Wolters Kluwer

The M&A Tax Report

February 2019 Volume 27, Number 7

The Monthly Review of Taxes, Trends & Techniques

Check Your Privilege(s): *Kovel*, Work Product, and Third-Party Valuations

By Donald P. Board • Wood LLP

"*You're going to want to get a valuation*." That may be one of the more familiar pieces of advice that readers of *The M&A Tax Report* give their clients. Appraisals certainly don't solve every tax problem. But sometimes a valuation can keep a client from getting into trouble in the first place.

This comes up most frequently when a client is considering how to *report* a transaction after the fact. But a responsible appraisal can also provide clients and their advisors with a valuable "reality check" while a transaction is still at the *planning* stage. Injecting even one reliable dollar figure into the analysis will often expose an enticing tax plan as so much wishful thinking.

However, engaging a third party to perform a valuation is not without risk. For the appraisal to be worth the fancy bond paper it's printed on, the consultant will need the relevant facts about the client and whatever it is that the client and its advisors have cooked up. That will mean providing the consultant with information that the IRS might love to get its hands on in the event of an audit.

The valuation process can also *generate* information that may prove hazardous to the client's financial health. The consultant will need to ask questions, identify key facts, weigh evidence, run alternative calculations, and mull over methodological issues. There will often be a good deal of back-and-forth among the consultant, the client, and the client's attorney, all faithfully preserved in the consultant's emails.

The most popular risk-reduction strategy is for the attorney to engage the valuation consultant under a so-called "*Kovel* letter." For many of us, hiring accountants, consultants, and experts under a *Kovel* is almost a reflex. This is not a bad thing, provided we have a realistic understanding of what a *Kovel* letter can and cannot do.

In recent years, the IRS has litigated a number of cases seeking to gain access to communications with valuation consultants. In fact, a dispute about a valuation for a $503-million worthless stock loss is currently shuttling between the U.S. District Court for the Northern District of California and the Ninth Circuit. [*See Sanmina Corp.*, No.

C 15-00092 WHA, 2018 WL 4827346 (N.D. Cal. Oct. 4, 2018).] We will come back to *Sanmina*, but our analysis should begin with *L. Kovel* [CA-2, 62-1 USTC ¶9111, 296 F2d 918 (1961)], the case that started it all.

Classic *Kovel*

Ironically, *Kovel* did not involve a *Kovel* letter. Mr. Kovel, a former IRS agent with accounting skills, had been on staff with a New York law firm for nearly 20 years before his rendezvous with history. The occasion was a grand-jury investigation of one Hopps, a client of the firm, who was suspected of serious tax crimes.

Mr. Kovel was subpoenaed to appear before the grand jury on September 6, 1961. The matter was urgent, because the statute of limitations was scheduled to run on September 8. Mr. Kovel admitted that he had received a statement of Mr. Hopps' assets and liabilities, but he refused to say anything more, invoking the law firm's attorney-client privilege.

Mr. Kovel was not a lawyer, but he was working under the supervision of the attorneys representing Mr. Hopps. Mr. Kovel contended that his employment was sufficient, *per se*, to bring him within the law firm's attorney-client privilege. The government conceded that the privilege extends to employees with "menial or ministerial" responsibilities (*e.g.*, a stenographer), but insisted that this did not apply to Mr. Kovel in his capacity as an accountant.

The district judge rejected Mr. Kovel's alleged privilege and ordered him to tell the grand jury about Mr. Hopps. When Mr. Kovel again refused, the judge sentenced him to a year's imprisonment for contempt. The accountant was immediately taken into custody, where he was held without bail.

Mr. Kovel appealed to the Second Circuit. He was granted bail, presumably because the grand jury had managed to indict Mr. Hopps even without his testimony. The Court of Appeals eventually vacated the contempt conviction, holding that the client's communications with the accountant were protected by the attorney-client privilege.

Judge Friendly's opinion analogized Mr. Kovel to an interpreter hired to help a lawyer interview a client who doesn't speak English:

> Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases. Hence the presence of an accountant, whether hired by the lawyer or by the client, while the client is relating a complicated tax story to the lawyer, ought not destroy the privilege, any more than would that of … [an interpreter]; the presence of the accountant is necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege is designed to permit.

Having established that an accountant's presence in the room as "translator" does not waive the attorney-client privilege, Judge Friendly held that the privilege can apply even when the attorney is *not present* for the interview:

The M&A Tax Report
The Monthly Review of Taxes, Trends & Techniques

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by Wolters Kluwer, 2700 Lake Cook Road, Riverwoods, Illinois 60015. Subscription inquiries should be directed to 2700 Lake Cook Road, Riverwoods, IL 60015.
Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

> By the same token, if the lawyer has directed the client … to tell his story in the first instance to an accountant engaged by the lawyer, who is then to interpret it so that the lawyer may better give legal advice, communications by the client reasonably related to that purpose ought fall within the privilege; there can be no more virtue in requiring the lawyer to sit by while the client pursues these possibly tedious preliminary conversations with the accountant than in insisting on the lawyer's physical presence while the client dictates a statement to the lawyer's secretary or is interviewed by a clerk not yet admitted to practice.

Today, accountants engaged under *Kovel* letters are rarely confined to interpreting "tedious preliminary conversations" with clients. The common view is that *Kovel* is less concerned with *what* the third-party consultant is doing than with *why* he is doing it. On this interpretation, communications with a third party are protected by the attorney-client privilege as long as they are reasonably calculated to help the attorney represent the client effectively.

Restrictive Reading

This liberal formulation of *Kovel* is popular with taxpayers and their counsel, but it enjoys less support in the courts than some of us may assume. For example, in *D.A. Ackert* [CA-2, 99-1 USTC ¶50,298, 169 F3d 136 (2d Cir. 1999)], the Second Circuit considered whether the privilege applied to communications between a lawyer and an investment banker. The lawyer had consulted the investment banker in an effort to understand an esoteric transaction and its potential tax consequences for his client.

The court acknowledged that the purpose of the consultation was to help the attorney provide his client with *better legal advice*. Nevertheless, the Second Circuit held that the attorney-client privilege did not apply. Judge Leval distinguished *Kovel* on the ground that the accountant in that case was simply helping "to clarify communications between attorney and client."

The investment banker in *Ackert*, on the other hand, had been consulted to help the attorney understand a transaction. The attorney was seeking information the client did not have. The banker was not helping the attorney understand client communications.

The investment banker in *Ackert* was not consulted under a *Kovel* letter—he was working for the investment house promoting the transaction. The fact that the transaction was a corporate tax shelter probably didn't help the taxpayer's cause, either. Nevertheless, *Ackert* is neither the first nor the only case to limit *Kovel* to communications with accountants and other third parties whose function is to "translate" or "interpret" communications between lawyer and client. [*See, e.g.*, *M. Adlman*, CA-2, 98-1 USTC ¶50,230, 68 F3d 1495 (2d Cir. 1995); *Evergreen Trading, LLC*, 2008-1 USTC ¶50,109, 80 FedCl 122 (2007).]

A third-party valuation is hardly an exercise in attorney-client translation. So, there is a serious question whether communications with a valuation consultant can be brought within the attorney-client privilege. If they cannot, it seems unlikely that engaging the consultant under a *Kovel* letter will change that result.

"Legal Advice *from the Lawyer"*

Even if the *Kovel* doctrine is extended to apply to third parties who are not engaged as "translators," it may still be difficult for a valuation consultant to qualify. The IRS and the courts have always been concerned that taxpayers might "outsource" ordinary business functions to their attorneys in the hope of cloaking them with the attorney-client privilege. As Judge Friendly emphasized, the attorney-client privilege does not apply unless the purpose of the third-party communication is to obtain "*legal* advice *from the lawyer*."

This becomes problematic when the attorney has engaged a third party to perform a task that the client (or the client's *own* consultant) might have undertaken. A court may wonder whether the engagement was really intended to help the client get legal advice from the lawyer. Rather than inquire too closely into states of mind, a court may prefer to reach an "objective" judgment based on the nature of the services or other external factors.

Kovel observed that the attorney-client privilege does *not* apply if what the client is really seeking "is not legal advice but accounting service." Similarly, there is no privilege "if the advice sought is the accountant's rather than the lawyer's." If an accountant or other third party is providing customary services, it is tempting to conclude that the attorney is just a conduit between the consultant and the client.

The taxpayers in *M. Richey* [CA-9, 2011-1 USTC ¶50,168, 632 F3d 559 (9th Cir. 2011)], for example, were considering donating a conservation easement. Hoping to claim a charitable deduction, they hired a law firm to provide them with legal advice. The law firm, in turn, retained Mr. Richey, a certified appraiser, to provide "valuation services and advice with respect to the conservation easement."

Mr. Richey prepared an appraisal, which the taxpayers attached to their tax return to support their charitable deduction. In the ensuing audit, the IRS issued a summons to Mr. Richey to turn over his appraisal work file and submit to questioning by an agent. The law firm instructed Mr. Richey not to comply, citing (among other things) attorney-client privilege.

The U.S. District Court denied the IRS's motion to enforce the summons, because the appraisal had been prepared at the law firm's direction. The Ninth Circuit reversed, but it did not ask whether Mr. Richey had been functioning as a "translator" or "interpreter" when he prepared the valuation. Instead, it focused on the fact that Mr. Richey had been engaged, at least in part, to "provide valuation services." That is not the kind of thing for which one hires a lawyer.

In principle, an attorney should be able to commission an appraisal simply to inform the legal advice he renders to the client. But Mr. Richey's appraisal was passed along to the taxpayers, who attached it to their return in accordance with Reg. §1.170A-13(c)(2)(A).

The Ninth Circuit concluded that communications with Mr. Richey relating to the preparation or drafting of the appraisal were not made for the purpose of obtaining *legal advice*. Hence, it was "clear error" for the District Court to treat the file as protected by the attorney-client privilege. Although the law firm had formally commissioned Mr. Richey, the consultant had really prepared the valuation *for the client*.

Work Product: "In Anticipation of" Litigation

The attorney-client privilege is not the only game in town. Under the work-product doctrine, documents, statements, correspondence, affidavits, attorney notes, models, exhibits, and similar materials prepared by an attorney, or by third parties acting under the direction of an attorney, may be protected from discovery if they were prepared "in anticipation of litigation." [*See Hickman v. Taylor*, 329 US 495, 510–511 (1947); Federal Rules of Civil Procedure ("FRCP") Rule 26(b)(3)(A).]

Administrative proceedings before the IRS qualify as "litigation." [*See Hodges, Grant & Kaufman*, CA-5, 85-2 USTC ¶9619, 768 F2d 719, 722 (5th Cir. 1985).] Hence, materials prepared by the taxpayer or its representatives in anticipation of an audit may be protected under the work-product doctrine. However, to prevent practically everything generated in the course of tax planning and tax compliance from qualifying for work-product protection, the courts treat "in anticipation of" as a relatively demanding standard.

The taxpayers in *Richey* were undoubtedly *thinking* about a potential audit when they engaged the law firm that hired Mr. Richey. It was also reasonable to expect that their charitable deduction would be examined. Hence, the taxpayers probably satisfied both the "subjective" and "objective" tests for determining whether the valuation was prepared in anticipation of litigation. [*See Evergreen Trading*, *supra*, 80 FedCl 122, 133.]

Nevertheless, the courts generally hold that documents are *not* prepared in anticipation of litigation if the taxpayer would have produced them even if there had been no prospect of an audit. The taxpayers in *Richey* were legally required to submit a valuation. The report was not prepared "because of" the potential audit, so the work-product doctrine did not apply. [*See Richey*, *supra*, 632 F3d 568; *see also M. Adlman, supra*.]

Veolia's $4.5-Billion Worthless Stock Loss

Veolia Environnement S.A. is a multinational corporation headquartered in France. The company provides municipal water, energy, and waste services in three dozen countries. Its U.S. operations are conducted by Veolia Environnement North America Operations Inc. ("Veolia").

In 1999, Veolia acquired Water Application & Solutions Corporation ("WASCO") for $8.2 billion. Five years later, Veolia believed that WASCO had become insolvent. Veolia began to look for ways to claim what it calculated would be a $4.5-billion worthless stock loss.

Veolia wanted to claim an *ordinary* loss for its WASCO stock, so it was necessary to satisfy complicated tests under Code Sec. 165(g)(3). Veolia hired a phalanx of advisors, included Cleary Gottlieb Steen & Hamilton LLP, to map out a strategy to claim the deduction and defend it if challenged by the IRS. Veolia and Cleary engaged two valuations firms to determine whether WASCO was insolvent.

After obtaining a private letter ruling on certain issues, Veolia converted WASCO from a Delaware corporation to a single-member limited liability company. Following the conversion (December 2006), the new LLC was disregarded for federal tax purposes. WASCO was deemed to have liquidated, which Veolia believed was enough to trigger the loss.

Despite the letter ruling, Veolia expected the IRS to challenge its position. In February 2007, it signed up for the IRS's new Pre-Filing Agreement ("PFA") program. Veolia submitted two reports by the valuation consultants to prove that its WASCO stock had been worthless at the time of the deemed liquidation.

The IRS issued summonses requiring Veolia to turn over all documents relating to the worthless stock deduction. Veolia largely complied, but it withheld some documents on the grounds that they were: (1) entitled to work-product protection pursuant to FRCP Rule 26(b)(3); or (2) subject to attorney-client privilege or the parallel privilege for non-attorney tax practitioners (in non-criminal cases) under Code Sec. 7525(a)(1).

Work Product—Anticipatory or Ordinary?

The IRS moved to compel Veolia to comply with the subpoenas. Veolia responded that it was entitled, under FRCP Rule 26(b)(3), to withhold documents that it or its representatives had prepared in anticipation of litigation. The company was not legally obligated to prepare a valuation, so the IRS could not deploy the "because of" argument that had derailed the taxpayers' work-product defense in *Richey*.

That did not stop the IRS from contending that the documents still had not, as a matter of fact, been prepared in anticipation of litigation. However, the U.S. District Court hearing the government's motion found that: (1) Veolia had hired Cleary and the consultants with the subjective intention not only to claim the worthless stock loss, but also to defend it on audit; and (2) Veolia's expectation that the IRS would want to review and possibly contest the company's $4.5-billion ordinary loss was objectively reasonable.

The District Court noted that Cleary had sought and obtained a private letter ruling regarding some aspects of the transaction. Even more significant was the fact that Veolia had enrolled in the PFA program. By the IRS's own account, the purpose of the PFA program is to address "issues that are *likely to be disputed in post-filing audits*." [*See* Rev. Proc. 2005-12, 2005-1 CB 311 (Dec. 22, 2004) (emphasis supplied).]

The IRS also launched a Hail Mary based on an Advisory Committee Note to FRCP Rule 26(b)(3) stating that materials prepared in the *ordinary course of business* are not prepared "in anticipation of litigation." The IRS observed that Veolia's ordinary business activities involved acquiring, managing, and disposing of subsidiary corporations such as WASCO. This frequently involved restructuring companies to derive tax benefits. *Ergo*, procuring valuations to support the $4.5-billion loss was just another day at the office.

The District Court rejected the IRS's argument. The huge dollar amount of the loss established that the valuations related to a transaction far outside the ordinary course of business. But focusing on the "ordinariness" of either the transaction or the related valuation seems misguided. If a valuation prepared in the ordinary course of business is not protected by the work-product doctrine, it is because the valuation would have been produced even if there had been no prospect of a litigation.

Testifying Experts

The work-product rules loosen up considerably when a consultant is expected to submit a report and testify at trial. If one side wants to bring in a third party as a "testifying expert," the other side must be given an opportunity to review—and possibly challenge—not only the consultants' credentials and methodology, but also the *information* on which the consultant relied in forming his or her opinion.

As part of its participation in the PFA program, Veolia had provided the IRS with its consultants' reports determining that its WASCO shares were worthless. Because the reports were proffered as evidence of the value of the stock, the consultants were testifying experts. The IRS therefore sought to discover the materials that the consultants had relied on in preparing their appraisals.

A testifying expert may be deposed under FRCP Rule 26(b)(4)(A). Drafts (in whatever form) of an expert's report are protected from disclosure [*see* FRCP Rule 26(b)(4)(B)], but the materials on which the expert relied are pretty much fair game. The other side can even get access to certain communications between the expert and the client's attorney.

FRCP Rule 26(b)(4)(C) acknowledges that communications between the testifying expert and the attorney are generally protected from discovery under Rule 26(b)(3)(A). But this protection does not extend to communications with the attorney to the extent that they: (1) relate to the expert's compensation; (2) identify facts or data that the attorney provided (assuming they were considered by the expert); or (3) identify assumptions that the attorney provided (assuming they were relied on by the expert).

In *Veolia*, the taxpayer tried to withhold "facts and data" that had been provided to the consultants by persons *other* than its attorneys. It did so on the theory that, because FRCP Rule 26(b)(4)(C) protects only attorneys, we can infer that only attorneys have any duty to disclose such information. The District Court rejected this absurd contention, and ordered Veolia to comply with the summons.

Sanmina: Let Counsel Do It?

Sanmina Corporation, located in San Jose, California, manufactures printed circuit boards. In 2009, Sanmina became convinced that one of its foreign subsidiaries was insolvent.

Sanmina AG seemed healthy, but Sanmina had doubts about the value of a $113-million intercompany receivable shown on the subsidiary's books. Sanmina's in-house tax attorneys had prepared memoranda in 2006 and 2009 (the "Internal Tax Memoranda") discussing the agreements that had created the receivable and analyzing their tax treatment. It appears that the Internal Tax Memoranda discussed the possibility that the receivable lacked economic substance and was merely a bookkeeping entry.

If the receivable was a mirage, Sanmina AG might well be insolvent. Sanmina decided to get an outside valuation. If the shares of its subsidiary were worthless, Sanmina would be able to claim a $503-million loss under Code Sec. 165(g).

The Direct Approach

Sanmina's outside counsel, DLA Piper, could have engaged a valuation consultant under a *Kovel* letter. But Sanmina and DLA Piper seem to have recognized that *Kovel* protection is less than watertight in a valuation case. So, they innovated: Sanmina asked *DLA Piper* to advise on the value the subsidiary.

The law firm produced a 102-page report in which it concluded that the shares of Sanmina AG were indeed worthless. Sanmina went ahead and claimed a $503-million loss on its 2009 return.

The IRS sent Sanmina an information document request regarding the loss. Sanmina responded by sending the IRS a copy of DLA Piper's report. The report included DLA Piper's conclusion that the $113-million receivable "should be disregarded." DLA Piper stated that its conclusion was "based on interviews with Management and related documents provided by Management."

DLA Piper did not disclose the contents of the documents, but it appended a footnote disclosing the captions and dates of the Internal Tax Memoranda. The IRS responded by serving Sanmina with a subpoena demanding the memoranda the law firm had cited. Sanmina refused, contending that the memos were protected by both attorney-client privilege and the work-product doctrine.

Days in Courts

In 2013, the IRS asked the U.S. District Court to enforce the subpoena. The IRS began by arguing that the attorney-client privilege did not apply to the Internal Tax Memoranda in the first place. The District Court pushed this aside, noting that the memoranda had been prepared by Sanmina's in-house tax attorneys, and that the memos had included extensive discussion of legal authorities relevant to the validity of the receivables.

The IRS also contended that the work-product doctrine was inapplicable. After all, the Internal Tax Memoranda were prepared in 2006 and 2009. No audit or litigation was pending, so how could Sanmina claim that the memos were prepared in anticipation of litigation? The District Court quickly dismissed the IRS's objection.

The IRS then argued that Sanmina had *waived* both the attorney-client privilege and work-product protection when: (1) it provided copies of the Internal Tax Memoranda to DLA Piper; and (2) it submitted DLA Piper's report to its adversary, the IRS. The District Court disagreed, stating that DLA Piper had received the Internal Tax Memoranda in its capacity as Sanmina's *attorney*, and that merely *mentioning* their existence did not vitiate their protected status under the work-product doctrine. [*See Sanmina Corp.*, 115 AFTR 2d 2015-1882 (N.D. Cal. May 20, 2015).]

On appeal, the Ninth Circuit vacated and remanded the case. The Court of Appeals gently scolded the District Court for declining to review the Internal Tax Memoranda *in camera*. The District Court was instructed to review the memos in order to provide a "more informed analysis." [*See Sanmina Corp.*, CA-9, 120 AFTR 2d 2017-6917 (Dec. 20, 2017) (unpublished opinion).]

Decision on Remand

On remand, the case got a fresh look from a new judge. After reviewing the Internal Tax Memoranda, the District Court found once again that they had *initially* been protected by the attorney-client privilege and the work-product doctrine. But this time it found that Sanmina had waived those protections—twice. [*See Sanmina Corp., supra*, 2018 WL 4827346 (N.D. Cal. Oct. 4, 2018).]

The first time was when Sanmina gave the Internal Tax Memoranda to DLA Piper. In the District Court's view, Sanmina had not shared the memoranda with the firm for the purpose of obtaining legal advice. Sanmina was looking to DLA Piper to prepare a valuation report, which Sanmina expected to turn over to the IRS to support its tax loss. Sanmina could not disclose its privileged communications with its in-house lawyers to DLA Piper for the valuation and then invoke the privilege to shield them from discovery by the IRS.

Sanmina claimed that DLA Piper had merely *reviewed* the Internal Tax Memoranda, and that the valuation had not actually *relied* on them. The District Court didn't buy it. The report had expressly stated that the DLA Piper's rejection of the $113-million receivable was "based on" documents provided by Sanmina's management, which the report had identified as the Internal Tax Memoranda.

The District Court also concluded that Sanmina's delivery of DLA Piper's report to the IRS had waived any applicable privileges with respect to the materials used to reach the valuation—including the Internal Tax Memoranda. This was matter of fairness:

> DLA Piper explicitly stated in the valuation report that it based its conclusions, at least in part, on the two memoranda at issue …. The analyses that informed the valuation report's conclusions should, in fairness, be considered together. … In order for the IRS or any other reader to evaluate the DLA Piper opinion, the materials on which the opinion were based became discoverable. Otherwise, the IRS or any other reader would be forced to simply accept the opinion without access to the foundational material, and, in this case, to the foundational material explicitly relied on in forming the opinion. [*See Sanmina Corp., supra*, 2018 WL 4827346 at 3.]

The IRS prevailed in the remand to the District Court, but Sanmina has filed an appeal with the Ninth Circuit. Sanmina has been fighting for the best part of a decade to keep the Internal Tax Memoranda under wraps. Is this just a matter of principle? Or are the mystery memos tax dynamite?

Conclusion

Kovel and the countless letters it has inspired may not provide as much protection as tax practitioners commonly assume. In a dispute involving, say, $100 million in tax, one should expect the IRS to press hard against any arrangement that purports to insulate ordinary tax planning from review. Valuations, which have little to do with "translating" communications between attorney and client, seem particularly vulnerable.

On the other hand, the IRS does not appear to be on any crusade to pierce the *Kovel* veil whenever and wherever it has been drawn. The Internal Revenue Manual mentions *Kovel* only once, and then only for the proposition that the burden of establishing the existence of a privilege is on the person asserting it. [*See* IRM 5.17.6.12 (rev. Dec. 11, 2007).]

The IRS has probably noticed that lawyers feel strongly about privileges, and that they take professional pride in fighting to maintain them. If the stakes are relatively modest, the IRS may find a policy of restraint preferable to launching into years of litigation. That might explain—and even justify—the use of *Kovel* letters in circumstances in which, technically, they should not do the taxpayer much good.

Wolters Kluwer

2700 Lake Cook Road
Riverwoods, IL 60015

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH

10028607-0730