Kovel

I. Introduction

The attorney-client privilege is a bedrock of our adversarial justice system, and necessarily so. Constitutionally-endowed fair trials and adequate representation would be impossible without the confidentiality privy to a client and their legal team. "The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client." *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981). As fundamental as this concept is, its applicability is unfortunately limited by the truncated scope of the evidentiary rules governing Attorney-Client Privilege, which did not foresee the emergence of today's highly nuanced legal arrangements, which include the need for translators, psychiatrists, public relations consultants, scientists, and other third party professionals beyond the traditional "ministerial" employee, who has traditionally been privileged. Specifically for our purposes, the prominent use of accountants and accounting firms by private citizens, law offices, and other relevant parties has lent chiaroscuro to the otherwise carefully delineated attorney-client relationship.

Ordinarily, sharing communications protected by Attorney-Client privileges would constitute a waiver of the privilege; however, the eventual recognition of the necessity of these third parties led to a reconsideration. The Internal Revenue Code has even addressed this issue via I.R.C. Section 7525 The scope of this provision, however, is regrettably too limited to be wholly relied upon. Importantly, it does not apply to criminal tax matters. Nor does it apply to written communications involving corporate 'tax shelters.' Lastly, the language of Section 7525 on its face applies only to communications between tax practitioners and taxpayers, leaving the critical role of the attorney up in the air. Given these considerable gaps in coverage, Section 7525, therefore, fails to sufficiently meet the needs of modern American taxpayers or their hired counsel.

With no guiding statutes or rules of evidence crafted to clarify this confusion, the resulting confusion is left to the courts to sift through and clarify. What role may an accountant play in the attorney-client relationship, and what confidentiality is afforded to them? We examine the most noteworthy case on the subject, *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961), as well as its progeny, which have provided some insight, but mostly succeed in frustrating those who seek to examine the accountant's critical role in the judicial process.

II. United States v. Kovel

The foundational case of the issue at hand is of course, *United States v. Kovel,* 296 F.2d 918 (2nd Cir. 1961). Judge Friendly's artful and classicist-oriented decision, recognized that the modern lawyer, in attempting to navigate an increasingly complex litigation environment, requires outside help in the form of third parties, and that attorney-client privilege should be extended to reflect this external aid in certain circumstances.

> On the other hand, in contrast to the Tudor times when the privilege was first recognized, see 8 Wigmore, evidence, 2290, the complexities of modern existence prevent attorneys from effectively handling clients' affairs without the help of others; few lawyers could now practice without the assistance of secretaries, file clerks, telephone operators, messengers, clerks not yet admitted to the bars, and aides of other sorts… We cannot regard the privileged as confined to 'menial or ministerial' employees. *United States v. Kovel*, at 921.

Certainly, the most fundamental passage of *Kovel* is the statement that, "What is vital to the privilege is that the communication be made *in confidence* for the purpose of obtaining *legal* advice *from the lawyer.* If what is sought is not legal advice but only accounting service… or if the advice sought is the accountant's rather than the lawyer's, no privilege exists." *Kovel,* at 922. Kovel then provides the oft-cited analogy of the role of the protected accountant as a translator or an interpreter essential to the lawyer's legal duty to the client.

> Accounting concept are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases. Hence the presence of an accountant, whether hired by the lawyer or by the client, while the client is relating a complicated tax story to the lawyer, ought not to destroy the privilege, any more than would that of the linguist in the second or third variations of the foreign language theme discussed above; the presence of the accountant is necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege is designed to permit. *Id.*, at 922.

Superficially, *Kovel* appears to be a remedy to the winnowed scope of I.R.C. Section 7525. Judge Friendly's decision warned, however, that the third-party privilege is not absolute, but comes with significant, if uncertain limitations. The attorney and/or client must separate general accounting advice with the intended legal interpretive services, of which only the latter is privileged. While the importance of this distinction was clearly not lost on the Court, Judge Friendly's decision accurately noted that the line drawn was 'arbitrary' and correctly prognosticated that the ambiguous nature of it would cause discordant interpretations in the future. "We realize also that the line we have drawn will not be so easy to apply as the simpler positions urged on us by the parties – the district judges will scarcely be able to leave the decision of such cases to computers; but the distinction has to be made if the privilege is neither to be unduly expanded nor to be come a trap." *Id.* 922-923.

III. Beyond Kovel

Though one must admire Judge Friendly's desire to avoid unwelcome strictures or unrestrained exploitations of his decision, *Kovel* nonetheless left much uncertainty as to what constitutes the legal/non-legal dichotomy, and resultant cases have contributed greatly to this discord. This uncertainty means that whether or not a privilege exists turns upon each case's idiosyncratic facts, and the decisions are often arbitrary. The range of cases in which *Kovel* has been found to apply is a broad one, even as the criteria to qualify winnows. Nonetheless, *Kovel* jurisprudence has produced some thematic undercurrents which lend some assistance in discerning privilege.

Successful Cases

One of the earliest, if not the earliest, applications of *Kovel* came in *United States v. Judson*, 322 F.2d 460 (9th Cir. 1963). The fact-intensive nature of this decision proves to be exemplary of courts' overall approach to *Kovel*. Under investigation for tax evasion, the appellant hired two accountants, to prepare statements of his net worth. The court held these documents, and the preparatory materials, privileged, stating that "This statement was prepared at the attorney's request, in the course of an attorney-client relationship, for the purpose of advising and defending his clients. The accounts' role was to facilitate and accurate and complete consultation between the client and the attorney about the former's financial picture." *Judson*, at 462. In contrast, the court held cancelled checks and bank statements not to be within the privilege. Still, the clear boundaries drawn by *Judson* are instructive.

United States v. Sanmina Corp. & Subsidiaries, 2015 U.S. Dist. LEXIS 66123 (Cal. Dist. 2015) The Court denied the IRS' petition to enforce its summons, resoundingly stating that, "For privilege purposes, there is no difference between legal advice and tax advice on compliance, so long as the advice goes beyond mere tax preparation and calculations." The Court further (and helpfully) elucidated that, "a document does not lose protection… merely because it is created in order to assist with a business decision. Thus, a legal tax analysis generated in anticipation of a possible IRS audit may constitute work product, even if that material also assisted in making a business decision." While this decision is doubtlessly beneficial to those asserting the privilege, it should be noted that this is one of the more liberal judicial approaches to interpreting *Kovel*, and reaffirms Judge Friendly's warnings of unpredictable readings of the contours of the privilege.

United States v. Cote, 456 F.2d 142 (8th Cir. 1972) entails memoranda and other materials prepared by an auditor on behalf of his clients, whose tax returns were under scrutiny. The court, in finding these materials privileged, carefully distinguished the auditor's function from a merely 'mechanical' one. "Here the taxpayers did not consult Murphy for accounting advice. His decision as to whether the taxpayers should file an amended return undoubtedly involved legal considerations which mathematical calculations alone would not provide." (144). Of additional importance, the court ruled that the fact that the accountant was previously employed by the taxpayers was not a dealbreaker for them, and should not be used as any bright line rule. "The fact of prior employment, however, is not controlling to the issue. A more definitive test is whether the accountant's services are a necessary aid to the rendering of effective legal services to the client. Whether the accountant performed services for the taxpayers in years prior to the attorney-client relationship is essentially immaterial." *Id.* Incidentally, the court in *Cote* found that while the privilege did attach to the accountant's work, the clients had inadvertently waived it in filing their amended returns, and were thus required to provide it; a painful lesson to be learned, and one that is representative of how capricious the courts may be on the subject.

One of the more idiosyncratic exercises of privilege took place in *In re Copper Market Antritrust Litigation*, 200 F.R.D. 213 (S.D.N.Y. 2001). Sumitomo, a Japanese manufacturer, retained a public relations firm (RLM) during a business scandal, in large part because the corporation had

no employees who spoke English and were sufficiently knowledgeable of American litigation. During this time, the PR firm was essentially subsumed into Sumitomo, working out of the Tokyo corporate headquarters and given full authorization to speak on part of Sumitomo. The Court ultimately recognized privilege over certain documents, nothing that, "for purposes of the attorney-client privilege, RLM can fairly be equated with Sumitomo for purposes of analyzing…communications to which RLM was a party concerning its scandal-related duties." *In re Copper Market Antitrust Litigation*, at 219. These communications were thus said to be made to facilitate legal services, and therefore clearly protected. Though the third party in this case was a public relations firm, as opposed to an accounting firm, this said third party met the "interpreter/translator" threshold necessary to apply *Kovel.*

Cases in which the Court did NOT recognize privilege

In *United States v. Richey*, the Ninth Circuit refused to recognize privilege concerning an appraisal between a client taxpayer and his lawyer and accountant. Richey, the Appellee, was retained to provide valuation services and advice with respect to a conservation easement. When the IRS conducted an investigation of his clients' tax returns, Richey asserted *Kovel* privilege. Upon review, the Ninth Circuit found that the communications in question were related to appraising the value of the easement, and not for the purpose of providing legal advice. Importantly, the Court's decision noted that "Richey…did not make a specific proffer of what communications, if any, [existed] in the appraisal work file, that are allegedly the proper subject of the attorney-client privilege." *United States v. Richey,*

United States v. Hatfield is another exemplary case of the blurry line between privileged legal services and unprotected general accounting services. In *Hatfield*, although an accounting firm was hired in the context of an investigation, the court nonetheless declined to recognize privilege. The line of reasoning is extremely edifying for future purposes. "Despite two lengthy evidentiary hearings, and thousands of pages of briefing and exhibits, Mr. Brooks has submitted no evidence concerning how Huron "helped" with the litigation. And Mr. Brooks has likewise submitted no evidence indicating which documents Huron prepared to "help" with litigation." *Hatfield*, at _____

United States v. Adlman, 68 F.3d 1485 (2d Cir. 1995); a corporation sought to raise the privilege as to memoranda prepared by an accounting firm, Arthur Andersen, concerning a corporate reorganization and potential tax losses. The accounting firm in question was the corporation's in-house auditor and accountant. The District Court sided with the government, pointing out that the alleged privileged communications were subsumed, without differentiation, by the larger body of general advisory communications between the accounting firm and the corporation. In particular, the court noted the lack of separate billing to indicate the intention of privilege. Perhaps most importantly, the *Adlman* court noted that, "the facts are subject to competing interpretations." (*Adlman*, at 1500). This statement resonates throughout post-*Kovel* jurisprudence.

Cavallaro v. United States, 284 F.3d 236 (1st. Cir. 2002); business-owning taxpayers hired a law firm for estate planning advice, while their children, acting as agents hired Ernst & Young for tax planning advice. In a subsequent tax investigation, the family asserted privilege over the accounting firm's communications. In denying the business's assertion of privilege, the District Court pointed out the lack of contemporaneous documentation" which indicated a change in the relationship between the business and Ernst & Young in the context of the investigation. *248*. The court noted the lack of indicia which would suggest the privilege; namely that the hired law firm and Ernst & Young largely acted independent of one another without coordination. Summarily, there was insufficient evidence to indicate that Ernst & Young was hired to facilitate legal advice.

Olender v. United States, 210 F.2d 795 (9th Cir. 1954). Although this case precedes the landmark *Kovel* decision, it is nonetheless instructive as it projects the fact-intensive approach used by post-*Kovel* courts in determining whether communications are privileged between client and accountant. (It is also merits mentioning that Judge Friendly invokes *Olender* in his *Kovel* decision). The client taxpayer had enlisted the services of a joint accountant-attorney after being charged with filing false income tax returns. However, the Court discerned from the facts that he was employed solely for his rote accounting duties, and that Olender turned to a separate attorney altogether for legal advice on the issues.

As one will see from this growing body of cases, the protection enunciated by *Kovel* has come increasingly under attack by various courts, further complicating reliance upon it. The translation and interpretive functions are increasingly viewed in the strictest light, and furthermore, only viewed as privileged in the context of pending or present litigation.

IV. Lessons to be learned from Kovel and Progeny

While no clearly enunciated doctrine has been promulgated to make our jobs easier, this corpus of cases yields us some valuable insights. Cases where privilege was denied are arguably more instructive than those in which the Court found in favor, as they better illustrate the boundaries of the privilege. Because the party claiming privilege bears the burden of proving that such a privilege exists, there are several essential steps to be taken.

First is the issue of timing. An attorney would be wise to tread very carefully where pre-existing relationships with the accountant or accounting firm are concerned, whether between the client or the attorney. They will have a far more difficult task to explain that their communications were meant to facilitate legal advice if the relationship preceded the tax investigation; the body of negative-outcome *Kovel* cases reveals that courts consider a prior relationship as evidence that the accountant (or third party) is conducting general accounting duties, rather than serving as a 'translator' of legal advice. This should be easy to understand. Enlisting an accountant's aid after the beginning of an investigation or proceeding reflects the desire to better interpret the legal implications of one's financial circumstances. Hiring a new accountant or accounting firm, rather than relying on your usual tax preparer, though not foolproof, strategy.

Secondly is ensuring that form meets with *Kovel* precedent. Courts will look externally for indicia of privilege; some may argue that form trumps substance in discerning whether Kovel applies. In hiring an accountant, the lawyer should take special care that the retainer specifies the relationship as one of facilitating legal advice, rather than general consulting. Therefore, avoid generic, boilerplate engagement letters, as many lawyers and firms routinely use accountants for day-to-day consulting work. Instead, err on the side of caution and craft letters which state the scope of the representation with particularity, and firmly state that all communications between the three parties are confidential, pursuant to attorney-client and *Kovel* privilege. On that note, specificity is important to demonstrate a *Kovel* relationship. "A party claiming the privilege must identify specific communications and the grounds supporting the privilege as to each piece of evidence over which privilege is asserted." *United States v. Martin*, 278 F.3d 988, 1000 (9th Cir. 2002). A Court will be less inclined to recognize the existence of a privilege where client/accountant claiming the privilege cannot differentiate between specifically-privileged communications and their entire body of communications as a whole. (see *Hatfield*). Similarly, delineating documents and communication as privileged or intended for confidentiality goes a long way in the eyes of the Court. A taxpayer will have an arduous task in arguing for the exercise of privilege when the intended communications are intermingled or comingled among a larger mass of documents and records. "Contemporaneous documentation" of intended confidentiality, which reverberates throughout *Kovel* jurisprudence, is thus essential. Another related strategy for distinguishing privileged communications is separate billing to denote the intention of confidentiality and/or privilege. Bills should describe with specificity the translator/facilities activities performed and be demarcated from the general consultation duties.

Lastly, and of utmost importance, the triumvirate relationship of client-attorney-accountant makes discerning privilege considerably murkier (versus the standard attorney-client privilege). There are accordingly imperative considerations in managing this trifold relationship. The wisest strategy is to let the a*ttorney* govern this tripartite relationship. The attorney should be considered the client in the *Kovel* arrangement, not the taxpayer/business/corporation, because it is the attorney's comprehension of the situation which must be facilitated to satisfy *Kovel.* Interrelated to this consideration, demonstrating privilege requires limiting the communications, so as to reflect the intention of confidentiality. The attorney should carefully manage the interactions between client taxpayer and accountant, and limit them to necessary facilitating and translating duties, so as to indicate that the accountant's role is strictly limited to legal considerations. The interaction of the actual client should be minimized; at the outset of the engagement, protocols should be established between all parties to manage and effectively limit unnecessary communications. This comes back full circle to the thorny issue of proving *Kovel* arrangement with a previously-engaged accountant/accounting firm.

V. Work-Product Privilege

Fortunately for taxpayers, the increasingly-flimsy protections afforded by *Kovel* are buttressed by the Work-Product Doctrine, which is embodied by Fed. R. Civ. P. 26(b)(3). As seen in *Sanmina*, *Kovel* privilege and work-product often overlap, to the advantage of the taxpayer. An attorney would be wise to supplement an assertion of privilege with that of Work-Product Doctrine. Simply put, Work-Product" Shelters the mental processes of the attorney, providing a privileged area within which he can analyze and prepare his client's case." *United States v. Nobles*, 422 U.S. 225, 238 (1975). The symbiotic relationship between Work-Product and Kovel can be convoluted. For example, while the Court did not find the extension of privilege extended to the accounting services in *Hatfield*, it did find that other documents were protected by the Work-Product Privilege. Thus, one who has not rigorously adhered to Kovel precautions via specified retainers and separate billings should not automatically assume that Work-Product will be a last refuge or safety net. That said, the concurrent existence of these two privileges merits a that Work-Product be analyzed in the same context as Kovel.

The Work-Product Doctrine is not omnipotent itself. It only applies to materials prepared "in anticipation of litigation" by a party or their agent. Whereas Kovel products are unassailable (once found to meet *Kovel*), the otherwise founded assertion of Work-Product doctrine may be overcome by a 'hardship' showing from the other party. Nonetheless, WPD enjoys a much more relaxed standard of applicability than does *Kovel*. Interestingly enough, *Adlman*, which restricted the use of *Kovel*, simultaneously provided a liberal interpretation of Work Product, extending it to those documents, et al. "prepared or obtained because of the *prospect* of litigation." This apparent contradiction is by no means unusual.

Even given the additional assistance of the Work-Product Doctrine, an attorney should proceed with the utmost caution when enlisting accounting aid for the purposes of a prospective trial. The *Kovel* decision was prescient in predicting the growing need for third party intermediaries in order to interpret and better comprehend a dizzingly complex modern world. In spite of Judge Friendly's sagacious decision, third party attorney-client privilege is viewed in a a narrow scope, and some will argue that the freedom enjoyed by it is slowly constricting. Therefore, it is imperative to proceed with the utmost caution and not take the often necessary assistance of the accountant (or other third party) for granted when arranging for their services.