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Carlisle: A 'Hollow Victory'?

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During the tax shelter frenzy of the late 1990s, promoters developed and marketed shelters that used offsetting currency options to generate artificial tax losses. After discovering that these shelters were worthless,[1] investors sought to recover damages from promoters, accountants, lawyers, banks, and other participants. *Arthur Andersen LLP v. Carlisle*,[2] the first investor suit to reach the Supreme Court, illustrates the procedural obstacles confronting shelter investors. The source of the controversy is a garden-variety son-of-BOSS tax shelter purchased in 1999 by three individual investors seeking to eliminate tax on around $97 million of gain from the sale of a business. The investors claimed that they paid fees and expenses of $4.35 million as the ''price of admission'' to participate in a shelter involving a financial boutique (Bricolage), an accounting firm (Andersen), a law firm (Curtis Mallet), and other entities.[3] The shelter turned out to be an expensive mistake: in a settlement with the government, the investors ultimately paid more than $25 million in taxes, penalties, and interest. The investors then sued the other participants for damages in federal district court, alleging fraud, professional malpractice, breach of fiduciary duty, and civil conspiracy. Bricolage filed a petition in bankruptcy, resulting in an automatic stay of proceedings against it in the district court. The remaining defendants then moved to stay proceedings against themselves, invoking an arbitration clause in an investment management agreement between the investors and Bricolage. The district court denied the defendants' motion, and the Sixth Circuit dismissed the defendants' interlocutory appeal for lack of jurisdiction.[4] The Supreme Court reversed and remanded the case to the Sixth Circuit for a decision on the merits.

Under the Federal Arbitration Act, a litigant in federal court is entitled to stay proceedings ''upon any issue referable to arbitration under an agreement in writing for such arbitration,'' and an order refusing to grant such a stay is appealable as of right.[5] The issue before the Court was whether a litigant who is not a party to the agreement containing an arbitration clause but seeks a stay relying on principles of equitable estoppel can bring an interlocutory appeal from an order denying the stay.[6] The Court, in an opinion written by Justice Antonin Scalia, answered in the affirmative.[7] In essence, the defendants'

[1]Courts have repeatedly held that these so-called son-of-BOSS shelters lack economic substance and therefore fail to achieve their objective. *See, e.g., Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007), *Doc 2007-28072*, *2007 TNT 248-5*; *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008), *Doc 2008-2695*, *2008 TNT 27-8*, *cert. denied*, 129 S. Ct. 131 (2008); *see generally* Burke and McCouch, ''COBRA Strikes Back: Anatomy of a Tax Shelter,'' 62 *Tax Law.* 59 (2008). The government's success in recovering penalties is more mixed. *See, e.g., Klamath Strategic Inv. Fund, LLC v. United States*, No. 07-40861 (5th Cir. May 15, 2009), *Doc 2009-11265, 2009 TNT 94-15*; *Clearmeadow Investments, LLC v. United States*, No. 1:05-cv-01223 (Ct. Fed. Claims June 17, 2009), *Doc 2009-13949, 2009 TNT 117-14*.

[2]129 S. Ct. 1896 (2009).

[3]Fees in comparable transactions typically amount to around 4.5 percent of the artificial tax losses to be generated by the shelter. *See* Burke and McCouch, *supra* note 1, at 61 n.9. The fees are often camouflaged through consulting agreements or other arrangements. *See, e.g., Jade Trading*, 80 Fed. Cl. at 32-33. There are striking similarities between the shelters in *Jade Trading* and in the present case, including Curtis Mallet's role as shelter counsel.

(Footnote continued in next column.)

[4]*Carlisle v. Curtis, Mallet-Prevost, Colt & Mosle, LLP*, 521 F.3d 597 (6th Cir. 2008), *Doc 2008-7972*, *2008 TNT 71-15*, *rev'd sub nom. Arthur Andersen LLP v. Carlisle*, 129 S. Ct. 1896 (2009), *Doc 2009-10046*, *2009 TNT 84-29*.

[5]*See* 9 U.S.C. sections 3 and 16(a)(1)(A); *see also* 9 U.S.C. section 4 (litigant entitled to compel arbitration under written agreement in accordance with its terms).

[6]The investment management agreement with Bricolage is the only written agreement identified by the litigants that contains an arbitration clause. That agreement calls for arbitration of ''any controversy arising out of or relating to [the] agreement or the breach thereof.''

[7]Justice Scalia's opinion proceeds on two alternative theories. The first part of the opinion treats section 16 as a self-contained grant of jurisdiction that precludes looking through to the substantive provisions of section 3 concerning a stay. *See Carlisle*, 129 S. Ct. at 1901. (''The jurisdictional statute here unambiguously makes the underlying merits irrelevant, for even utter frivolousness of the underlying request for a section 3 stay cannot turn a denial into something other than 'an order . . . refusing a stay of any action under section 3.''') Nevertheless, the second part looks through to the substantive provisions of section 3 to determine whether the requirements of the statute are met. *See id.* at 1902. (''If a written arbitration provision is made enforceable against (or for the benefit of) a third party under state contract law, the statute's terms are fulfilled.'')

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argument is that the plaintiffs cannot ''have it both ways'': as a matter of equity, the plaintiffs should not be able to rely on the substantive terms of their agreement with Bricolage as the foundation for their claims against the other defendants while repudiating the arbitration clause contained in the same agreement.[8] The defendants' premise is unexceptionable as a statement of equitable doctrine, but it is difficult to see how they could possibly prevail on the facts of the case. Courts considering similar claims in other tax shelter cases have consistently held that the investors' claims ''must be dependent upon, or founded in and inextricably intertwined with, the contractual obligations of the agreement containing the arbitration clause.''[9] Those requirements might be met, for example, if the investors had entered into a written agreement with Bricolage containing an arbitration clause and outlining the structure of the tax shelter to be implemented with the other defendants.[10] Here, however, the agreement with Bricolage was a standard investment management agreement that was carried out in accordance with its terms. Bricolage's performance of services as an investment adviser played only a subsidiary role in implementing the tax shelter, and the investors' claims therefore do not appear to depend on or arise from the existence or the terms of the agreement with Bricolage.[11] The mere fact of collusion between Bricolage and the other defendants, if proved, should not allow the other defendants to compel arbitration, especially given the conspicuous absence of arbitration clauses in their agreements with the investors.[12]

An unusual feature of the case involves stock warrants in two startup technology companies which the investors allegedly were required to purchase as a condition of participating in the tax shelter. It appears that the investors (through a limited liability company) purchased the stock warrants for $4.35 million from an offshore entity which had acquired the warrants several weeks earlier from the issuers for less than one-twentieth of that amount. The warrants were eventually found to be virtually worthless. Such extreme volatility by itself might call into question the valuation of the warrants. Moreover, although the warrants played no functional role in generating the artificial tax losses which constituted the primary purpose of the shelter transaction, two possible explanations come to mind. First, the warrants might simply be bona fide investments which were completely independent from the rest of the transaction.[13] In that case, the warrants would have no relevance for the shelter transaction and would add nothing to the defendants' argument for equitable estoppel. An alternative explanation is that the warrants might represent a form of disguised fee-sharing among the participants in the shelter transaction.[14] Interestingly, aside from standard advisory fees stipulated in the Bricolage investment management agreement and the flat $100,000 fee that each investor paid for Curtis Mallet's legal opinions,[15] no other fees are discussed or accounted for in the documents relating to the shelter transaction. Even if the warrants indeed represent $4.35 million of disguised fee-sharing, they have no bearing on the issue of equitable estoppel because they were not related to the performance of the investment management agreement between the investors and Bricolage.

As a practical matter, the primary impact of the Court's decision may be to invite ''intentional delay by savvy parties who seek to frustrate litigation by gaming the system.''[16] A plausible sequence of steps might unfold

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Justice Scalia apparently saw no need to acknowledge, much less reconcile, the apparent tension between the two theories.

[8]*Goldman v. KPMG, LLP*, 173 Cal.App.4th 209, 220 (App. 2009) (quoting *Grigson v. Creative Artists Agency, LLC*, 210 F.3d 524 (5th Cir. 2000)).

[9]*Id.* at 218; *see also Stechler v. Sidley Austin Brown & Wood, LLP*, 382 F. Supp.2d 580 (S.D.N.Y. 2005); *Denney v. Jenkens & Gilchrist*, 412 F. Supp.2d 293 (S.D.N.Y. 2005), *Doc 2005-345*, *2005 TNT 3-16*; *Ross v. American Express Co.*, 547 F.3d 137 (2d Cir. 2008). In denying the defendants' motion for a stay, the district court determined that the plaintiffs' claims were not founded on or intertwined with the Bricolage agreement containing the arbitration clause.

[10]*Cf. Camferdam v. Ernst & Young International, Inc.*, No. 02 Civ. 10100 (S.D.N.Y. Feb. 13, 2004), *Doc 2004-3854*, *2004 TNT 37-11* (accounting firm's engagement letter set forth structure of tax shelter with law firm as third-party beneficiary and gave rise to intertwined claims against law firm and accounting firm). Similarly, as Justice Stephen Breyer suggested at oral argument in *Carlisle*, if the investors and the other participants agreed orally that the arbitration clause in such an agreement would be binding on all of them, it is possible to imagine a situation in which a nonsignatory might invoke equitable estoppel to compel arbitration.

[11]*Cf. Goldman*, 173 Cal.App.4th at 230-233 (limited liability company operating agreements); *Stechler*, 382 F. Supp.2d at 591-592 (LLC operating agreements); *Denney*, 412 F. Supp.2d at 299-300 (accountants' consulting agreement).

[12]*See Goldman*, 173 Cal.App.4th at 223 (''Mere allegations of collusive behavior between signatories and nonsignatories to a contract is not enough to compel arbitration between parties who have not agreed to arbitrate: those allegations of collusive behavior must also establish that the plaintiff's claims against the nonsignatory are 'intimately founded in and intertwined with the obligations imposed by the [contract containing the arbitration clause].''' (quoting *MS Dealer Service Corp. v. Franklin*, 177 F.3d 942 (11th Cir. 1999))).

[13]In a somewhat casual summary of the facts, immediately before describing the agreement with Bricolage, Justice Scalia states that ''as part of the scheme'' the investors purchased the warrants through ''limited liability corporations [sic].'' *Carlisle*, 129 S. Ct. at 1899. The implied linkage between the warrants and the Bricolage agreement is not supported by the record. Moreover, the record belies Justice Scalia's description of defendant Integrated Capital Associates as ''a prior owner of the worthless warrants who had also been a client of the [Curtis Mallet] law firm.'' *Id.* at 1899 n.1.

[14]This explanation is prompted by allegations both in the present case and in another similar investor suit against Curtis Mallet which was eventually settled. *See Adell v. Curtis, Mallet-Prevost, Colt & Mosle*, No. 114104/2005 (N.Y. Sup. Ct. Mar. 1, 2007).

[15]The investors paid $300,000 to defendant Intercontinental Pacific Group as reimbursement for fees that had apparently previously been paid to Curtis Mallet.

[16]*Carlisle*, 129 S. Ct. at 1904 (Souter, J., dissenting). The defendants' equitable estoppel argument may be sufficiently ''far-fetched'' to stand no realistic chance of prevailing on the

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as follows: on remand from the Supreme Court, the Sixth Circuit affirms the district court's order after a *de novo* review; the defendants petition (unsuccessfully) for certiorari; back in district court, the defendants move (unsuccessfully) to compel arbitration;[17] the defendants appeal (unsuccessfully) the district court's denial of their motion to the Sixth Circuit; the defendants petition (unsuccessfully) the Supreme Court for certiorari; the defendants return to the district court and prepare at last to litigate the merits of the plaintiff's claims. For the defendants, this figurative elevator ride up and down the federal judicial system offers a golden opportunity to ''wear down the opponent''[18] while avoiding discovery of evidence relating to the plaintiffs' substantive claims.[19] Ironically, even if the defendants ultimately intend to reach a settlement rather than litigate the case on the merits, they may see the Court's decision as something more than a ''hollow victory.''[20]

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merits, but it does not appear sufficiently ''frivolous'' to justify an award of damages or costs. *Id.*

[17]Interestingly, although the plaintiffs appear to have reached a settlement with Bricolage, the remaining defendants evidently have not yet sought to compel arbitration under section 4 of the Federal Arbitration Act. If they eventually do so and the district court denies their request, they will be able to lodge an appeal as of right under the Court's reading of section 16 of the Federal Arbitration Act.

[18]*Id. Cf. Tigers Eye Trading, LLC v. Commissioner*, T.C. Memo. 2009-121, *Doc 2009-11964*, *2009 TNT 100-10* (noting procedural complexity in ''myriad of other pending Son-of-BOSS cases'').

[19]The question whether an interlocutory appeal under section 16 of the Federal Arbitration Act divests a district court of jurisdiction has given rise to a split among the circuits. *See Cambio Health Solutions, LLC v. Reardon*, 228 F. Supp.2d 883 (M.D. Tenn. 2002) (citing cases and staying proceedings pending appeal). The *Carlisle* decision may prompt the Supreme Court to resolve this issue in due course.

[20]*Carlisle*, 129 S. Ct. at 1901.

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