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Protected Communications: *Adams* Case Addresses When the *Kovel* Rule Shields Accountant-Client Emails from the Government

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The old legal saw "hard facts make bad law" has been acknowledged since at least 1837.[2] This maxim means that it is difficult to extract general rules of application from cases in which the facts are particularly muddied. Muddied facts certainly surrounded the criminal charges leveled against a taxpayer, a lawyer, in *United States v. Adams*[3] for allegedly "engag[ing] in a scheme and artifice to defraud investors" in two related companies (together, "Apollo").[4] The Government argued that the alleged scheme also involved a few tax plays, and further argued that these tax plays involved communications between the Taxpayer and his accountants.[5] The Taxpayer successfully asserted that the communications were privileged and could not be accessed by the Government. The Government was successful, however, in obtaining certain underlying documents. This Legal Update distills the Court's decision in order to provide some unclouded strategies for taxpayers who desire to keep their communications with their accountants away from government scrutiny.[6]

Background of the Underlying Tax Issues

The facts were complex, but a simplified version is as follows. The Government asserted that the Taxpayer set up a series of entities and transactions to bilk investors.[7] The Taxpayer told his investors that their funds would be used to fund operations of Apollo. The Government alleged, however, that the funds were instead personally used by the Taxpayer or paid to his law firm for services never rendered. When the scheme started to unravel, the Taxpayer started *another* entity (unbeknownst to his investors) called "Scio" and presented Scio as a private, unrelated buyer for Apollo securities. The investors then transferred their shares in Apollo to Scio, and the Taxpayer allegedly continued his scheme at Scio. Again, these allegations were taken from the indictments, and we make no view as to their validity.

The Government asserted, with respect to the tax issue, that the Taxpayer gave false information to the accounting firm so that he could pay taxes at a lower rate and on only a portion of his full income.[8] Specifically, the Government alleged:

> The difference between Mr. Adams having exercised the warrants in 2003 and then [having] sold the stock in 2008-2010, as falsely claimed on the amended returns, as opposed to having sold unexercised warrants in 2008-2010, would affect his ability to take advantage of a lower tax rate . . . . Thus, if Mr. Adams exercised the warrants in 2003, thereby acquiring the stock, and did not sell that stock until 2008 or later, then the lower, long term

> rate would apply. But if Mr. Adams simply sold unexercised warrants in 2006-2010, which resulted in the warrants being exercised, then the proceeds of those sales would be taxed as ordinary income subject to the much higher marginal rates . . . . In addition, the amended returns prepared with the assistance of the [accounting] firm claimed that Mr. Adams held the stock created as a result of his exercise of warrants for more than five years, which allowed him to claim a partial exclusion (50% of the gains) under 26 U.S.C. § 1202.[9]

The Government sought to obtain the communications (mostly emails) between the Taxpayer and the accounting firm that led to the Taxpayer filing amended returns claiming this preferential treatment. In response, the Taxpayer asserted that the communications were either privileged or attorney work product and, as a result, were protected from disclosure.

Basis for the Claim of Privilege

The Taxpayer asserted that his communications with the accountants were protected by the attorney-client privilege. "The attorney-client privilege protects confidential communications between a client and an attorney that are made for the purpose of obtaining legal advice."[10] The Second Circuit extended the attorney-client privilege to communications between an accountant and a client when the accountant has been retained by the attorney, provided that the communications are undertaken in confidence for the purpose of obtaining legal advice from the attorney.[11] This rule, known as the *Kovel* Rule, is generally accepted throughout the United States and applies to communications between the client and the accountant, not just the attorney and the accountant. The application of the *Kovel* Rule to accountants-client communications is particularly difficult when the accountant has prepared tax returns for the client because it is difficult to distinguish between communications for tax return preparation and those made for the provision of legal services.[12]

Courts uphold claims of *Kovel* privilege where the third party acts as a "translator" of a "foreign language" (which can include financial accounting)—where the third party merely explains to the lawyer what something *means* and the lawyer then provides advice and analysis on the basis of that translation.[13] Those same courts, however, have made clear that the *Kovel* privilege is not expansive. It does not apply to "dual purpose" documents (those that have a legal purpose and an accounting purpose) or communications not essential to providing legal advice.[14] Relatedly, third-party advice that only improves the quality of the lawyer's advice is not protected.[15]

And because *Kovel* is not itself a separate privilege but instead rides on the coattails of the general attorney client privilege, where the general privilege is lost so is any protection granted by *Kovel*. For example, where the taxpayer discloses the legal advice received (which can include disclosure on a tax return) to someone outside the privilege scope, the communications with third parties underlying that advice become discoverable under the logic of "waiver."[16] A taxpayer also can lose privilege through the crime-fraud exception, which, as the Supreme Court has said, "assure[s] that the 'seal of secrecy' between lawyer and client does not extend to communications 'made for the purpose of getting advice for the commission of a fraud' or crime."[17] Accordingly, where the taxpayer obtains legal advice to further the commission of a crime, those otherwise privileged communications lose their privileged status.

In *Adams*, the Government challenged the *Kovel* relationship between the Taxpayer, his attorney and the accountants. In the alternative, the Government argued that the crime-fraud exception to the attorney-client privilege applied.[18]

The Court's Decision in *Adams*

THE *KOVEL* PRIVILEGE

To bolster the Taxpayer's privilege claims, the Taxpayer's attorney submitted two formal declarations to the Court stating that the information provided by the accountants was necessary in order to properly provide legal advice to the Taxpayer. The Court then conducted an *in camera* review of the contested documents and found that nothing in the communications between the Taxpayer and the accountants contradicted the attorney's declarations.[19] Therefore, there was no reason to disregard the *Kovel* arrangement.[20]

The Court then considered whether the Taxpayer's filing his amended returns acted as a waiver of the privilege granted by the *Kovel* arrangement. The Eighth Circuit (to which an appeal would be heard) had held that when "by filing the amended returns the taxpayers communicated, at least in part, the substance of that information [provided by the accountant] to the government,"[21] the taxpayers must then "disclose the detail underlying the reported data."[22] This doctrine is sometimes referred to as "subject matter waiver," and in practice applies differently when a party seeks to use the privileged information for its own benefit versus when it does not. When a party tries to use otherwise privileged information for its own benefit, the subject matter waiver exception operates to waive privilege to that and related information (such as the information the taxpayer relied on in the process of receiving the privileged legal advice) so the party seeking the relied-upon documents is not unfairly disadvantaged.[23] In *Adams*, however, the Court found that the information reported on the Taxpayer's amended returns did not apprise the government of the information provided to the accountants or received from them in the process of obtaining legal advice.[24] Thus, the filing of the amended returns did not waive the attorney-client privilege.

THE CRIME-FRAUD EXCEPTION

After dispensing with the potential waiver concerns, the Court turned to whether the Taxpayer had obtained advice from the accountants in order to commit a crime or further a fraud. "Under the crime-fraud exception, attorney-client privilege 'does not extend to communications made for the purpose of getting advice for the commission of a fraud or a crime.'"[25] The test for the crime-fraud exception has two parts. First, the Government must show that there is "a factual basis adequate to support a good faith belief by a reasonable person . . . that in camera review of the materials may reveal evidence to establish the claim that the crime-fraud exception applies."[26] As the Supreme Court has said, the first step is a relatively low bar,[27] and the Court found that the Government met it simply by showing that the Taxpayer filed his amended return shortly after speaking with the accountants.[28]

But the standard applicable to the second step of the analysis, the "ultimate showing" as it is called, is more nebulous.[29] The Supreme Court did not provide a bright line, and so Circuits have split on what standard applies.[30] The Court in this case made note of this and then pulled in rules from the First, Ninth and Eleventh Circuits to craft its own two-part "ultimate showing" standard.

First, there must be a *prima facie* showing that the client was engaged in criminal or fraudulent conduct when he sought the advice of counsel, that he was planning such conduct when he sought the advice of counsel or that he committed a crime or fraud subsequent to receiving the benefit of counsel's advice. Second, there must be a showing that the attorney's assistance was obtained in furtherance of the criminal or fraudulent

activity or was closely related to it.[31] The first part of the Eleventh Circuit's test is objective and appears to be subject to less controversy than the second part.

The second part required "reasonable cause to believe that the attorney's services were utilized in furtherance of the ongoing unlawful scheme."[32] The Court quantified the standard by requiring an ultimate showing that "something less than a mathematical (more likely than not) probability that the client intended to use the attorney in furtherance of a crime or fraud."[33] Though the Court could not exhaustively apply this new standard to the Taxpayer's allegedly privileged documents without risking exposing their contents, it did find for the Taxpayer on the crime-fraud exception.[34]

APOLLO AND SCIO ATTORNEY COMMUNICATIONS

The Taxpayer did not fare quite as well on keeping the documentation underlying his attorney-client privilege claim compared to the emails with accountants from the eyes of the Government. The privileged status of the underlying documentation rested on whether the Taxpayer had communicated with the lawyers at Apollo and Scio in his individual capacity or as a representative of those organizations. If he spoke with those lawyers as a representative, then it is the company that had the right to claim privilege and *not* the individual Taxpayer.[35]

In answering the question, the Court noted that the default answer is that when a corporate employee seeks legal advice it is assumed that the individual is acting for the corporation.[36] The Taxpayer was therefore tasked with proving that he received the advice in his individual capacity.

To make this showing, the Court assessed the Taxpayer's actions using a Third Circuit multipart test.[37] The elements are:

1. The employee sought legal advice from the attorney;
2. The employee made it clear that they were seeking advice individually rather than in a representative capacity;
3. The attorney communicated with the employee in the employee's individual capacity, knowing that a possible conflict of interest could arise;
4. The communications with counsel were confidential; and
5. The substance of the communications with counsel did not relate to company matters.[38]

Applying the five elements to the Taxpayer, the Court held that the communications were made to the Taxpayer as a representative of the companies. Indeed, the former lawyer for Scio specifically stated that he did not have an attorney-client relationship with the Taxpayer. This created a factual conflict with the Taxpayer's claim to the contrary, and the Court upheld the presumption that communications are made to the entity.[39] As for the communications with the Apollo attorney, the Court found that the Taxpayer had done nothing to make clear that he, not Apollo, was the client.[40]

Practice Points

The *Adams* case offers certain practice pointers for taxpayers who include their accountants in resolving tax disputes, as is frequently the case. First, although the Taxpayer in *Adams* overcame the negative inference of using the same accountants for forensic advice as for return preparation, the case points to the clear advantage of not doing so. Second, a taxpayer is much less likely to be successfully challenged on claims of privilege when the communications are made directly to the attorney and not directly to the client (though the client can always be cc'd on any communication). When preparing for a

tax controversy, accountants should communicate directly to in-house or external counsel with advice that encompasses how the controversy should be addressed. Finally, the *Adams* decision makes clear that privilege will not be lost solely on the basis that the position has been included on a filed tax return.

As we noted at the outset, the privilege issues were muddied in the *Adams* case by the fact that the Taxpayer claimed privilege for himself with respect to documentation between attorneys for corporate taxpayers. The issue as to whom the attorneys are working for is likely to be of particular importance when employee malfeasance is alleged in a dispute. When an individual believes that there is a risk that their behavior could give rise to liability, it is important for that person to seek their own counsel.

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Endnotes

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[2] *See* https://en.wikipedia.org/wiki/Hard_cases_make_bad_law#cite_note-3

[3] Case No. 0:17-cr-00064-DWF-KMM, Indictment (Docket No. 1).

[4] Indictment, at 1.

[5] Indeed, the Taxpayer alleged in its response to the Government's motion that the tax charges on the Superseding Indictment were added *with the express goal* of accessing these communications. *See* Taxpayer's Response, at 19–20 (Docket No. 201) (noting possible inconsistencies between the tax charge and the other criminal charges) ("[t]he government cannot have it both ways—either Mr. Adams embezzled funds, or he sold investors warrants and/or stock from exercising his warrants").

[6] Note that the decision in *Adams* was an Order, and not an Opinion. Generally, an order (published or otherwise) may be cited before federal appellate courts, though it is granted only persuasive (rather than precedential) effect. *See* Fed. R. App. P. 32.1(a) (allowing parties to cite unpublished or nonprecedential opinions, orders, or judgments published after January 1, 2007). Minnesota's Local Rules of Procedure for its Federal District Court do not expressly address this point, and so it is not clear that taxpayers should rely on this case as a "silver bullet."

[7] The Government's full explanation of the Taxpayer's actions related to Apollo begins on page 4 of the Indictment and First Superseding Indictment, and its overview of the Scio transaction begins on page 11 of each.

[8] Taxpayer Response, at 21 (Docket No. 201) (quoting the Government's Suppression Motion).

[9] Government Opposition to Taxpayer's Motion to Suppress, at 81 (Docket No. 172).

[10] *U.S. v. Adams*, Case 0:17-cr-0064-DWF-KMM (D. Wis. Oct. 27, 2018). The long-form list of elements of attorney client privilege is: (1) legal advice is sought (2) from a professional legal advisor in that capacity, and the (3) communications made for that purpose (4) in confidence (5) by the client (6) at the client's insistence (7) are permanently protected unless waived. *See, e.g.*, 8 J.H. Wigmore, Evidence § 2292 (McNaughton rev. 1961). For a brief description of the purpose of the attorney-client privilege, *see Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981) ("[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 administration of justice").

[11] *U.S. v. Kovel*, 296 F.2d 918, 921-22 (2d Cir. 1961). Although the third party is most often an accountant, "the privilege must include all the persons who act as the attorney's agents." These include investment bankers, appraisers, public relation consultants and insurance brokers. *See, e.g.*, *Evergreen Trading, LLC ex rel Nussdorf*, 80 Fed. Cl. 122 (2007). Further, *Kovel* is not itself a privilege but instead an exception to the general rule that revealing otherwise privileged communications to a third party waives that privilege. *See Cavallaro v. U.S.*, 284 F.3d 236, 245–46 (1st Cir. 2002).

[12] *Kovel*, 296 F.2d at 922 ("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"). Distinguishing between the two in tax cases is a fact-intensive, often unclear process. *See U.S. v. Frederick*, 182 F.3d 496, 500–01 (7th Cir. 1999) (holding that preparing tax returns is an accounting task, not a legal one).

[13] *Kovel*, 296 F.2d at 921–22 ("This analogy of the client speaking a foreign language is by no means irrelevant to the appeal at hand. Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases.").

[14] *See UPMC v. CBIZ, Inc.*, Slip Copy, 2018 WL 1542423, at *8 (W.D. Pa. Mar. 29, 2018) (dual-purpose documents); *U.S. v. Ackert*, 169 F.3d 136, 139 (2d Cir. 1999) (the communication must be more than just "important"; it must be necessary to the provision of legal services); *Serrano v. Chesapeake Appalachia LLC*, 298 F.R.D. 271, 282 (W.D. Pa. 2014) (same).

[15] *See Cavallaro v. U.S.*, 284 F.3d 236, 245–46 (1st Cir. 2002).

[16] *See Evergreen Trading, LLC ex rel Nussdorf*, 80 Fed.Cl. 122, 130 (2007).

[17] *U.S. v. Zolin*, 491 U.S. 554, 563 (1989) citing *O'Rourke v. Darbishire*, [1920] A.C. 581, 604 (P.C.).

[18] Generally speaking, even privileged communications lose that status if the client obtained the legal advice in order to further a fraud or crime, as will be discussed further herein.

[19] Order, at 3.

[20] *Id.*

[21] *U.S. v. Cote*, 456 F.2d 142, 144 (8th Cir. 1972).

[22] *Id.* at 144

[23] The often-used analogy is to using privilege as a "sword" rather than a "shield." Courts tend to frown on the former. *See, e.g.*, *Shukh v. Seagate Technology, LLC*, 848 F. Supp. 2d 987 (D. Minn. 2011) (noting that the goal of waiver is to prevent parties from using advice as both a sword and a shield).

[24] The Government tried everything to avoid this finding. In its Reply, the Government walked through each step of the alleged transaction and explained exactly what information the Taxpayer must have given to the accountants. (Government Reply, at 8 (Docket No. 217) (setting out the information that must be provided to the IRS in order to justify the purported tax treatment of the warrants/stocks).) It argued that if the Taxpayer had to release that information to the IRS anyway, how could it claim privilege over that information here? Nevertheless, the Court found that either the Government was wrong about what information was required or that the communications in question did not contain that information.

[25] *In re Green Grand Jury Proceedings*, 492 F.3d 976, 979 (8th Cir. 2007) (quoting *U.S. v. Zolin*, 491 U.S. 554, 563 (1989)).

[26] Order, at 5–6 (citing *Zolin*, 491 U.S. at 572; *In re Green Grand Jury Proceedings*, 492 F.2d at 982).

[27] *Id.*

[28] Order, at 6–7.

[29] Order, at 7 (citing *In re Gen. Motors Corp.*, 153 F.3d 714, 716 (8th Cir. 1998) (noting that the Supreme Court in *Zolin*, 491 U.S. at 563 n.7, "expressly declined to specify the 'quantum of proof' required to establish the crime/fraud exception" but that the standard is higher than the threshold showing required for *in camera* review)).

[30] *Triple Five of Minnesota, Inc. v. Simon*, 213 F.R.D. 324, 327 (D. Minn. 2002) (noting the various standards).

[31] *Triple Five of Minnesota, Inc. v. Simon*, 213 F.R.D. 324, 327 (D. Minn. 2002) (quoting *In re Grand Jury Investigation*, 842 F.2d 1223, 1226 (11th Cir. 1987).

[32] Order, at 7. *U.S. v. Martin*, 278 F.3d 988, 1001 (9th Cir. 2002) (quoting *In re Grand Jury proceedings*, 87 F.3d 377, 381 (9th Cir. 1996)).

[33] *U.S. v. Weed*, 99 F. Supp. 3d 201, 205 (D. Mass. 2015) (quoting *In re Grand Jury Proceedings*, 417 F.3d 18, 23 (1st Cir. 2005)).

[34] Motion, at 8.

[35] Order, at 16 (citing *U.S. v. Int'l Bhd. of Teamsters*, 119 F.3d 210, 215 (2d Cir. 1997); *see also Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 611 n.5 (8th Cir. 1977)).

[36] *In re Grand Jury Subpoena*, 274 F.3d 563, 571 (1st Cir. 2001).

[37] *In re Bevill, Bresler & Schulman Asset Mgmt. Corp*., 805 F.2d 120, 123, 125 (3d Cir. 1986)

[38] Order, at 16.

[39] Order, at 18.

[40] Order, at 17.