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# PRIVILEGED COMMUNICATIONS WITH ACCOUNTANTS: THE DEMISE OF *UNITED STATES V. KOVEL*

## I. INTRODUCTION

In handling complex financial transactions, particularly those with significant tax implications, attorneys often need the advice and assistance of accountants to competently represent their clients. Accountants help lawyers understand the financial and tax implications in a variety of transactions, but are particularly helpful in tax-advantaged transactions, sometimes referred to as tax shelters.<sup>1</sup> Absent such assistance, attorneys would be forced to proceed without a complete understanding of the tax implications and risks of a particular transaction. The advice and assistance of an accountant, however, is valuable only to the extent that an attorney can have "full and frank"<sup>2</sup> discussions with an accountant without fear that such communications will be discovered by outsiders, particularly the Internal Revenue Service (IRS).

Forty years ago, in the landmark case of *United States v. Kovel*,<sup>3</sup> the Second Circuit extended the attorney-client privilege to include communications an attorney has with an accountant to assist the attorney in understanding the client's financial information. In that case, the court analogized the accountant's role to that of an interpreter.<sup>4</sup> The law is well-established that if an attorney needs an interpreter to understand his client, the presence of the interpreter will not vitiate the attorney-client privilege.<sup>5</sup> According to the Second Circuit, the tax laws can be as incomprehensible as a foreign language to many lawyers;<sup>6</sup> "[h]ence the presence of an accountant . . . while the client is relating a complicated tax story to the lawyer, ought not destroy

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1. The Internal Revenue Code defines a "tax shelter" as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." I.R.C. § 6662(d)(2)(C)(iii) (West 2002).

2. *Upjohn Co. v. United States*, 449 U.S. 383, 392 (1981).

3. 296 F.2d 918 (2d Cir. 1961).

4. *Id.* at 921.

5. *Id.*

6. *Id.* at 922.

the privilege . . . ."<sup>7</sup>

The attorney-client privilege, however, is valuable only to the extent it is predictable. Any uncertainty in the law will render the privilege virtually worthless because no competent attorney would engage in confidential communications with a client or a representative of a client unless he were certain the privilege would apply.<sup>8</sup> Despite the holding in *Kovel*, certainty no longer exists with regard to communications between and among a client, the client's attorney, and the client's accountant. Over the past four decades, courts have repeatedly narrowed the holding in *Kovel*. As a result, there is very little protection left for communications with accountants, and the little protection remaining is often confusing and unpredictable.

This Comment will first examine the attorney-client privilege, focusing on the issue of whether the presence of a third party during attorney-client communications breaches the confidentiality necessary for the privilege to apply. Second, this Comment will analyze Internal Revenue Code (I.R.C.) section 7525, the statute purporting to create a limited accountant-client privilege for certain tax matters. Part IV of this Comment will examine the ever-dwindling protection the attorney-client privilege affords accountants. In Part V, this Comment will briefly examine the protection that the work product doctrine affords accountants that are employed by attorneys. Finally, this Comment will call upon courts to reinstate the holding in *Kovel*, due to the limited applicability of section 7525.

## II. ATTORNEY-CLIENT PRIVILEGE

According to common law, the attorney-client privilege is "the oldest of the privileges for confidential communications . . . ."<sup>9</sup> According to *Upjohn Co. v. United States*, "[i]ts purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and

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7. *Id.*

8. An attorney is also obligated to protect confidential client information. MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2002). "A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation . . . ." *Id.* Model Rule 1.6, unlike the common law attorney-client privilege doctrine, is inapplicable, however, in a litigation context. It is not a defense to a summons or subpoena, and it may not be used as a privilege in discovery or at trial. *Id.* at cmt. 5.

9. 8 JOHN HENRY WIGMORE, EVIDENCE § 2290 (John T. McNaughton ed. 1961).

administration of justice."<sup>10</sup> Its presence therefore helps to ensure that clients "seeking legal advice will be able to confide fully and freely in [their] attorney[s], secure in the knowledge that [their] confidences will not later be . . . exposed to public view to [their] embarrassment or legal detriment."<sup>11</sup> However, this privilege is not only designed "to protect . . . the giving of professional advice to those who can act on it but also the giving of information to the lawyer to enable him to give sound and informed advice."<sup>12</sup>

To be protected as a privileged communication, information must be communicated to an attorney for the purpose of securing legal advice.<sup>13</sup> Therefore, a discussion with an attorney concerning business advice will not be considered privileged.<sup>14</sup> Communications are protected under the attorney-client privilege if: (1) a person is seeking legal advice from a lawyer acting in his legal capacity; (2) the communication is made for the purpose of obtaining legal advice; (3) the communication is made in confidence; and (4) the communication is made by the client.<sup>15</sup>

The attorney-client privilege is centered around the requirement that, in order to be protected, "the communication [must] be made in confidence. . . ."<sup>16</sup> However, this "privilege shields only those communications . . . to an attorney that [are] intended to be confidential."<sup>17</sup> Thus, the privilege is generally inapplicable if the communication takes place in the presence of third parties.<sup>18</sup> However, the presence of a third party will not vitiate the attorney-client privilege if the third party is an agent of the attorney or the client "whose intervention is necessary to secure and facilitate the communication between attorney and client . . . ."<sup>19</sup>

Determining which agents are necessary to secure and facilitate communication between an attorney and a client is a fact-sensitive

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10. *Upjohn*, 449 U.S. at 390.

11. *Fin. Tech. Int'l, Inc. v. Smith*, 49 Fed. R. Serv. 3d 961, 964 (S.D.N.Y. 2000) (quoting *Priest v. Hennessy*, 409 N.E.2d 983, 985 (N.Y. 1980)).

12. *Upjohn*, 449 U.S. at 390.

13. See 8 WIGMORE, *supra* note 9, § 2296, at 566-67.

14. *United States v. Vehicular Parking, Ltd.*, 52 F. Supp. 751, 753-54 (D. Del. 1943).

15. *United States v. El Paso Co.*, 682 F.2d 530, 538 n.9 (5th Cir. 1982) (quoting WIGMORE, *supra* note 9, § 2292 at 554); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 68 (2002).

16. *United States v. Kovel*, 296 F.2d 918, 922 (2d Cir. 1961) (emphasis omitted).

17. *United States v. Evans*, 113 F.3d 1457, 1462 (7th Cir. 1997).

18. *Id.*

19. *Fin. Tech. Int'l, Inc. v. Smith*, 49 Fed. R. Serv. 3d 961, 967 (S.D.N.Y. 2000) (quoting *Mileski v. Locker*, 178 N.Y.S.2d 911, 916 (Sup. Ct. 1958)).

inquiry and thus difficult to predict. Nonetheless, certain principles can be gleaned from the case law. For instance, courts have held that the presence of certain types of third parties, such as a client's translator,<sup>20</sup> interpreter,<sup>21</sup> parent,<sup>22</sup> or adult child<sup>23</sup> may be necessary to secure and facilitate communication between the client and his attorney. In many instances, there could be no "full and frank"<sup>24</sup> communication between an attorney and client without the presence of these third parties because they literally convey and translate information from the client to the attorney.<sup>25</sup> By contrast, courts have held that the presence of other types of third parties, such as investment bankers or business advisors, are generally unnecessary to secure and facilitate communication between an attorney and client.<sup>26</sup> These third parties generally do not translate information from the client to the attorney; rather, they provide information independently to the attorney.<sup>27</sup> As such, their presence breaches the confidentiality necessary to invoke the attorney-client privilege.<sup>28</sup> The question this Comment addresses is whether the presence of an accountant retained to assist an attorney in a complex tax-advantaged transaction is necessary to secure and facilitate communication between an attorney and a client and thus is protected by the attorney-client privilege.

### III. I.R.C. § 7525

Congress ostensibly answered this question when it enacted section 7525(a) of the I.R.C., which provides:

[W]ith respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication

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20. *Kovel*, 296 F.2d at 921.

21. *Mileski*, 178 N.Y.S.2d at 915.

22. *Hendrick v. Avis Rent A Car Sys., Inc.*, 944 F. Supp. 187, 189 (W.D.N.Y. 1996).

23. *Stroh v. Gen. Motors Corp.*, 623 N.Y.S.2d 873, 875 (App. Div. 1995).

24. *Upjohn Co. v. United States*, 449 U.S. 389, 392 (1981).

25. *See United States v. Evans*, 113 F.3d 1457, 1462 (7th Cir. 1997); *Kovel*, 296 F.2d at 921; *Fin. Tech. Int'l, Inc. v. Smith*, 49 Fed. R. Serv. 3d 961, 967 (S.D.N.Y. 2000) (quoting *Mileski*, 178 N.Y.S.2d at 916).

26. *United States v. Ackert*, 169 F.3d 136, 139 (2d Cir. 1999) (holding that the presence of investment banker vitiates the attorney-client privilege); *Cavallaro v. United States*, 153 F. Supp. 2d 52, 59 (D. Mass. 2001) (holding that the presence of accountants for children's business vitiates parent's attorney-client privilege).

27. *See Ackert*, 169 F.3d 136; *Cavarallo*, 153 F. Supp. 2d 52.

28. *See Ackert*, 169 F.3d 136; *Cavarallo*, 153 F. Supp. 2d 52.

between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.<sup>29</sup>

A "federally authorized tax practitioner" is defined as any person authorized to practice before the Internal Revenue Service, including some accountants.<sup>30</sup> Section 7525 is designed to place accountants on par with attorneys as far as privileged communications are concerned.<sup>31</sup>

Section 7525, however, has three significant limitations. First, it does not apply to criminal tax matters.<sup>32</sup> Second, it does "not apply to any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter."<sup>33</sup> For purposes of this exception, the term "tax shelter" means "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."<sup>34</sup> Finally, section 7525, by its terms, applies only to communications between a federally authorized tax practitioner and a taxpayer.<sup>35</sup> It is unclear whether it applies to communications between a taxpayer's federally authorized tax practitioner and the taxpayer's attorney. Considering these limitations, section 7525 is no substitute for the protection afforded by *Kovel*, particularly when an attorney seeks the advice and assistance of an accountant in connection with a tax-advantaged transaction.

#### IV. ACCOUNTANTS AND THE ATTORNEY-CLIENT PRIVILEGE

Aside from the limited protection afforded by I.R.C. § 7525, there is no accountant-client privilege in federal court. However, under certain

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29. I.R.C. § 7525(a)(1) (West 2002).

30. *Id.* § 7525(a)(3)(A).

31. *Id.* § 7525(a) (stating that the tax advisor privilege applies to the same extent as attorney-client privilege).

32. *Id.* § 7525(a)(2).

33. *Id.* § 7525(b). The protection prescribed by section 7525(a) apparently applies to oral communications related to corporate tax shelters and to all communications related to non-corporate tax shelters.

34. *Id.* § 6662(d)(2)(C)(iii).

35. *Id.* § 7525(a).

circumstances the attorney-client privilege can extend to shield communications to accountants when the purpose of the communication is to assist the attorney in rendering advice to the client. The leading case in this area is *United States v. Kovel*,<sup>36</sup> in which the United States Court of Appeals for the Second Circuit extended the attorney-client privilege to shield communications by an attorney's client to an accountant hired by the attorney to assist the attorney in understanding the client's financial information. The court analogized the accountant's role to that of an interpreter.<sup>37</sup> If an attorney needs an interpreter to understand his client, the presence of the interpreter will not destroy the attorney-client privilege.<sup>38</sup> The tax laws can be as incomprehensible as a foreign language to a lawyer.<sup>39</sup>

The *Kovel* court stressed, however, that not all accountants are included within the protection of the attorney-client privilege:

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.<sup>40</sup>

For all practical purposes, *Kovel* extended the attorney-client privilege to include communications between a lawyer and an accountant when those communications are intended to assist the lawyer in representing his client. The protection prescribed in *Kovel*, moreover, applies to all types of transactions, including tax-advantaged transactions.<sup>41</sup> Over the past four decades, however, the holding in *Kovel* has been restricted in several ways. As a result, there is no longer any certainty that communications between a lawyer and an accountant will be protected by the attorney-client privilege. The restrictions imposed on *Kovel* are examined below.

#### A. *Elements of the Attorney-Client Privilege: Strict Compliance Required*

The party claiming the benefit of the attorney-client privilege has

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36. 296 F.2d 918 (2d Cir. 1961).

37. *Id.* at 921.

38. *Id.*

39. *Id.* at 922; *see also supra* note 6 and accompanying text.

40. 296 F.2d at 922 (emphasis omitted) (citations omitted).

41. *Id.* at 921-24.

"the burden of proving all [of the] essential elements."<sup>42</sup> In *United States v. Adlman*,<sup>43</sup> the United States Court of Appeals for the Second Circuit specifically addressed the circumstances under which an attorney's consultation with an accountant will subject reports prepared by the accountant to the attorney-client privilege. In that case, the taxpayer, Sequa Corporation, was contemplating a reorganization that would result in a very large tax loss.<sup>44</sup> In deciding whether to pursue the reorganization, Adlman, an attorney and Sequa's vice president for taxes, hired Arthur Andersen (AA) to prepare a memorandum discussing the probable tax consequences of the proposed restructuring.<sup>45</sup> Adlman relied on the memorandum in making recommendations to the corporation and included AA's recommendations as to the form of the transaction in a letter to Sequa's vice president for finance.<sup>46</sup> AA later formalized the analysis in the memorandum by issuing two opinion letters in which it evaluated the reorganization and concluded that it "should result in a substantial [tax] loss for Sequa."<sup>47</sup> Adlman claimed that the two AA memoranda were prepared for the purpose of assisting him in providing legal advice to Sequa.<sup>48</sup> The court disagreed, and its findings are quite instructive:

The problem with Adlman's argument is that *the facts are subject to competing interpretations*. In many respects, the evidence supports the conclusion that Sequa consulted an accounting firm for tax advice, rather than that Adlman, as Sequa's counsel, consulted AA to help him reach the understanding he needed to furnish legal advice. Adlman himself serves not only as counsel to Sequa but also as one of its officers. AA, furthermore, is regularly employed by Sequa to furnish auditing, accounting, and advisory services. AA furnished extensive advisory services to Sequa in connection with the merger, including tax advice. If the facts were that Sequa furnished information to AA to seek AA's expert advice on the tax implications of the proposed transaction, no privilege would apply.<sup>49</sup>

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42. *United States v. Evans*, 113 F.3d 1457, 1461 (7th Cir. 1997).

43. 68 F.3d 1495 (2d Cir. 1995).

44. *Id.* at 1497.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.* at 1498.

49. *Id.* at 1500 (emphasis added); *see also* *Cavallaro v. United States*, 153 F. Supp. 2d 53,



As *Adlman* illustrates, the party claiming protection under the attorney-client privilege has the burden of proving each of the elements of such privilege.<sup>50</sup> This requires contemporaneous proof<sup>51</sup> of a *Kovel* agreement.<sup>52</sup> In many instances, this could mean that determining whether the attorney-client privilege applies to communications with accountants involves analyzing form over substance.<sup>53</sup> Therefore, those who "paper" the file with the right agreements and billing statements will succeed, while those who are a bit sloppy will not, despite the true nature of the relationship between the lawyer, accountant, and client.

*B. Client Communication: Accountant as Translator of Information*

If an accountant is retained by a law firm, communications with the accountant will be covered by the attorney-client privilege only if the accountant's function is "to make a literal translation" of information from the client to the lawyer.<sup>54</sup> In *United States v. Ackert*,<sup>55</sup> an investment banker (Ackert) with Goldman, Sachs approached Paramount with a tax-advantaged investment proposal.<sup>56</sup> During the negotiations, Meyers, Paramount's senior vice president and tax counsel, contacted Ackert on several occasions to discuss various aspects of the proposal, including its tax consequences.<sup>57</sup> Meyers claimed that these conversations were necessary to "advise Paramount about the tax implications of the proposed investment."<sup>58</sup> Paramount ultimately chose to accept the proposal, but they selected a different investment banker than Ackert.<sup>59</sup> However, they still paid Goldman,

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58 (D. Mass. 2001) (finding that the attorney-client privilege did not apply to communications with Ernst & Young where the retention letter between Ernst and the client provided that "[a]ll advice and other service [Ernst & Young] provide[s] pursuant to this engagement are solely for the benefit of [the client] and are not for the benefit of anyone other than the [client] or its shareholders."); Gregory J. Wallance, *How to Waive Privilege Without Really Trying*, 12 CORP. COUNS. 4 (1997) (arguing that the use of a corporation's regular auditor as a *Kovel* consultant waives the attorney-client privilege).

50. *Adlman*, 68 F.3d at 1500.

51. A separate and detailed retention agreement or separate billing are examples of contemporaneous proof.

52. See *Adlman*, 68 F.3d at 1500 n.1.

53. *Id.*

54. *United States v. Kovel*, 296 F.2d 918, 921 (2d Cir. 1961).

55. 169 F.3d 136 (2d Cir. 1999).

56. *Id.* at 138.

57. *Id.*

58. *Id.*

59. *Id.*

Sachs \$1.5 million for their services.<sup>60</sup>

During a subsequent audit, Ackert was summoned to testify about his involvement in the investment proposal.<sup>61</sup> "Paramount asserted the attorney-client privilege with respect to questions concerning any conversations Ackert had with Meyers," claiming that Ackert played a role similar to that of the accountant in *Kovel*.<sup>62</sup> The district court upheld Paramount's claim of privilege.<sup>63</sup> The Second Circuit reversed, ruling:

We also reject Paramount's argument based on *Kovel*. That decision recognized that the inclusion of a third party in attorney-client communications does not destroy the privilege if the purpose of the third party's participation is to improve the comprehension of the communications between attorney and client. That principle, however, has no application to this case. Meyers was not relying on Ackert to translate or interpret information given to Meyers by his client. Rather, Meyers sought out Ackert for information Paramount did not have about the proposed transaction and its tax consequences. Because Ackert's role was not as a translator or interpreter of client communications, the principle of *Kovel* does not shield his discussions with Meyers.<sup>64</sup>

Similarly, in *Calvin Klein Trademark Trust v. Wachner*,<sup>65</sup> a case involving a public relations firm rather than an accounting firm, the court further limited the scope of *Kovel*. In *Calvin Klein*, the law firm of Boies, Schiller & Flexner L.L.P. (BSF) retained the public relations firm of Robinson Lerer & Montgomery (RLM) "to act as a consultant to [BSF] for certain communications services in connection with [BSF's] representation of Calvin Klein, Inc. [(CKI)]."<sup>66</sup> CKI claimed that the communications between BSF and RLM were protected by the attorney-client privilege because the communications were needed by BSF to formulate legal advice.<sup>67</sup> The court rejected this argument, holding that "the possibility that communications between RLM and

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60. *Id.*

61. *Id.*

62. *Id.* at 138-39.

63. *Id.*

64. *Id.* at 139-40.

65. 198 F.R.D. 53 (S.D.N.Y. 2000).

66. *Id.* at 54.

67. *Id.*

BSF may help the latter formulate legal advice is not in itself sufficient to implicate the privilege: 'the privilege protects communications between a client and an attorney, not communications that prove important to an attorney's legal advice to a client.'"<sup>68</sup> The court also rejected CKI's *Kovel* argument:

[E]ven assuming *arguendo* that somewhere hidden in the voluminous documents here in issue are nuggets of client confidential communications that were originally made for the purpose of seeking legal advice, their disclosure to RLM waives the privilege, since inspection of the documents here in question clearly establishes that RLM, far from serving the kind of "translator" function served by the accountant in *Kovel, supra*, is, at most, simply providing ordinary public relations advice . . . . The possibility that such activity may also have been helpful to BSF in formulating legal strategy is neither here nor there if RLM's work and advice simply serves to assist counsel in assessing the probable public reaction to various strategic alternatives, as opposed to enabling counsel to understand aspects of the client's own communications that could not otherwise be appreciated in the rendering of legal advice.<sup>69</sup>

Thus, under *Ackert* and *Calvin Klein*, communications with an accountant are privileged only if the accountant is retained solely to translate and interpret information conveyed by the client to the law firm. Although one of the roles an accountant serves is to "interpret" client financial and tax information for an attorney, an accountant also provides independent information and expertise for the attorney to use in representing his or her client. This latter communication, according to *Ackert* and *Calvin Klein*, is not protected by the attorney-client privilege. Therefore, *Ackert* and *Calvin Klein* severely limit the protection afforded by *Kovel*.

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68. *Id.* (quoting *United States v. Ackert*, 169 F.3d 136, 139 (2d Cir. 2000)).

69. *Id.* at 54-55. *But see* *Byrnes v. Empire Blue Cross Blue Shield*, No. 98 Civ. 8520 (BSJ) (MHD), 1999 WL 1006312, at \*2 (S.D.N.Y. Nov. 4, 1999) (mem.) (holding that communications between actuary and attorneys are privileged). *Ackert* is distinguishable because it was not apparent who hired the accounting firm, nor what capacity they were acting in to assist with legal services, whereas "here the Segal Company was involved as a consultant on the very project for which the attorney was also rendering assistance to Empire." *Id.*

*C. Functional Equivalent of Client Employee*

If an accountant is retained by the client (as opposed to by the law firm), communications between the lawyer and the accountant will be included within the attorney-client privilege only if the accountant acts as the functional equivalent of an employee of the client. In *In re Copper Market Antitrust Litigation*,<sup>70</sup> a Japanese manufacturer (Sumitomo) retained the same public relations firm, RLM, as in *Calvin Klein* "to handle public relations matters arising from the copper trading scandal."<sup>71</sup> Sumitomo did not have public relations employees who were fluent in English or knowledgeable about United States litigation.<sup>72</sup> RLM worked out of Sumitomo's Tokyo headquarters and was given unfettered authority to speak on behalf of Sumitomo.<sup>73</sup> During the litigation, Sumitomo's lawyers frequently conferred with RLM.<sup>74</sup> The plaintiffs sought all documents relating to RLM's consulting work.<sup>75</sup> Sumitomo claimed that some of these documents were privileged.<sup>76</sup> The plaintiffs argued that *Ackert* governed this dispute and there was therefore no privilege.<sup>77</sup> The court found that:

RLM was, essentially, incorporated into Sumitomo's staff to perform a corporate function that was necessary in the context of the government investigation, actual and anticipated private litigation, and heavy press scrutiny obtaining at the time. Sumitomo retained RLM to deal with public relations problems following the exposure of the copper trading scandal. Sumitomo's internal resources were insufficient to cover the task. . . . [Thus,] 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. Accordingly, confidential communications between RLM and Sumitomo's counsel, or between RLM and Sumitomo, or among RLM, Sumitomo's in-house counsel and [outside counsel] that were made for the purpose of facilitating the rendition of legal services to Sumitomo can be protected from disclosure by the attorney-

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70. 200 F.R.D. 213 (S.D.N.Y. 2001).

71. *Id.* at 215.

72. *Id.*

73. *Id.* at 216.

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.* at 213.

client privilege.<sup>78</sup>

By analogy, if an accountant is retained by a client, as opposed to by a law firm, communications between the accountant and the client's lawyers will be privileged only if the accountant is found to be the functional equivalent of an employee of the client.<sup>79</sup> This would be a difficult standard to meet in most cases, as accountants are generally required to act as independent contractors and would not be considered to hold the same status as an employee of a client.<sup>80</sup> *Copper Market* further restricts the protection afforded by *Kovel*.

#### D. Pre-Retention Communications With Accountant

Prior to the time an accountant enters into a *Kovel* agreement, communications with the accountant are not privileged.<sup>81</sup> Thus, any communications the accountant has with the client prior to the retention of the law firm are not privileged. The privilege, if any, does not arise until after the accountant enters into a *Kovel* agreement with the law firm.

#### E. Summary of Protection of Accountant Communications

In the forty years since *Kovel* was decided, courts have repeatedly restricted the protection that it afforded communications among clients, lawyers, and accountants. *Adlman* requires strict compliance with the elements of the attorney-client privilege, as well as detailed contemporaneous proof of such compliance.<sup>82</sup> *Ackert* and *Calvin Klein* restrict *Kovel* to situations in which the accountant acts solely as a translator of information from the client to the lawyer.<sup>83</sup> *Copper Market*, for all practical purposes, requires that the accountant be retained by

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78. *Id.* at 219; *see also In re Bieter Co.*, 16 F.3d 929 (8th Cir. 1994) (holding that, because the independent real estate consultant was a functional equivalent of an employee of the client, communications between the consultant and the lawyers were privileged).

79. *Copper Mkt.*, 200 F.R.D. 213.

80. *Id.*

81. *In re Grand Jury Proceedings Under Seal*, 947 F.2d 1188, 1190-91 (4th Cir. 1991) (holding that attorney-client privilege does not protect communications with a consultant prior to a *Kovel* arrangement); *United States v. Cote*, 326 F. Supp. 444, 449-50 (D. Minn. 1971) (holding that the attorney-client privilege does not apply to an accountant who was employed by the client eight years before attorney was retained), *aff'd*, 456 F.2d 142 (8th Cir. 1972); *see also Summit, Ltd. v. Levy*, 111 F.R.D. 40, 41-42 (S.D.N.Y. 1986) (same).

82. *United States v. Adlman*, 68 F.3d 1495, 1500 (2d Cir. 1995).

83. *United States v. Ackert*, 169 F.3d 136, 139 (2d Cir. 1999); *Calvin Klein Trademark Trust v. Wachner*, 198 F.R.D. 53, 54 (S.D.N.Y. 2000).

the law firm, as opposed to the client.<sup>84</sup> Further, *In re Grand Jury Proceedings Under Seal* requires that the client retain the law firm before retaining the accountant.<sup>85</sup> These cases epitomize form over substance, and have done nothing but create uncertainty and confusion in an area of the law in which certainty is crucial.

## V. WORK PRODUCT DOCTRINE

### A. Work Product Doctrine Generally

The attorney-client privilege is not the only protection available to communications among clients, lawyers, and accountants. The work product doctrine also provides protection, as it "shelters the mental processes of the attorney, providing a privileged area within which he can analyze and prepare his client's case."<sup>86</sup> According to the *Restatement (Third) of the Law Governing Lawyers*: "Work product consists of tangible material or its intangible equivalent in unwritten or oral form, other than underlying facts, prepared by a lawyer for litigation then in progress or in reasonable anticipation of future litigation."<sup>87</sup> The doctrine essentially shields communications and other material prepared in anticipation of litigation; it is distinct from the attorney-client privilege and may be applied in circumstances when the attorney-client privilege does not apply.<sup>88</sup> The doctrine protects an attorney's "pattern of investigation, . . . determination of relevant facts, preparation of legal theories, planning of strategy, and recording of mental impressions."<sup>89</sup> The doctrine also applies to information and materials prepared by a party representative working on behalf of the attorney, or gathered by an agent acting under an attorney's direction.<sup>90</sup>

The attorney work product doctrine is at once broader and narrower than the attorney-client privilege. The work product doctrine "extend[s] to information which an attorney secures from a witness while acting for his client."<sup>91</sup> It encompasses "memoranda, briefs, communications and other writings prepared by counsel for his own use," while the attorney-

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84. See *Copper Mkt.*, 200 F.R.D. at 217-20.

85. 947 F.2d at 1191.

86. *United States v. Nobles*, 422 U.S. 225, 238 (1975).

87. *RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS* § 136 (1996).

88. See *Hickman v. Taylor*, 329 U.S. 495 (1947).

89. *In re Grand Jury Subpoena*, 622 F.2d 933, 935 (6th Cir. 1980) (quoting *Hickman*, 329 U.S. at 511; *Besly-Welles Corp. v. Balax, Inc.*, 43 F.R.D. 368, 371 (E.D. Wis. 1968)).

90. *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 603 (8th Cir. 1977).

91. *Hickman*, 329 U.S. at 508.

client privilege generally does not.<sup>92</sup> In addition, the attorney-client privilege is inapplicable to "writings . . . reflect[ing] an attorney's mental impressions, conclusions, opinions or legal theories."<sup>93</sup> However, these writings are included within the protection of the work product doctrine.<sup>94</sup>

Although the work product doctrine protects a much wider category of materials than the attorney-client privilege, its protection is not absolute. A party may obtain discovery of materials otherwise protected by the work product doctrine if the party seeking discovery can demonstrate that it has a substantial need for the materials in the preparation of its case and that it is unable, without undue hardship, to obtain the substantial equivalent of the materials by other means.<sup>95</sup> This holding has been specifically incorporated into Rule 26(b)(3) of the Federal Rules of Civil Procedure.<sup>96</sup> However, even upon a showing of substantial need and undue hardship, the courts are required to protect "opinion work product"—work product reflecting the attorney's mental processes—from disclosure to an adversary.<sup>97</sup> Opinion work product is discoverable only upon a showing beyond substantial need and undue hardship. This standard has sometimes been described as being between very high and absolute.<sup>98</sup>

The "substantial need and undue hardship exception" has not been specifically adopted, however, in the Tax Court's Rules of Practice and Procedure. The notes of the Rules Committee regarding Rule 70(b), which governs discovery in the Tax Court, state that work product is "generally intended to be outside the scope of allowable discovery."<sup>99</sup> In *P. T. & L. Construction Co. v. Commissioner*,<sup>100</sup> the Tax Court took particular note of the "negative recognition" given to the work product doctrine in the Court's Rules and the Rules Committee's notes.<sup>101</sup>

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92. *Id.*

93. *Id.*

94. *Id.* at 511.

95. *Id.* at 508-09.

96. FED. R. CIV. P. 26(b)(3). The generally accepted view is that the IRS bears a reduced burden to show necessity. *See, e.g., United States v. Arthur Young & Co.*, 496 F. Supp. 1152, 1158 (S.D.N.Y. 1980), *aff'd in part and rev'd in part*, 677 F.2d 211 (2d Cir. 1982), *aff'd in part and rev'd in part*, 465 U.S. 805 (1984).

97. *Upjohn Co. v. United States*, 449 U.S. 383, 400-02 (1981).

98. *Id.*

99. 60 T.C. 1097, 1098 (1973).

100. 63 T.C. 404 (1974).

101. *Id.* at 408.

Moreover, in *Zaentz v. Commissioner*,<sup>102</sup> the Tax Court flatly stated that "under the Tax Court Rules, the work product of counsel is not discoverable."<sup>103</sup> However, the Tax Court recently held that "[t]he work product privilege is a qualified one that, in some circumstances, may be overcome by a showing of good cause and substantial need."<sup>104</sup> It is important to note that, while the Tax Court's rules apply to pretrial discovery in matters tried before that court, Rule 26(b)(3) of the Federal Rules of Civil Procedure applies to trials in the district court, the Court of Federal Claims, and to summons enforcement actions in the district court.

The most significant limitation on the work product doctrine is the requirement that, in order to be protected, information must have been obtained or produced "in anticipation of litigation."<sup>105</sup> Litigation does not need to have commenced or be immediately imminent at the time the materials are produced so "long as the primary motivating purpose behind the creation of the document[s] was to aid in possible future litigation."<sup>106</sup> In *Upjohn Co. v. United States*, for example, documents that had been prepared in anticipation of future litigation were held to be protected work product even though no lawsuits had been commenced or even threatened at the time of creation.<sup>107</sup> However, "a remote prospect of future litigation" is not sufficient to invoke the work product doctrine.<sup>108</sup> In tax litigation, whether a notice of deficiency has been issued is not determinative of whether documents were prepared in anticipation of litigation.<sup>109</sup>

Courts differ concerning whether the work product doctrine applies to materials prepared in anticipation of prior litigation sought by an opponent in subsequent litigation.<sup>110</sup> The "in anticipation of litigation" requirement also raises the question of what constitutes litigation for purposes of the work product doctrine. For example, the work product doctrine has been held not to apply to materials prepared in anticipation

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102. 73 T.C. 469 (1979).

103. *Id.* at 478.

104. *Ames v. Comm'r*, 112 T.C. 304, 310 (1999).

105. FED. R. CIV. P. 26(b)(3).

106. *United States v. Adlman*, 134 F.3d 1194, 1502 (2d Cir. 1998); *United States v. Davis*, 636 F.2d 1028, 1040 (5th Cir. 1981).

107. 449 U.S. 383, 386-87, 397-402 (1981).

108. *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 604 (8th Cir. 1977).

109. *Bernardo v. Comm'r*, 104 T.C. 677, 688 (1995).

110. *Compare Bituminous Cas. Corp. v. Tonka Corp.*, 140 F.R.D. 381 (D. Minn. 1992), *with Waste Mgmt., Inc. v. Int'l Surplus Lines Ins. Co.*, 579 N.E.2d 322 (Ill. 1991).



of an administrative proceeding before the IRS.<sup>111</sup>

*B. Accountants and the Work Product Doctrine*

Just as the attorney-client privilege applies only to communications with an attorney or his agents, the work product doctrine extends only to materials prepared or obtained by an attorney or his agents or employees.<sup>112</sup> For example, in *United States v. Nobles*,<sup>113</sup> an investigator's report prepared for an attorney in anticipation of litigation was held to be protected work product.<sup>114</sup> Similarly, financial analyses can be protected as work product if they are prepared by an accountant to assist a lawyer in assessing a client's potential criminal liability.<sup>115</sup>

To be protected as work product, however, materials must have been prepared for or transferred to an attorney in connection with the rendering of legal advice.<sup>116</sup> In addition, the same protection applies if an attorney retains these materials to render legal advice.<sup>117</sup> Materials cannot be "funneled" through an attorney simply to afford them protection.<sup>118</sup> Likewise, "[a]n attorney may not be used to insulate records an individual previously has prepared for his business."<sup>119</sup> However, materials gathered at an attorney's request by a client to allow an accountant to prepare a report in anticipation of litigation are work product, because an attorney's opinions and mental impressions would ultimately be shown.<sup>120</sup> In contrast, "[d]ocuments created by and received from an unrelated third party and given by the client to his attorney" are not protected by the work product doctrine unless the production of those documents would somehow reveal the attorney's thought-process or mental impressions.<sup>121</sup> Therefore, "since arbitrations

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111. *In re* Special Sept. 1978 Grand Jury (II), 640 F.2d 49, 65 (7th Cir. 1980). The Seventh Circuit has also declined to apply the work product doctrine to materials prepared for a prior administrative proceeding unrelated to the case before it. *Velsicol Chem. Corp. v. Parsons*, 561 F.2d 671, 676 (7th Cir. 1977). Likewise, in *Peterson v. United States*, the court refused to extend work product protection to IRS appellate conferee and field agent reports. 52 F.R.D. 317 (S.D. Ill. 1971).

112. *United States v. Nobles*, 422 U.S. 225, 238-39 (1975).

113. *Id.*

114. *Id.* at 238.

115. *In re* Grand Jury Proceedings, 601 F.2d 162, 171 (5th Cir. 1979).

116. *United States v. Clark*, 847 F.2d 1467, 1471 (10th Cir. 1988).

117. *Id.*

118. *Sneider v. Kimberly-Clark Corp.*, 91 F.R.D. 1, 4 (N.D. Ill. 1980).

119. *Grand Jury Proceedings*, 601 F.2d at 171 n.7.

120. *United States v. Bell*, 95-1 T.C.M. (CCH) ¶ 50,006 (N.D. Cal. 1994).

121. *In re* Grand Jury Subpoenas, 959 F.2d 1158, 1165-66 (2d Cir. 1992).

are adversarial in nature . . . documents prepared by or for a party in connection with arbitrations should ordinarily be protected by the work product doctrine."<sup>122</sup> However, reports prepared by an accountant engaged by an attorney to assist the attorney's client in preparing tax returns are not privileged under either Rule 26(b)(4)(B) or the work product doctrine.<sup>123</sup>

Because the work product doctrine applies only to materials prepared in anticipation of litigation, it provides little protection for communications among a client, lawyer, and accountant in connection with the planning and execution of a tax-advantaged transaction. However, the protection of the work product doctrine has been held to encompass documents, the primary purpose of which are "to assess the desirability of a business transaction, which, if undertaken, would give rise to the litigation."<sup>124</sup> In *Adlman*, the Second Circuit held that "a document created because of anticipated litigation . . . does not lose work-product protection [under this formulation] merely because it is intended to assist in the making of a business decision influenced by the likely outcome of the anticipated litigation."<sup>125</sup> Despite this holding, the work product doctrine would generally not apply to communications among a client, lawyer, and accountant in connection with the planning and execution of a transaction.

### C. Waiver

Unlike disclosure of materials protected by the attorney-client privilege, disclosure of work product materials does not ordinarily result in a waiver of the doctrine's protection. While disclosure of information protected by the attorney-client privilege to anyone outside of the privileged relationship ordinarily results in a waiver, disclosure of work product materials to a third party results in a waiver only "if the disclosure to a third party 'is inconsistent with the maintenance of secrecy from the disclosing party's adversary.'"<sup>126</sup> Unlike the attorney-client privilege, where a waiver generally extends to all communications

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122. *Samuels v. Mitchell*, 155 F.R.D. 195, 200 (N.D. Cal. 1994).

123. *Bell*, 95-1 T.C.M. (CCH) ¶ 50,006.

124. *United States v. Adlman*, 134 F.3d 1194, 1195 (2d Cir. 1998).

125. *Id.* The case was remanded with instructions to the district court to determine whether the document was prepared "because of" expected litigation. *Id.* at 1203-04.

126. *Minn. Sch. Bds. Ass'n Ins. Trust v. Employers Ins. Co. of Wausau*, 183 F.R.D. 627, 631 (N.D. Ill. 1999) (quoting *United States v. Am. Tel. & Tel. Co.*, 642 F.2d 1285, 1299 (D.C. Cir. 1980)); see also *Bramlette v. Hyundai Motor Co.*, No. 91-C3635, 1993 WL 338980, at \*3 (N.D. Ill. Sept. 1, 1993) (mem.).

relating to the same subject matter, selective and strategic disclosure of work product may be consistent with the doctrine; the purpose underlying the work product doctrine does not involve confidential communications as much as implementation of the adversarial process and protection of the attorney's participation in it.

## VI. CONCLUSION

Attorneys often need the advice and assistance of accountants to competently represent clients. This is particularly true when attorneys represent clients in tax-advantaged transactions. Attorneys can make full use of the accountant's advice and expertise, however, only if the attorneys can have confidential communications with the accountants. *Kovel* recognized this fact. Since then, however, courts have limited the protection *Kovel* provided to attorney-accountant communications. It is time to reverse this situation.

The goal of I.R.C. § 7525 was to place accountants on par with lawyers as far as confidential communications are concerned. That section, however, does not apply to communications related to tax-advantaged transactions. In addition, these transactions are not protected under the work product doctrine. This is counterintuitive for two reasons. First, there are some areas of tax law that accountants know better than lawyers; tax shelters is one such area. Accountants know precisely what is legal and what is not. The refusal to extend section 7525 to tax shelters will not prevent such transactions. Rather, it will merely force clients to consummate such transactions without the expert advice of accountants. Second, why should the attorney-client privilege protect tax shelter advice from an attorney to a client, but not the same advice from an accountant? If section 7525 really intends to place lawyers and accountants on par, this distinction makes no sense. The I.R.C. should either include or exclude all communications between clients and accountants from the protection of the attorney-client privilege because the status quo simply encourages clients to retain lawyers rather than accountants. As a result, it is time for the courts to reinstate *Kovel* and, as such, bring needed certainty to a very uncertain area of the law.

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