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BUCKLE UP

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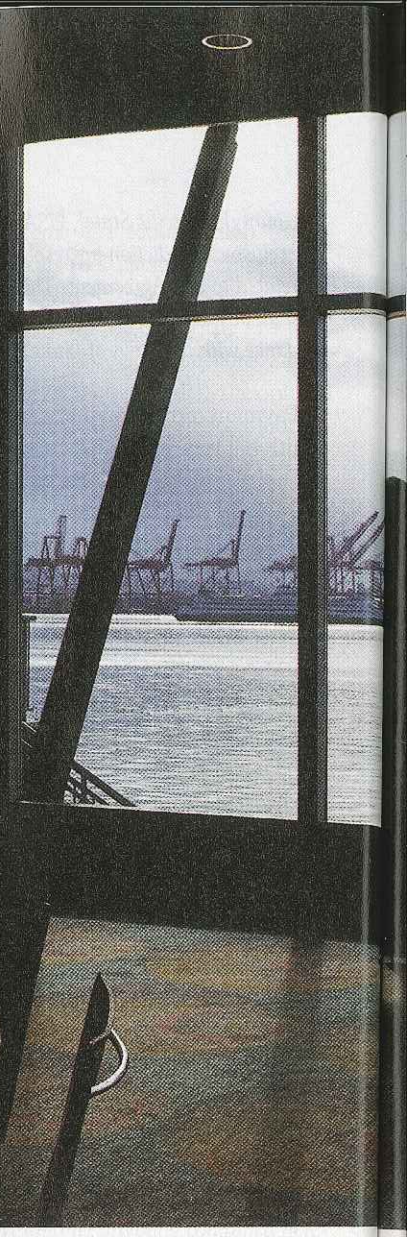
Are Courts Ready to Protect More Accountant-Client Communications?



Courts increasingly recognize that the need for confidential communications between accountants and clients is similar to that between attorneys and clients.

by Stuart J. Bassin, J.D., and William DeVinney, J.D.

Accountants, particularly those working in the tax arena, regularly face questions concerning whether their communications with clients are confidential and protected from disclosure. When courts have decided these questions, the result frequently turns upon the legal characterization of the relationship between accountant and client.

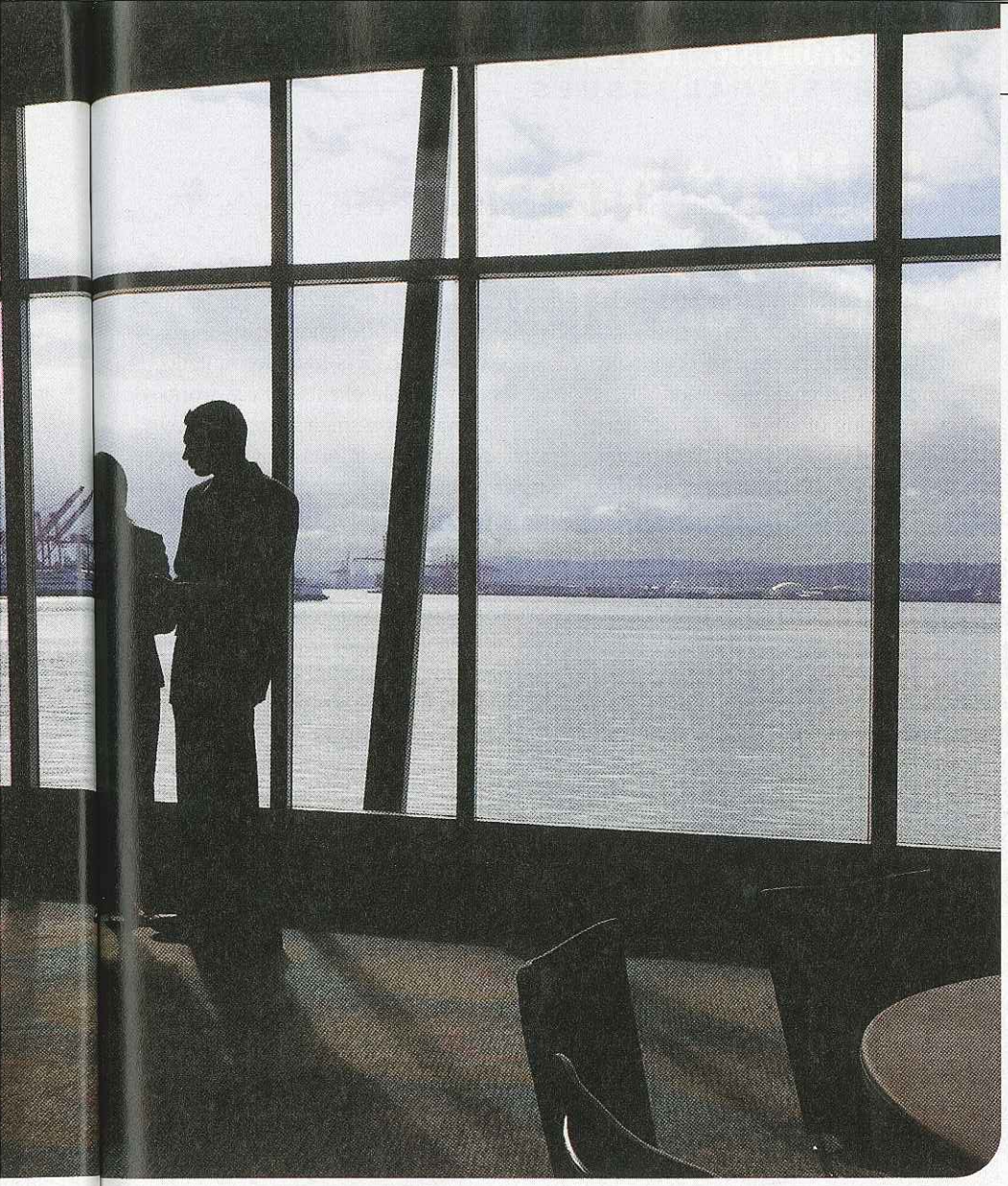
Historically, courts have been reluctant to extend the same protection to accountants that they extend to communications between clients and their attorneys. But recent court decisions, especially those involving corporate tax reserve accrual workpapers, indicate that the judicial view of the accountant-client relationship is changing and that courts may be willing to provide greater protection for communications between accountants and their clients.

Background

The confidentiality of communications between accountants and their clients arises in a variety of situations. The communications may occur when an accountant is retained to investigate sensitive matters. The communications may involve clients' seeking accountants' advice in planning or structuring transactions, particularly their tax consequences, and later if the accountants participate in analyzing complex tax law issues that are challenged by governmental authorities. In these and other situations, accountants and their clients exchange a large amount of confidential information and discuss the accountants' analyses or recommendations.

Both clients and accountants must be concerned whether their communications will later be protected from disclosure to future opponents and adversaries, including the IRS. Sec. 7525, which was added to the Code in 1998, generally protects tax advice an accountant provided from disclosure to the same extent that the same advice would be protected if an attorney provided it. Protection under Sec. 7525 does not extend to criminal matters.

Some accountant communications with clients and their attorneys in both



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civil and criminal cases may be protected under the so-called *Kovel* doctrine (*Kovel*, 296 F.2d 918 (2d Cir. 1961)), in which the Second Circuit found that the attorney-client privilege can extend to an accountant when an attorney retains the accountant to provide accounting-related services. In *Kovel*, the court analogized the role of an accountant to that of a foreign language translator whose service is essential to enable the attorney to provide legal advice.

But many communications between client and accountant fall outside these two widely recognized rules. Further, accountants and their clients historically have not fared well in protecting other types of accountant-client communications from compulsory disclosure. For a short time, the Second Circuit in the *Arthur Young* case recognized an accountant-client privilege at least for work product prepared by accountants certifying a public company's books and records (*Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), rev'd, 465 U.S. 805 (1984)). The Supreme Court, however, stated in dicta in a 1973 case, *Couch*, 409 U.S. 322, that there is no accountant-client privilege and later ruled that there was no comparable accountant-client work product protection when it reversed the Second Circuit's decision in *Arthur Young*. The question addressed in this article is whether there is reason to question the continuing vitality of this apparent judicial rejection of protection for accountant-client communications.

The Antiquated View of the Accountant-Client Relationship

Historically, the courts have refused to protect communications between accountant and client, even if those same communications would have been protected if they had involved an attorney, by characterizing the relationship between the accountant and client very differently from that of attorney and client. Attorneys are routinely characterized as confidential advisers and advocates, while accountants traditionally have not been viewed this way.

Along these lines, the Second Circuit's decision in *Arthur Young*, which was later reversed by the Supreme Court, had protected documents the government sought from a company's accountant not because of the accountant's role as confidential adviser, but because the appellate court believed auditors should feel free to create an honest assessment of their client's tax returns or financial statements without fear that the IRS could then obtain and use that information against the client in an IRS audit or in litigation. Otherwise, the client would be tempted to withhold negative information from the auditor, which would in turn undermine the accuracy of reporting on the client's tax returns or financial statements. Protecting accountant-client communications would ensure that accountants and their clients could work together in preparing thoroughly audited financials without fear that their communications would be disclosed to future adversaries.

The Supreme Court rejected that perspective and adopted a different view of the auditor's relationship with a client. According to the Court, although an auditor owes a duty to its client, the auditor "owes *ultimate allegiance* to the corporation's creditors and stockholders, as well as to the investing public" (emphasis added). Further, the auditor's role is not to protect its client's interest, but to serve "as a disinterested analyst charged with public obligations." The auditor's "public watchdog" function demands that the accountant "*maintain total independence from the client* at all times and requires complete fidelity

to the public trust" (emphasis added). According to the Court, no protection for accountant-client communications is required because no responsible corporate management team would withhold information from its auditors. Rather than risk an adverse opinion, a responsible corporate management team will disclose all relevant information, even if it is negative. Based upon this view of the accountant as unaligned with the client, the Court rejected claims for protection of communications from, or work product created by, an accountant.

> Attorneys are routinely characterized as confidential advisers and advocates, while accountants traditionally have not been viewed this way.

A More Realistic View of the Accountant-Client Relationship

Most observers would view the *Arthur Young* Court's characterization of the accountant-client relationship as reflecting a rather outdated (and perhaps naïve) notion of the modern accountant's role. In fact, clients hire and pay accountants to provide services that advance the client's interests. Subject to the bounds of law and professional ethics, accountants strive to advance clients' interests in various ways, such as by suggesting structures for the client's affairs that minimize the clients' tax liability. No client expects that its accountants' ultimate loyalty runs to some third party or that the accountant will voluntarily disclose client confidences.

That reality conflicts with the *Arthur Young* Court's characterization of the relationship between the client and the accountant as independent and potentially antagonistic. This characterization affects several recurring questions whether documents created or reviewed by accountants can be protected. For example, as Edna Selan Epstein notes in *The Attorney-Client Privilege and the Work-Product Doctrine*, work product protection for client documents is waived when the documents are disclosed to an adversary or potential adversary or where disclosing the document to corporate advisers substantially increases the opportunity for potential adversaries to obtain the information.

In these situations, the "essential question with respect to waiver of the work-product privilege by disclosure is whether the material has been kept away from adversaries" (*Nicholas v. Wyndham Int'l Inc.*, No. 2001/147-M/R (D.V.I. 2/27/03), slip op. at 8). Seeking to exploit this waiver rule, and relying upon *Arthur Young*'s view of the client-accountant relationship, the government has recently contended, with little success, that disclosure of confidential or otherwise privileged information to an accountant waived otherwise valid claims of attorney-client privilege or work product protection.

In more recent cases, such as *Textron Inc.*, 577 F.3d 21 (1st Cir. 2009), the battle has been over the IRS's attempts to obtain tax accrual workpapers from accountants and their corporate clients. These workpapers contain assessments prepared by clients, accountants, in-house lawyers, and outside counsel concerning the likelihood that a taxpayer's reported tax liability for prior years will be increased on audit. They show computations of the accounting reserve required by FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes*, for possible future adjustments to previously filed tax returns.

While the workpapers may take varying forms, they typically identify tax reporting positions that may be challenged during an audit, as well as an assessment of the likelihood that the position will be sustained on audit. These workpapers provide useful information to management about the company's financial position and satisfy the FIN 48 requirements for evaluating potential future liabilities in certified financial statements. But preparing these workpapers also creates a huge potential hazard for the client because, in the IRS's hands, they provide a virtual road map for conducting an audit of the company.

The courts have diverged in their opinions on disputes over the IRS's efforts to obtain the workpapers. In *Textron*, a sharply divided First Circuit ruled that the workpapers were not protected work product. In a 2010 case, *Deloitte LLP*, 610 F.3d 129, the D.C. Circuit ruled that the workpapers

EXECUTIVE SUMMARY

- **Accountants working in the tax area may be asked by clients whether they are protected** by any privilege similar to the privilege that protects communications between attorneys and clients.
- **Accountants who provide services through an attorney** can qualify for the privilege under the *Kovel* doctrine or through the limited privilege provided under Sec. 7525.
- **Generally, federal courts have been unwilling to recognize a broader accountant-client privilege,** finding that accountants owe a duty to the public more than to their clients, which distinguishes it from the attorney-client relationship.
- **In some recent cases, mostly involving tax accrual workpapers,** courts have found the accountant's role to be one of an adviser to a client rather than a watchdog for the public.

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were protected work product and that the accountants' role in creating the workpapers did not constitute a waiver. Most recently, in *Wells Fargo & Co.*, Misc. No. 10-57 (JRT/JJG) (D. Minn. 6/4/13), a federal district court in Minnesota ruled last year that substantial portions (but not all) of the workpapers were protected work product and that there was no waiver. Thus, while the courts have reached differing conclusions, they have consistently rejected the government's waiver arguments.

Before reaching the waiver issues, the taxpayer must establish that the workpapers are protectable as work product, which protects material prepared "in anticipation of litigation." The attorney work product doctrine, which arose from the Supreme Court's decision in *Hickman v. Taylor*, 329 U.S. 495 (1947), protects information created in preparation for litigation. In *Hickman*, one party tried to force opposing counsel to turn over his notes taken during a witness interview. By creating a privilege to protect those materials, the doctrine prevents a party from preparing its case on "wits borrowed from the adversary" (329 U.S. at 516 (Jackson, J., concurring)).

Of greater interest here, the courts in almost all of the cases have discussed the nature of the accountant-client relationship. For example, in contrast to the Supreme Court's portrayal of the accountant as an impartial arbiter whose ultimate duty runs to the public, the court in *Deloitte LLP* (which involved the IRS's attempt to obtain documents that had been prepared for Dow Chemical that related to ongoing tax litigation) emphatically rejected the IRS's argument that an auditor and its client are adversaries, stating that "as an independent auditor, Deloitte cannot be Dow's adversary." The court determined that, although an accountant's ethical rules (citing 2005 AICPA Code of Professional Conduct §101.08) require the accountant to withdraw representation if there is any danger of litigation between the accountant and the client, any inherent "tension between an auditor and a corporation that arises from an auditor's need to scrutinize and investigate a corporation's records and book-keeping practices simply is not the equivalent of an adversarial relationship contemplated by the work product doctrine" (*Deloitte LLP*, 610 F.3d 129, quoting *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (S.D.N.Y. 2004)).

Likewise, the court rejected the IRS's argument that the auditor was a "conduit to an adversary" where various regulatory agencies, such as the SEC or the PCAOB, have the authority to demand confidential information from the auditor. The D.C. Circuit held that, despite the accountant's obligations to produce documents in certain situations, the clients justifiably expected

that their communications with their accountants would remain confidential. Indeed, AICPA Code of Professional Conduct Section 301.1 *requires* that an accountant maintain confidentiality. Thus, the court found that a client can, and should, reasonably expect that its auditor will keep its confidences in most situations.

In *Textron Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007), a district court observed that the purpose of the work product privilege was to prevent an adversary, or potential adversary, from gaining an unfair advantage by obtaining materials that reveal the company's strategy or assessment of its case. That privilege could be waived, therefore, only by disclosure in a manner that is inconsistent with keeping privileged information from an adversary. The district court found that disclosing tax accrual workpapers to its accountant was not inconsistent with Textron's keeping those materials from its adversaries, including the IRS.

On appeal (*Textron Inc.*, 553 F.3d 87 (1st Cir. 2009)), the First Circuit initially agreed that the work product privilege protected the tax accrual workpapers, but the court also found that Textron's accountants' workpapers (which included information from Textron's tax accrual workpapers) might be discoverable in some circumstances and thus disclosing the tax accrual workpapers to Textron's accountants might constitute disclosure to a conduit of a potential adversary. The First Circuit, therefore, remanded the case to the district court for more detailed findings on the manner in which Textron shared its tax accrual workpapers with its accountants and whether that disclosure was consistent with keeping those workpapers from its adversaries. However, as noted above, on rehearing, the First Circuit held that tax accrual workpapers are not protected by the work product privilege (*Textron Inc.*, 577 F.3d 21 (1st Cir. 2009)).

Most recently, in the *Wells Fargo* decision, the court treated the auditor-client relationship as confidential rather than adversarial, rejecting the IRS's argument that Wells Fargo waived its work product privilege on any tax accrual workpapers by disclosing them to its auditor, KPMG. While the IRS argued that KPMG was either an adversary, a potential adversary, or a conduit to an adversary, the court rejected the waiver argument because the IRS failed to produce any evidence that Wells Fargo and KPMG might be adverse to one another.

Similarly, the court found that KPMG's obligation to disclose information to the IRS or other regulatory bodies in remote circumstances did not make KPMG a conduit to an adversary. Thus, the court treated KPMG as working in a protected relationship with Wells Fargo, and its attorneys, in analyzing Wells Fargo's tax positions.

Interestingly, the inquiry's focus in the opinions is the nature of the information in the workpapers, not who created the documents. For example, in *Deloitte*, the IRS argued that a memorandum that Deloitte had created was not privileged because an accountant had created it. The D.C. Circuit rejected that argument, reasoning that "the question is not who created the document or how they are related to the party asserting work-product protection, but whether the document contains work product—the thoughts and opinions of counsel developed in anticipation of litigation."

Similarly, the district court in *Wells Fargo* found that tax accounting workpapers KPMG prepared were entitled to the same protection as those the client or its attorneys prepared. The work product privilege applied to all documents that were closely tied to the attorneys' analysis, "even if [that analysis] is disclosed within business documents drafted by non-lawyers" (*Wells Fargo*, slip op. at 82). Thus, it made no difference who created the documents.

Conclusion

These recent cases suggest evolution in judicial thinking about the nature of the relationship between accountants and their clients. Courts are more willing to recognize the accountant's role as an adviser and counselor seeking to advance the client's interests. That role is enhanced where the essential confidentiality of communications between accountant and client is recognized, even if that protection frustrates some of the investigative efforts of the IRS and other regulators. Thus, while the law still does not recognize an accountant-client privilege, the courts' increasing recognition of the need for confidential communication between clients and their accountants may lead to greater protection for their communications. ❖

AICPA RESOURCES

***JofA* articles**

- "Accountant Workpaper Privilege Upheld by First Circuit," Jan. 23, 2009, tinyurl.com/knl5tgz
- "Attorney-Client Privilege: CPAs and the E-Frontier," April 2004, page 64

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***CPA Insider* article**

- "The Accountant-Client Privilege: Does It Exist?" June 7, 2010, tinyurl.com/mxlh54v

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