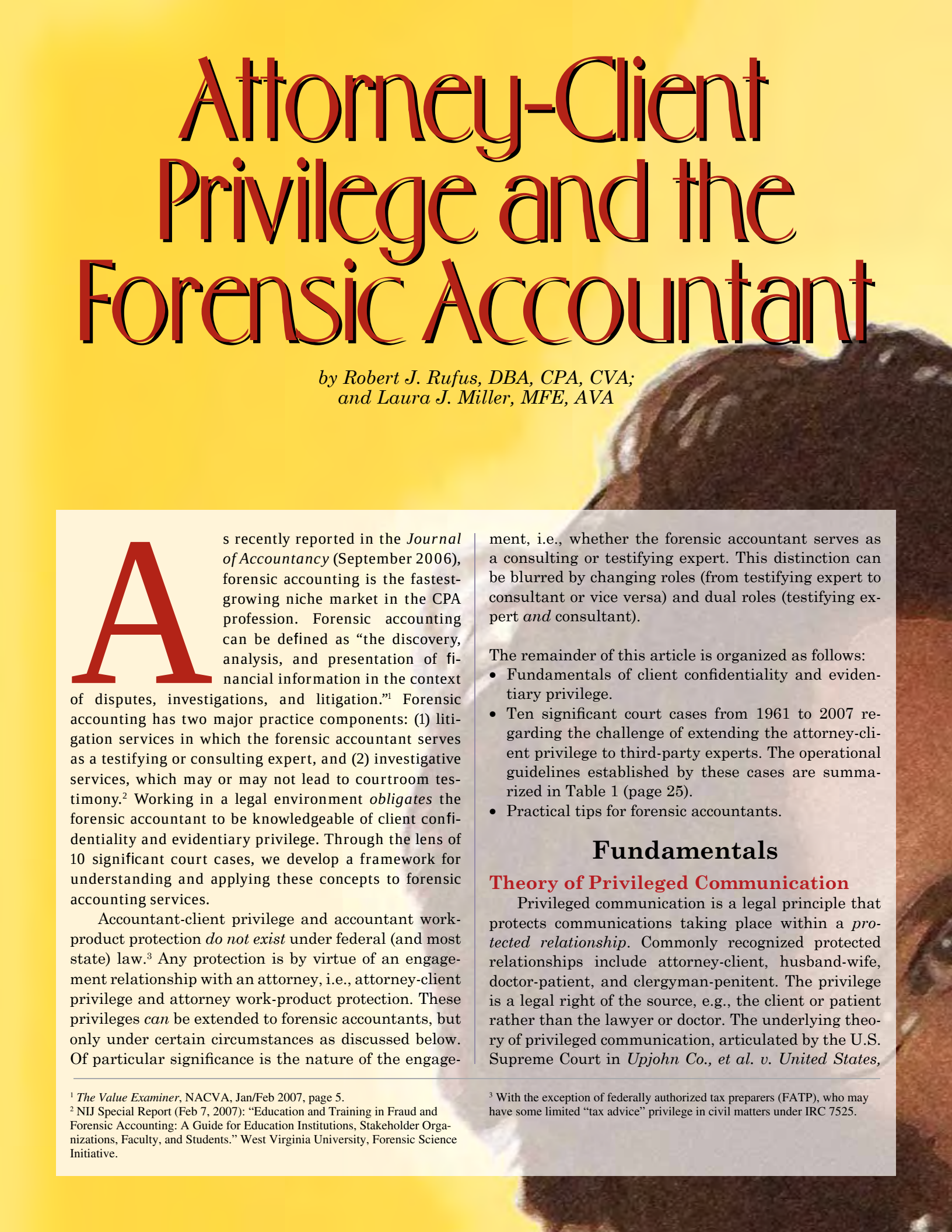
Attorney-Client Privilege and the Forensic Accountant

by Robert J. Rufus, DBA, CPA, CVA; and Laura J. Miller, MFE, AVA



As recently reported in the *Journal of Accountancy* (September 2006), forensic accounting is the fastest-growing niche market in the CPA profession. Forensic accounting can be defined as "the discovery, analysis, and presentation of financial information in the context of disputes, investigations, and litigation."[1] Forensic accounting has two major practice components: (1) litigation services in which the forensic accountant serves as a testifying or consulting expert, and (2) investigative services, which may or may not lead to courtroom testimony.[2] Working in a legal environment *obligates* the forensic accountant to be knowledgeable of client confidentiality and evidentiary privilege. Through the lens of 10 significant court cases, we develop a framework for understanding and applying these concepts to forensic accounting services.

Accountant-client privilege and accountant work-product protection *do not exist* under federal (and most state) law.[3] Any protection is by virtue of an engagement relationship with an attorney, i.e., attorney-client privilege and attorney work-product protection. These privileges *can* be extended to forensic accountants, but only under certain circumstances as discussed below. Of particular significance is the nature of the engagement, i.e., whether the forensic accountant serves as a consulting or testifying expert. This distinction can be blurred by changing roles (from testifying expert to consultant or vice versa) and dual roles (testifying expert *and* consultant).

The remainder of this article is organized as follows:

- Fundamentals of client confidentiality and evidentiary privilege.
- Ten significant court cases from 1961 to 2007 regarding the challenge of extending the attorney-client privilege to third-party experts. The operational guidelines established by these cases are summarized in Table 1 (page 25).
- Practical tips for forensic accountants.

Fundamentals

Theory of Privileged Communication

Privileged communication is a legal principle that protects communications taking place within a *protected relationship*. Commonly recognized protected relationships include attorney-client, husband-wife, doctor-patient, and clergyman-penitent. The privilege is a legal right of the source, e.g., the client or patient rather than the lawyer or doctor. The underlying theory of privileged communication, articulated by the U.S. Supreme Court in *Upjohn Co., et al. v. United States,*

[1] *The Value Examiner*, NACVA, Jan/Feb 2007, page 5.
[2] NIJ Special Report (Feb 7, 2007): "Education and Training in Fraud and Forensic Accounting: A Guide for Education Institutions, Stakeholder Organizations, Faculty, and Students." West Virginia University, Forensic Science Initiative.
[3] With the exception of federally authorized tax preparers (FATP), who may have some limited "tax advice" privilege in civil matters under IRC 7525.

et al. (1981), is that in certain instances (i.e., protected relationships) society is best served by the suppression (protection from disclosure) of information.

Suppression of information, however, is inconsistent with the general duty to disclose and is thus closely guarded by the courts. In our legal system, each party is obligated to disclose to the opposing party all relevant and non-privileged evidence it proposes to use at trial, whether favorable or unfavorable.[4]

Attorney-client Privilege

Attorney-client privilege, the oldest of the protected privileges in law, is defined as the "client's right to refuse to disclose and to prevent any other person from disclosing confidential communications between the client and the attorney."[5] The requisite elements for establishing privilege include a *communication* that (a) relates to the rendering of legal services, (b) is made in confidence, and (c) is made to a person the client reasonably believed was an attorney.[6]

The attorney-client privilege is intended to encourage people involved in legal disputes to be candid with their attorneys, thus enabling the attorneys to give sound legal advice. Once the attorney-client privilege has been established, it may be extended to non-attorneys (e.g., subordinates and consulting experts) who assist attorneys in rendering legal advice or services.

Work-product Doctrine

The work-product doctrine, recognized by the U.S. Supreme Court in *Hickman v. Taylor* (1947), provides protection from discovery of documents, interviews, statements, and other items prepared by an attorney in anticipation of trial. The work-product privilege allows lawyers to prepare for litigation without risk that their work will be revealed to court adversaries.[7] Consistent with the rules governing attorney-client privilege, the work-product doctrine can be extended to items prepared by non-attorneys who assist in rendering legal services.[8]

Rules of Discovery

The Federal Rules of Civil Procedure[9] (FRCP) govern the conduct of all civil actions brought in federal district courts and serves as a model for most state courts. The provisions of Rule 26 of the FRCP govern the discovery process, which is the pre-trial phase in litigation in which opposing parties produce or compel the production of documents and other evidence via discovery devices (e.g., depositions, requests for production, interrogatories). Of special relevance to our discussion are Rules 26(a)(2) and 26(b)(4).

Rule 26(a)(2) requires the disclosure of any person employed to provide expert testimony in a case, including disclosure of each expert's signed "written report." Moreover, Rule 26(a)(2)(B) permits discovery of all the information the expert "considered" in preparing his or her report. Rule 26(b)(4)(A) permits an opposing party to discover the facts known or opinions held, through interrogatories or by deposition, of "any person who has been *identified as an expert* whose opinions may be presented at trial."

Rule 26(b)(4)(b), however, provides that facts known or opinions held by a *non-testifying expert*, who has been specifically engaged in anticipation of litigation, can be discovered by an opposing party only "upon showing of exceptional circumstances."[10] The purpose of this rule is to allow parties to freely consult with their experts, "without fear that every consultation with an expert may yield grist for the adversary's mill."[11]

Armed with a fundamental understanding of the concepts of client confidentiality and evidentiary privilege, we now examine 10 focus cases that apply these concepts to the forensic accountant.

10 Focus Cases

1. Landmark Decision Extends Privilege to Accountants

The 1961 landmark decision *U.S. v. Kovel* extended the attorney-client privilege to communications between a client and an accountant employed by an attorney.

Louis Kovel, an accountant and former IRS agent, was a *regular employee* of a law firm. During the course of his employment, Kovel was subpoenaed by a federal grand jury to provide testimony regarding one of the law firm's clients with whom Kovel had shared communications. Kovel appeared before the grand jury but refused to answer questions about the client, even after being directed to do so by the court, asserting attorney-client privilege.

In Kovel's defense, it was argued that his status as a regular employee of the law firm exempted his testimony and production via attorney-client privilege. The government argued that under no

[4] In criminal matters, only the prosecution is required to disclose.
[5] *Black's Law Dictionary*, 1999, p. 1215.
[6] For a full discussion of the foundation of attorney-client privilege and the classic test, see *U.S. v. United Shoe Mach. Corp*. (110 F. Supp. 295, D.Mass. 1953).
[7] Unlike attorney-client privilege, the work-product doctrine is a right of the attorney rather than the client.
[8] See *U.S. v. Nobles* (422 U.S. 225, 238, 1975).
[9] Can be found at www.law.cornell.edu/rules/frcp/Rule26.htm.
[10] See House v. Combined Ins. Co. of Am. (168 F.R.D. 236, N.D. Iowa 1996) for a discussion of the factors considered by the courts in determining exceptional circumstances.
[11] Rubel v. Eli Lilly and Company, 160 F.R.D. 458, 460 (S.D.N.Y. 1995).
[12] An example can be found at www.divorcenewjersey.com/publish/library/NJ-

circumstances did a non-attorney accountant have privilege. The lower court agreed with the government, finding Kovel in contempt for refusing to answer and sentencing him to a year in prison.

The appeals court, however, reasoned that the presence of privilege is essential when an accountant, "whether hired by the lawyer or the client…is necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege is designed to permit." The appeals court vacated the lower court's decision and set aside Kovel's sentence for criminal contempt.

Kovel established operational guidelines and a functional test for determining when an accountant who works for an attorney may invoke attorney-client privilege, most notability the propositions that:

- Communications between a client and an accountant made for the purpose of facilitating the rendering of legal services (not accounting services) are privileged.
- When the client first communicates with his accountant, the communication is not protected, even though the client later consults an attorney on the same matter.
- If the client first consults with a lawyer who later retains an accountant, or if the client consults a lawyer with his own accountant present, the privilege applies.
- Communications between the client's accountant and attorney are privileged.

Referring to this decision, forensic accountants are commonly advised to secure a "Kovel letter" outlining the nature and scope of an engagement. A Kovel letter simply serves to confirm that the forensic accountant is being retained to assist the lawyer in providing legal services.[12]

2. Privilege Extends to Consulting Accountants

Bauer v. Orser (1966) extended the protection afforded by *Kovel* to *non-employee consulting accountants* engaged by attorneys to perform expert services necessary to provide proper legal advice.

This enforcement action was instituted by an IRS special agent (Bauer) to compel the production of certain records and work papers in the possession of a CPA (Orser) who had been engaged by an attorney to provide expert accounting services.

In Orser's defense, it was argued that the requested records were exempt from production through the attorney-client privilege. Orser argued that he had been engaged by the attorney to assist in providing legal services (not accounting services) and that during the course of the engagement his efforts were directed and controlled by the attorney. Finally, it was argued that the work papers, summary sheets, and notes generated by Orser were the property of the employing attorney.

Ruling in Orser's favor, the court reasoned that a consulting accountant "is in the same position as an accountant who is a regular employee of a law firm engaged in legal work for which such accounting assistance is necessary to the lawyers in the effective performance of their legal services." Moreover, it was undisputed that the accountant was engaged by the attorney to provide "expert" services considered essential to providing proper legal advice.

Relevant factors considered by the court in the *Bauer* case include the following:

- The CPA was engaged to assist an attorney in providing effective and proper legal counsel.
- The CPA's services were performed within the scope of an agency relationship with the attorney.
- The CPA was directed and controlled by the attorney during the engagement.
- The CPA had no prior relationship with the attorney's client.
- The CPA invoiced and was paid by the attorney.

3. No Privilege for Accounting Services

The *U.S. v. Cote* (1971) opinion further clarified the functional test provided in *Kovel*, concluding that an accountant who works for a lawyer may *not* invoke the privilege "if what is sought is not legal advice but only accounting service…or if the advice is the accountant's rather that the lawyer's."

This enforcement action was initiated by the IRS to compel the testimony and production of certain records and work papers in the possession of a CPA (Cote) who had prepared the original and amended returns of taxpayers under IRS investigation.

In Cote's defense, it was conceded that no privilege existed for records related to the original returns. However, it was argued that Cote prepared the amended returns pursuant to an engagement with an attorney and that such records were attorney-client protected. In rebuttal, the IRS cited the general rule that income tax work papers are not confidential because, by definition, they contain information that will later appear on a return. Interestingly, both parties cited *Kovel* in support of their arguments.

Following the direction provided in *Kovel*, the court focused on "what advice was sought…and from

CLE%202005%_Family%20Part%20Discovery_Kovel%20Letter.

whom." Ruling in favor of the IRS, the court questioned the nature of the engagement relationship between the accountant and the attorney, concluding that the CPA did not provide assistance in rendering legal advice (only accounting advice) and that the attorney did not control the scope of the CPA's services.

In developing its opinion, the court made the following findings:

- Federal law recognizes no accountant-client privilege.
- The accountant (not the lawyer) was first engaged.
- The accountant had a longstanding professional relationship with the client.
- The engaging attorney did not control or supervise the efforts or work product of the accountant.
- The claimant of the privilege has the burden of proof.

4. Dual Roles: Testifying Expert and Consultant

The *Furniture World, Inc. v. D.A.V. Thrift Stores, Inc.* (1996) decision highlights the perils of assuming the dual roles of both testifying and consulting expert.

This enforcement action was brought to compel the production of documents and testimony of a witness identified as *both* a testifying and consulting expert. The defendant argued that the specific information sought was attorney-client privileged because it had been provided to the witness in her capacity as a consulting expert rather than a testifying expert.

The court concluded that a testifying expert is "subject to the full gamut of discovery," reasoning that "a person initially selected to testify as an expert at trial cannot be shielded from questioning by later being also designated as a consultant expert and invoking the work-product doctrine. Counsel must choose to designate an expert as either one who will testify at trial or consult with counsel. Having an expert who is both creates an unmanageable situation by requiring a question-by-question analysis of an expert witness' deposition testimony to determine whether the work-product doctrine applies."

This case cautions the practitioner to properly qualify his or her role as either a consulting expert or a testifying expert—never both simultaneously.

5. Consultant's Past Work Not Privileged

The *Green v. Sauder Mouldings, Inc.* (2004) decision qualifies the attorney work-product privilege to include only "those facts or opinions marshaled by a party's representative—here, the consultant—after he is retained by the litigating party and only when prepared in anticipation of *that party's* litigation" [emphasis in original].

This enforcement action was brought by the defendant to compel production of an "investigative report" prepared by the plaintiff's consulting expert in a personal injury case.

Importantly, the expert prepared the report some two years before the date of his engagement with the plaintiff's counsel, while working as an employee of a third party. Plaintiff's counsel argued that engaging the expert as a consultant entitled him to assert work-product privilege over the report.

The court, in a favorable ruling for the defendant, reasoned that supporting the plaintiff's assertion would undermine Rule 26 and allow "a party to manufacture privilege by hiring an expert who had already performed work for another party to the same litigation."

6. Multiple Engagements Require Separate Engagement Letters and Distinct Files

This 2005 grand jury proceeding (Under Seal—Misc. Case No. 2:04-00167) highlights the confusion and conflict created by multiple engagements and the importance of properly executed engagement (Kovel) letters.

This protective action was brought to quash a grand jury subpoena of the testimony and work papers of a CPA engaged by counsel in *two separate* engagements involving the same client. The first engagement involved negotiating an offer-in-compromise with the IRS; the second involved assisting counsel in the defense of an IRS criminal investigation, with efforts including witness interviews, case strategy, and the preparation of a written report.

The government argued that because the accountant was hired to perform accounting services rather than assist in providing legal advice, there was no legitimate expectation of privacy. The government further argued that there was no distinction between the two engagements and that, even if attorney-client privilege had applied, it was waived when the accountant met with IRS to discuss a proposed settlement.

The accountant's lawyer argued that the nature and scope of the two engagements were clearly specified in the respective engagement letters and that, in the second engagement, the accountant worked under the direction and control of counsel. The accountant's lawyer also argued that the second engagement work file (including witness interviews, case strategy, and a written report) was exempt as attorney work product.

Following an *in camera*[13] examination of the accountant's files, the

[13] Held in the judge's private chambers.

court granted the motion to quash *only* with respect to the second engagement. Regarding the first engagement, the court reasoned that, even if the accountant acted as an agent for the attorney, consultations for the purpose of negotiating an IRS compromise are accounting services and thus not privileged. Regarding the second engagement, the court acknowledged that the accountant's engagement letter qualified the scope of services as assisting counsel in providing legal services and that the files were properly segregated and labeled as protected documents (i.e., attorney-client privileged).

In developing its opinion, the court made the following important observations regarding the second engagement:

- The nature of the engagement was clearly identified as assisting counsel in providing legal services.
- The CPA's work files (engagements one and two) were segregated, with the latter being labeled "attorney-client privileged."
- The lawyer was first engaged.
- The accountant had a longstanding professional relationship with the lawyer.
- The engaging attorney supervised and controlled the CPA's efforts.

7. Consulting Expert's Influence on Testifying Expert

The decision in *Derrickson, et al. v. Circuit City Stores, Inc.* (1999) raises concerns regarding interactions between a testifying expert and a consulting expert.

In *Derrickson*, a testifying expert submitted his report containing various tables prepared by a non-testifying expert. The testifying expert acknowledged that he relied on the tables and that they served as the foundation for his opinion.

In its deliberations, the court reasoned that where the "fruits of their labor are indivisible," an opposing party cannot properly cross-examine a testifying expert without also examining the non-testifying expert. The court made a distinction between cases where there was a "collaboration" of effort and "where the testifying expert relied on a single, discrete written report by a non-testifying expert," concluding in the latter situation that only the non-testifying expert's report need be produced.

The court's reasoning in *Derrickson* focused on the non-testifying expert's involvement in forming the testifying expert's opinion/report. The implications are far-reaching, given the proliferation of collaborative efforts between experts, specifically firm associates.

8-10. Changing Roles Creates Confusion

The issue of whether an expert initially designated as a testifying expert, but later re-designated as a

Table A: Summary of Operational Guidelines

Nature of Accountant's Engagement	Attorney-client Privilege Extended to Accountant?
Engaged by an attorney or non-attorney as a testifying expert	No
Engaged by an attorney as a consulting expert to assist in providing legal advice	Yes
Engaged by a non-attorney as a consulting expert to assist in providing legal advice	No
Engaged by an attorney as a consulting expert to assist in providing accounting and/or tax advice	No
Engaged by an attorney as *both* a consulting and testifying expert to assist in providing legal advice (dual roles)	?
Engaged by an attorney as a consulting expert to assist in providing legal advice, specifically to assist the testifying expert in developing his/her opinion	?
Engaged by an attorney as a consulting expert in *dual* engagements: (1) to assist in providing accounting services and (2) to assist in providing legal advice.	(1) No (2) Yes
Engaged by an attorney as a testifying expert but *re-designated* as a consulting expert *before* a report or opinion is rendered	Yes
Engaged by an attorney as a testifying expert but *re-designated* as a consulting expert *after* a report or opinion is rendered	No

non-testifying consultant, may be deposed has been addressed on a number of occasions. For example:

In *Sunrise Opportunities, Inc. v. Regier* (2006), the court articulated the question: "Do the rules require a party's expert to be deposed if he originally is identified as a testifying expert, but later the party decides that the expert will not testify?" In answering that question, the court focused on the reasons a testifying expert needs to be deposed (i.e., to facilitate effective cross-examination), concluding that no such justification exists for a non-testifying witness. Accordingly, the court ruled that a non-testifying expert cannot be deposed under Rule 26(b)(4)(A).

In *Estate of Douglas L. Manship, et al. v. U.S.* (2006), the court ruled that the re-designation of a witness from testifying to non-testifying status *before* an expert report or other disclosure opinion is rendered affords the witness protection under Rule 26(b)(4)(B).

In *Bradley, et al. v. Cooper Tire, et al.* (2007), the court ruled that where a re-designated expert had, before re-designation, produced a written report, such re-designation did not afford the witness protection under Rule 26(b)(4)(B).

These three examples clearly suggest that (a) changing roles should be documented by an amended engagement letter, and (b) a re-designation must be made *before* an expert report or opinion is disclosed.

Practical Tips

Before concluding, we must disclose that our firm was the accountant in the above-mentioned 2005 grand jury proceeding (Case 6). From this "Kovel" experience, we share the following lessons learned and practical tips.

First, it is essential to secure a carefully crafted engagement letter that accomplishes all four of the following:

- Qualifies your role as a consulting *or* testifying expert, not both simultaneously
- Qualifies the scope of your services—to assist an attorney in providing legal advice
- Confirms your role as an agent of the attorney—an agency relationship
- Identifies your efforts as being attorney-client privileged

Second, label all correspondence and work product as "attorney-client privileged," and segregate it accordingly.

Finally, send all billings and reports directly to the attorney, not to the client.

The failure of a forensic accountant to protect the attorney-client or work-product privileges can have severe consequences, including an unfavorable case outcome, negative goodwill, disciplinary action, or even a malpractice claim. For these reasons, it is important to proactively assert and maintain privilege, erring always on the side of caution. VE

Acknowledgements

The authors would like to thank Daniel Lester, Esq., for his review of the legal concepts presented in this article.

Robert J. Rufus, DBA, CPA, CVA, is president of Rufus & Rufus Accounting Corporation, based in Huntington, WV. He has over 25 years of professional experience in forensic accounting and financial crimes. Rufus is a licensed private investigator and former IRS agent. E-mail: rjrufus@rufusandrufus.com.

Laura J. Miller, MFE, AVA, is a forensic analyst with Rufus & Rufus Accounting Corporation. Her work experience includes business valuations, economic damages, domestic relations, and financial crimes. E-mail: ljmiller@rufusandrufus.com.

Case Citations

Upjohn Co., et al. v. U.S., et al. (No. 79-886, 449 U.S. 383, 101 S. Ct. 677, 66 L. Ed. 2d 584, 1981 U.S.)
Hickman v. Taylor (329 U.S. 495, 67 S. Ct. 385, 91 L. Ed. 451, 1947 U.S.)
U.S. v. Kovel (No. 168, Docket 27207, 296 F.2d 918, 1961 U.S. App.)
Bauer v. Orser (No. 743, 258 F. Supp. 338, 1966 U.S. Dist.)
U.S. v. Cote (No. 4-70-Civ. 510, 326 F. Supp. 444, 1971 U.S. Dist.)
Furniture World, Inc. v. D.A.V. Thrift Stores, Inc. (No. CIV 95-902, 168 F.R.D. 61, 1996 U.S. Dist.)
Green v. Sauder Mouldings, Inc. (No. 3:04-CV-264, 223 F.R.D. 304, 2004 U.S. Dist.)
Derrickson, et al. v. Circuit City Stores, Inc. (Civil Action No. DKC 95-3296; 1999 U.S. Dist. Lexis 21100)
Sunrise Opportunities, Inc. v. Regier (No. 05-C-2825, 2006 U.S. Dist.)
Estate of Douglas L. Manship, et al. v. U.S. (No. 04-C-91-M2, 2006 U.S. Dist.)
Bradley, et al. v. Cooper Tire, et al. (No. 07-MC-001-JM, 2007 U.S. Dist.)