

LEGAL UPDATE

CLIENT NEWSLETTER OF CARR, MORRIS & GRAEFF, P.C.

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PRIVILEGE

ATTORNEY-CLIENT PRIVILEGE AND IN-HOUSE COUNSEL

It is well known that communications between an attorney and his client are privileged. Attorneys cannot provide reliable advice without full disclosure from their clients. A corporation, like other individuals, is a client and may assert this privilege regardless of whether the corporation's lawyer is *outside* counsel or *in-house* counsel. However, when counsel is in-house a host of issues are raised as counsel often plays a part in business as well as legal aspects of corporate life. Conversations with in-house counsel are more susceptible to challenge on the basis that the communication or advice given are more business than legal in nature.

For example in *E.I. du Pont de Nemours & Co. v. Forma-Pack, Inc.* (1980), the Maryland Court of Appeals, held that communications by DuPont's in-house counsel to an outside collection agency were not protected. The court explained that:

Only those attorney-client communications pertaining to legal assistance and made with the intention of confidentiality are within the ambit of the privilege. To make the communications privileged, they must relate to professional advice and to the subject-matter about which such advice is sought. For the privilege to apply, the client's confidential communication must be for the primary purpose of soliciting legal, rather than business, advice. The privilege extends essentially only to the substance of matters

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TAX

RECENT DEVELOPMENTS IN THE ECONOMIC SUBSTANCE DOCTRINE--PART II, THE COLTEC CASE

In *Coltec Industries, Inc. v. United States*, 454 F. 3d 1340, decided on July 12, 2006, the United States Court of Appeals for the Federal Circuit was faced with a complicated but classic contingent liability transaction. In 1996 Coltec reported a capital loss of \$378 million generated by selling high-basis stock at a low price. The IRS disallowed the loss. Coltec paid the assessment and filed a refund action in the U.S. Court of Federal Claims. The trial court awarded Coltec a full refund and the government appealed. The appellate court concluded that although Coltec's capital loss fell within the literal terms of the Code the transaction lacked economic substance and must be disregarded.

In 1996 Coltec had numerous subsidiaries. In that year it sold one of them for a gain of \$241 million. Coltec met with its tax advisors to discuss a strategy to offset this gain. The advisor proposed a contingent liability transaction consisting of three steps. First, the parent company would reorganize a dormant subsidiary into a special purpose entity. Second, the parent would transfer property and contingent liabilities to the subsidiary in exchange for stock of the subsidiary. Third, the parent would sell the stock to a third party for a nominal amount. The parent would calculate its basis in the stock of the subsidiary as equal to the property transferred to the subsidiary, not reduced by the contingent liabilities assumed by the subsidiary. Upon the sale the parent would show a large loss.

Coltec had significant asbestos liabilities. One of its subsidiaries, Garlock, Inc., and one of Garlock's subsidiaries, Anchor Packing Company, had manufactured or distributed asbestos products. In the early 1990s Garlock and Anchor had been named as defendants in 100,000 asbestos cases and corporate veil-piercing claims were common in such cases. Coltec decided to implement its tax advisor's plan and admitted tax avoidance was one of its reasons for doing so. First, Coltec renamed one

of its dormant subsidiaries Garrison Litigation Management Group, Ltd. Second, Garrison issued 99,800 shares of common stock and 1,300,000 shares of Class A stock to Coltec in exchange for \$4 million. Garrison also issued 100,000 shares of common stock to Garlock, assumed managerial responsibilities for handling asbestos claims against Garlock, and assumed all asbestos claims against Garlock, including veil-piercing claims against Anchor. Garlock transferred to Garrison all Anchor stock, asbestos insurance policies, furniture, and a promissory note in the amount of \$375 million. Garlock also agreed to advance Garrison up to \$200 million more.

The \$375 million amount of the note was calculated to cover future Garlock and Anchor asbestos liabilities based on estimates from two consultants. Finally, Garlock sold all of its 100,000 shares of Garrison stock to two banks for \$500,000. As a condition of the sale Coltec agreed to indemnify the banks against any veil-piercing claims for asbestos liabilities. In its 1996 consolidated return Coltec reported Garlock's basis in the Garrison stock as \$379 million, that is, the sum of the \$375 million promissory note and the \$4 million of other property transferred to Garrison, but not reduced by the assumption by Garrison of the asbestos contingent liability. Coltec then claimed a loss of about \$379 million from its sale of Garrison stock to the banks for \$500,000. The loss offset Coltec's gains for that year and the unused losses were carried forward to offset future years' gains.

Before the Court of Federal Claims the government argued that in the basis calculation the contingent liability should have been deducted or, alternatively, that the transaction lacked economic substance. The trial court held that under the literal wording of the Code the basis calculation did not have to be reduced by the contingent liability amount or, alternatively, the transaction had economic substance. On appeal the Court of Appeals for the Federal Circuit agreed with the trial court that under the Code basis was correctly calculated as property transferred unreduced by the contingent liability. Nevertheless, the appellate court disagreed with the trial court

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CORPORATE**A COMPANY'S MOST IMPORTANT CONTRACT MAY BE ITS COMMERCIAL LEASE**

An eccentric corporate law professor of mine often described companies as nothing more than a compilation of contracts—shareholders agreements, revenue sharing agreements, employment contracts, sales agreements, etc. Your company's commercial lease may very well be its most important contract. Many well-run large companies have an internal legal policy that all contracts that create potential liability to the company in excess of a certain amount must be reviewed by in-house legal counsel or its equivalence. Yet many of these same large companies do not hold commercial leases in the same regard, and they are often passed off to the company executive with the lightest workload. This is a mistake, and it is no less a mistake for small businesses not to review their commercial leases with the same degree of scrutiny with which they review their sales agreements with their largest customer.

Commercial leases can be far more important than the majority of contracts a company enters into. The reasons for this are twofold. First, the commitment and liability created by a long-term commercial lease can be staggering when viewed in aggregate. Second, the disruption and interference in a company's operations caused by unfavorable terms may cripple a company and cause unquantifiable damage. As a simple illustration, imagine the damage to a restaurant receiving substantial patronage from pedestrian traffic when it must relocate due to the Landlord declining to renew the lease at the end of the term. Such a landlord effectively holds the option to terminate the restaurant, giving that landlord the negotiating power to demand ransom rent.

The provisions of commercial leases, like most other contracts, can be divided into two parts: *Business Terms*, including the premises, rent and term; and *Legal Terms*, such as events of default, use, mitigation of damages, etc. It is important that both the Business Terms and the Legal Terms receive ample consideration and review. In so doing, please consider the following Business Terms:

Parties. Ensure that the tenant is properly identified, especially so when the company has one or more subsidiaries or affiliates.

Building. Again ensure accurate identification of the building in which the company will rent space and any common areas within the building which the tenant company is obligated to pay a portion of the expenses. Also, carefully review the description/floorplan of the premises

to ensure it meets with your expectations.

Rent. The rent and any escalations in rent during the term and during any renewal periods must be clearly set out. Often the rent or escalations in rent may be determined by formula, ensure that all factors incorporated into the formula are fully understood and that you have a reasonable expectation of such future factors.

Date of Commencement and Expiration. Such dates need to be clearly defined.

Term/Renewal. The lease document can contain many different dates; ensure that the *term* is clearly defined. Further ensure that the renewal provisions match your expectations with special attention paid to determining how rental payments are to be calculated in any renewal period. The tenant's right to a renewal period may prove worthless if the lease calls for extensive rent increases in subsequent terms.

Contraction/Expansion Options. If the premises is located in a multi-tenant building, inquire whether landlord offers options for your company to expand or contract the premises with the growth of your company. Be wary of how the exercise of this option may affect the above terms and the cost of this option incorporated into the rent.

Payments beyond Rent. Commercial tenants are often required to pay operational expenses, maintenance, utilities and/or real estate taxes. Be aware of these extra-rent expenses and have a reasonable forecast of their future costs. If terms such as *full service*, *triple net* and *base year* are unknown to you, consult your agent or counsel.

Parking/Signage. Depending on the nature of your business, parking and signage may be important terms to consider.

Upfitting/Fixtures. Tenant's intended use of the premises may require extensive improvements and installation of trade fixtures. The lease should account for such improvements and fixtures.

Whereas the Business Terms largely set forth the desired exchange between the landlord and tenant, it is the following Legal Terms which must always be considered, many of which come into effect only when the Business Terms are frustrated:

Events of Default. For any number of reasons one party to a commercial lease may charge that the other party has defaulted on the lease. The lease should be explicit in this area. Any "Event of Default" other than the failure of the tenant to pay the rent should be carefully reviewed.

Notice/Cure. Following an "Event of Default," review the lease provisions concern-

ing what notice the defaulting party must receive and any rights it may have to cure the default.

Use. Commercial leases may allow a tenant to use the demised premises for "any lawful purpose," but many have further restrictions which may impair the tenant's intended use.

Assignment. Various reasons arise during the term of a lease why a tenant would desire to vacate/sublet the demised premises.

Relocation. A lease may call for small tenants in multi-tenant buildings to relocate at the landlord's election.

Waiver of Subrogation. Given that both the landlord and the tenant will secure insurance, both parties will agree to only seek recovery for damage to building or property from the insurance company and not one another.

Mitigation of Damages. A commercial tenant is bound to remit rental payments during the term. Consider the ramifications of a tenant defaulting prior to the expiration of the term by failing to pay rent and subsequently vacating the premises, either voluntarily or by judicial order. May the tenant assign or sublet the premises? Must the landlord promptly seek to re-lease the premises? Can the landlord permit the premises to remain vacant and allow outstanding rental payments continue to accrue? Must the landlord re-let the abandoned premises before other empty space in the building? Always consider the maximum liability upon default, the "worst-case" scenario.

Personal Guarantee. Particularly with start-up or unproven businesses, a landlord may ask for the personal guarantees of the principals. Our counsel here is consistent—give a personal guarantee only as a *last resort*, only if this is the lease you *must* have and the landlord is unyielding. Even then, negotiate to guarantee only the risk portion of the landlord's commitment, *i.e.*, the broker's commission and any build-out costs or other incentives like rent abatement.

Even the smallest commercial leases can represent the commitment to make payment of thousands of dollars per month for several years and often require the personal guarantee of the company's principal(s). Moreover, commercial tenants often enter into leases at the outset of the business or at some other prosperous period during which pessimistic thoughts are not entertained. Commercial leases are often a significant financial liability and contain terms or provisions which, if not fully considered on execution, may frustrate or impede future company operations or growth.

JUSTIN BANFORD

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on the second issue holding the transaction had no economic substance and must be disregarded for tax purposes.

THE COURT'S REASONING

The Court of Appeals for the Federal Circuit held the relevant facts with respect to the economic reality of the transaction were largely undisputed. Coltec argued the transaction made Coltec a more attractive target company or a more attractive acquirer of other companies because the transaction added a barrier to the veil-piercing claims against Coltec. Coltec relied for this argument on the testimony of some of its executives. The court held these were only the subjective views of Coltec's managers unsubstantiated by any objective evidence. Coltec's defense would stand if potential plaintiffs were obligated to pursue only Garrison instead of Garlock but that was clearly not the case. Coltec cited no legal authority for that proposition and introduced no expert testimony to that effect. In fact Coltec conceded Garrison's assumption of Garlock's asbestos liabilities could not affect a release of Garlock's liabilities to potential plaintiffs. Moreover, Coltec had been forced to indemnify the banks against any veil-piercing claims. In sum, after the transaction Garlock and Coltec remained as potentially liable to asbestos claimants as before the transaction. There was no change in the flow of economic benefits, no real opportunity to make a profit, and Coltec's financial position was not appreciably affected.

DISCUSSION

It is evident the Court of Appeals got the economic substance issue exactly right and the author is at a loss to understand why taxpayer continued to litigate this case to the bitter end. As noted above contingent liability transactions were marked out as "listed transactions" by the IRS in 2001 because of their potential for abuse. It is possible, however, to set up a counterfactual example where such a transaction would have economic substance. Using the *Coltec* case as a point of departure the transaction would have economic substance if the following factors were present. First, the sale of Garrison would have to be to a litigation group which would either try or compromise claims. The litigation group would have an incentive to keep payments or verdicts below the amount of the promissory note or cash transferred by Garlock. For example, if after all the cases were processed Garrison paid out only \$200 million in verdicts or claims the litigation group would have a neat profit of \$175 million. In effect, the purchasers of Garrison would be betting the two

consultants were wrong and overestimated the potential liability.

Second, Coltec could not indemnify the litigation group since that would imply that Coltec was still liable if plaintiffs could not collect from Garrison. Third, and most importantly, Coltec would need to establish with virtually 100% confidence, through the testimony of expert witnesses on tort law and corporation law or through the citation of all relevant legal authorities, that plaintiffs would not be able to pursue their claims against Garlock or Coltec. In other words, the assumption of the liability by Garrison, a separate corporation owned by a litigation group, would need to have the effect of isolating the liability within that corporation only, with no recourse to Garlock or Coltec.

If all these factors were present then the transaction would clearly have economic substance. Coltec would limit its liability on asbestos claims to \$375 million which it would pay out to Garrison. If the verdicts exceeded that sum Coltec would not be liable, and Garlock would simply become insolvent and go out of business. Since Coltec actually did pay out \$375 million it would be entitled to a deduction for that amount. From the point of view of the Treasury it should be immaterial if the deduction was applied to a capital gain or to ordinary income since actual dollars were expended. The business purpose comes in because Coltec would have been able to limit liability to the stated amount. It would have had a flow of economic benefits, an opportunity to limit losses if not quite make a profit, and its financial position would have been appreciably affected since the note payable on its balance sheet (and the cash eventually paid to settle the note) was the most accurate reflection of its liability. Coltec would have converted a contingent liability of uncertain and potentially unlimited value to an ascertainable liability of \$375 million. Such certainty would indeed make Coltec a more desirable acquisition target or a more desirable acquirer of other companies.

As illustrated by this case the application of the economic substance doctrine is highly fact-bound. It is hard to make generalizations about its application. Changing one relevant fact may make the doctrine inapplicable. Thus, the economic substance doctrine has given rise to much litigation in the past and will undoubtedly continue to do so in the future. As our revenue laws and regulations become more complex with each passing day, so do the opportunities for devising tax-avoidance transactions. The doctrine will continue to be important in separating permissible tax avoid-

ance from unlawful tax evasion.

NÉSTOR CRUZ

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PRIVILEGE*Continued from page 1*

communicated to an attorney in professional confidence.

The court further held that "where an attorney acts as a business advisor or collection agent, the communications between him and his client are not protected by the attorney-client privilege."

As this case highlights, in-house counsel is involved in a variety of routine business practices that raise questions about the confidentiality of communications. For example in-house counsel frequently attends board of director and other corporate meetings or they are sent a copy of meeting minutes. Are the discussions and minutes privileged simply because corporate counsel was present or copied? Courts generally find these communications to be non-privileged. Routine, non-privileged communications do not attain privileged status because they are "funneled" through counsel.

Further, uncertainty can arise as to who exactly within the corporation is the attorney's client. Courts routinely recognize that not every corporate employee is the "client." Courts have employed a variety of tests to determine which employees may communicate with counsel in a privileged context. Often courts will look at who within the corporation has "control" – that is, executives and/or managers. This tends to be a small group. Or, courts will expand this group to include individuals within the corporation who have information pertinent to the "subject matter."

One way to protect the privilege is to label documents appropriately. Counsel should note within or on the document that the document being prepared or work performed is "legal" and/or the nature of the legal dispute. Documents should also be labeled "privileged." Also, it is helpful to minimize those issues that are reduced to writing. Depending on the issue it may be necessary to retain outside counsel. Above all else counsel and high-ranking personnel must maintain control of a developing legal issue by restricting access to necessary parties, stressing the confidentiality of matter and ensuring that documents and communications flow through only the appropriate channels.

DANA THERIOT

**CARR, MORRIS
& GRAEFF, P.C.**

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial Litigation; Criminal Representation; Alternative Dispute Resolution; Employment/Labor; Discrimination; and Wage-Hour.

The firm maintains its office in the Metro Center region of downtown Washington. It has attorneys admitted to all of the local judicial jurisdictions—the District of Columbia, Maryland and Virginia.

STAFF NOTES

Oh, so close. Phil Schwartz's bid for the Springfield Golf & Country Club (golf) championship ended in bitter disappointment. While winning the championship would have been the crowning jewel of his tenure as club president, the golfing gods weren't smiling on young Phil as he dropped a second round match 3-2. Phil had soundly trounced Mr. Bye in his first round match.

Reunion. Firm alumnus Steve Wilanski graced us with a visit recently. Steve—one of our earliest hires—is now a Vice President and Counsel to SallieMae in Chicago.

Margarita and Néstor Cruz spent Thanksgiving break in Austria. While in Vienna they attended a performance of *Fidelio* at the Vienna Court Opera on the 202nd anniversary of its premiere there.

Holiday needs. Drunken holiday office parties are so very 1960's. As you develop your more dignified and sedate holiday event, imagine the fun of sponsoring a group blood donation! The American Red Cross can help: 1-800-GIVE-LIFE.

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