnership interest and claim a tax loss. The IRS concluded that the loss from this transaction is not a bona fide loss reflecting actual economic consequences and, as a result, is not deductible. The IRS also stated that criminal penalties may be appropriate under the tax code and other provisions of federal law in cases where attempts are made to conceal the transaction through use of a grantor trust and improper netting of the capital gains and losses of the grantor trust are made.

6. The Bill has been reproduced in its entirety at 11 *The European Magazine, and London Review* 360-63 (May 1787) [hereinafter *European Magazine*].

7. *Id.* at 361.

dealings with good success on Hounslow-Heath, where they dealt with a gentleman for a gold watch.”⁸ The bill further recites that the defendant indicated to the plaintiff “that Finchley in the said county of Middlesex was a good and convenient place to deal in . . . and that the said commodities were very plenty at Finchley.”⁹ The defendant noted that if they were to deal in Finchley, “it would be almost all gain to them.”¹⁰ The parties “dealt with several gentlemen for divers watches, rings, swords, canes, hats, cloaks, horses, bridles, saddles, and other things to the value of £200 and upwards.”¹¹ The parties also discussed “a gentleman at Blackheath, who had a good horse, bridle, saddle, watch, sword, cane, and other things to dispose of, all of which . . . they might have for little or no money; . . . in case they could prevail on the said gentlemen to part with the said things.”¹² After “some small discourse” with the said gentleman, the parties obtained the items “at a very cheap rate.”¹³ The bill further recites that the parties’ joint dealings also took place in Bagshot, Salisbury, Hampstead, and other places in amounts up to and in excess of £2,000.¹⁴ The plaintiff alleged that the defendant would not fairly account for the profits of the oral partnership with the plaintiff and, as a result, the plaintiff brought suit against the defendant for an accounting of the profits.¹⁵

On October 3, 1725, upon the motion of counsel for the defendant, the bill was referred for scandal and impertinence.¹⁶ On November 13, the bill was dismissed with costs to be paid by the counsel who signed it.¹⁷ On November 29, the report of the bill as scandalous and impertinent was confirmed, and an order was issued to attach the bodies of William White and William Wreathcock, the solicitors for the plaintiff.¹⁸ On December 6, White and Wreathcock were each fined £50 and committed to the custody of the Warden of the Fleet until the fines were paid.¹⁹ Jonathan Collins, the counsel who signed the bill, was ordered to pay the costs.²⁰ The plaintiff was executed at Tyburn in 1730, and the defendant was executed at Maidstone in 1727.²¹ Wreathcock, one of the solicitors for the plaintiff, was convicted in 1735 of robbing an individual but was reprieved and transported.²²

8. *Id.*

9. *Id.*

10. *Id.*

11. *European Magazine*, *supra* note 6, at 361.

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.* at 362-63.

16. *European Magazine*, *supra* note 6, at 364.

17. Notes, *The Highwayman's Case (Everet v. Williams)*, 9 L.Q.R. 197, 198 (July 1893).

18. *European Magazine*, *supra* note 6, at 364.

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

III. *DIVERSIFIED GROUP, INC. V. DAUGERDAS*²³

Diversified Group, Inc. ("DGI") develops and markets corporate tax shelters.²⁴ It is not a licensed accounting firm nor is it a law firm. Paul Daugerdas is a certified public accountant and licensed attorney in Illinois. A majority of Daugerdas' work involved rendering legal opinions on tax strategies. Prior to 1994, Daugerdas was employed by a national accounting firm. From 1994 to 1998, Daugerdas was a partner in a law firm. He changed law firms in December 1998, to become the head of the structured investment practice at his new firm.²⁵

Daugerdas and James Haber, president of DGI, had known each other for ten years. On several occasions in 1992, Haber sent Daugerdas materials describing various financial products that DGI was marketing. Haber expressed his belief to Daugerdas that the materials would be kept confidential.²⁶

In March 1995, Daugerdas agreed to evaluate a tax strategy developed by DGI involving foreign tax credits.²⁷ Daugerdas signed a confidentiality agreement with DGI. The confidentiality agreement permitted Daugerdas to present the tax strategy to prospective clients as long as those clients signed a confidentiality agreement. If the prospective client decided to utilize the tax strategy, DGI would be fairly compensated.²⁸

In November 1996, Daugerdas and his law firm were engaged by Haber and DGI as its attorneys in connection with commercial, corporate, and federal income tax issues associated with DGI's Alternative Long-Term Financing Strategy ("ALFS").²⁹ This engagement required Daugerdas to maintain the confidentiality of information received from DGI, "except to the extent DGI consented to the contrary, or as necessary to carry out [its] representation or as required by the ethical rules governing lawyers or by applicable law."³⁰ DGI could terminate the relationship at any time and its materials would be returned.³¹

Daugerdas was permitted to introduce the ALFS to other parties. If Daugerdas introduced a prospective client to the ALFS, he was entitled to 50 percent of DGI's net profits on the transaction. If, however, Daugerdas simply gave a tax opinion on an ALFS transaction, he was entitled to only one-half of one percent of the size of the particular transaction.³²

23. 139 F. Supp. 2d 445; a second action filed by Jenkens & Gilchrist, Daugerdas' current employer, against DGI was consolidated with the first action of DGI against Daugerdas.

24. *Id.* at 448.

25. *Id.* at 448-49.

26. *Id.* at 449.

27. *Id.*

28. 139 F. Supp. 2d at 449.

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

At the time of the engagement in November 1996, DGI sent materials to Daugerdas regarding the ALFS. Two months later, Daugerdas sent a letter to Haber detailing his comments on the ALFS. From November 1996 until October 1999, DGI alleged that it acted and communicated with the belief that Daugerdas was its attorney.³³ DGI also alleged that its relationship with Daugerdas “represented a valid contractual understanding” between them.³⁴ Pursuant to this contractual understanding, once Daugerdas evaluated one of DGI’s tax strategies, he was prohibited from marketing that strategy without compensating DGI or obtaining its consent. Any profits that Daugerdas earned were to be shared equally with DGI. In addition, DGI promised to make its clients aware that Daugerdas would give a tax opinion letter on the transaction. Haber contends “the parties’ obligations under this oral contract were reiterated each time a new strategy was developed.”³⁵

The court then describes two different tax strategies utilized by DGI and Daugerdas: (1) the option partnership strategy (“OPS”) and (2) the short-sale strategy.³⁶ Under the OPS, a taxpayer purchases and writes options and transfers these options to a partnership to create a substantial increase in basis in the partnership interest.³⁷ Under the short-sale strategy, a taxpayer “borrows a treasury security, sells the security short, and then contributes the proceeds to a partnership in exchange for a partnership interest.”³⁸ DGI claimed that it developed the OPS in 1998 and that it spent “hundreds of hours of professional time developing it.”³⁹

Haber informed Daugerdas of the OPS sometime in 1998. According to Haber, Daugerdas agreed to help evaluate the OPS from a tax standpoint, and, in addition, “develop and market the strategy in accordance with their prior practice and the terms of the contractual understanding.”⁴⁰ Daugerdas marketed the short-sale strategy from 1991 until October 1999. In October 1999, Congress issued proposed legislation effectively ending the short-sale strategy. As a result, beginning in October 1999, Daugerdas began to utilize the OPS for his clients even though Daugerdas had informed his clients in 1995 or 1996 “that they could substitute options for the short-sale of securities and achieve the same tax result.”⁴¹ Daugerdas “implemented the OPS for the ‘benefit of dozens of clients’ without compensating DGI or obtaining its consent.”⁴²

DGI in its complaint against Daugerdas alleged (1) breach of fiduciary duty, (2) breach of contract, and (3) unjust enrichment.⁴³ Daugerdas

33. 139 F. Supp. 2d at 450.

34. *Id.*

35. *Id.*

36. *Id.* at 450-51.

37. *Id.* at 450. See *supra* note 5 (the OPS appears to be the subject of Notice 2000-44).

38. 139 F. Supp. 2d at 451.

39. *Id.* at 450-51.

40. *Id.* at 451.

41. *Id.* at 451.

42. *Id.*

43. 139 F. Supp. 2d at 447.

moved for summary judgment. The court held that a fact issue existed as to whether DGI provided Daugerdas with confidential information giving rise to an attorney-client relationship and therefore a fiduciary duty.⁴⁴ The court also held that even if the OPS was not a “confidence” or “secret” when disclosed by DGI to Daugerdas, Daugerdas’s use of the materials given him by DGI for evaluation of legal issues in his independent marketing of the OPS could constitute a breach of fiduciary duty.⁴⁵ As a result, the court denied Daugerdas’ motion for summary judgment with respect to DGI’s claim of breach of fiduciary duty. On the second claim of breach of “contractual understanding,” the court held that the claim was barred by New York’s statute of frauds.⁴⁶ On the third claim of “unjust enrichment,” the court held that to the extent that this claim was based on the alleged oral agreement, it was barred by the statute of frauds, and, to the extent that it was based upon Daugerdas alleged breach of fiduciary duties, it was duplicative of that claim.⁴⁷ As a result, the third claim was dismissed.

The court scheduled a conference for April 13, 2001.⁴⁸ The case was closed on October 3, 2001.

IV. CONCLUSION

An overwhelming number of corporate tax shelters are considered abusive, and the entire business of marketing them is considered to be an area of low prestige that garners little to no respect.⁴⁹ It really is amazing to see parties involved in developing and marketing corporate tax shelters going to court over a dispute involving fees in selling corporate tax shelters and asking the court to resolve the dispute—almost as amazing as two highwaymen asking the court to account for the profits of their partnership.

44. *Id.* at 445, 452-58.

45. *Id.*

46. *Id.* at 445, 458-60.

47. *Id.* at 445, 460-61.

48. *Id.* at 461.

49. See generally Canellos, *supra* note 2, at 56 (“It is inconceivable that a practitioner who specialized in tax shelters would ever reach a position of responsibility in these [the New York State Bar Association and similar] organizations.”); Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. REV. 149, 150 (“The opinion writers [of corporate tax shelters] lose (or never have) professional reputation; Most members and leaders of the New York State Bar Association regard the shelter phenomenon as deplorable.”).