Work Product Doctrine Vindicated in *Textron*

January 2009
by James E. Merritt, Hollis L. Hyans, Edward L. Froelich

Related Practices:

- Federal Tax
- Litigation
- State and Local Tax

On January 21, the Court of Appeals for the First Circuit, in a 2-1 decision, affirmed in part and remanded in part the decision of the trial court in *United States v. Textron*, 507 F. Supp. 2d 138 (D.R.I. 2007). In a vigorous and thorough decision, the First Circuit resoundingly decided in favor of the taxpayer on the critical issue of whether tax accrual workpapers can constitute protected work product.[1] The court remanded the case for further consideration of the issue of waiver. The key to the court's decision was its holding that documents that serve both a litigation purpose and business purpose, commonly referred to as dual purpose documents, can constitute work product.

To recall from our prior updates, this case involves Textron's refusal to comply with a summons seeking certain tax accrual workpapers for Textron's 2001 tax year. Through the summons, the IRS sought not only Textron's workpapers relating to the remaining issue under audit (the treatment of certain SILO, Sale-In Lease-Out, transactions) but all of its tax accrual workpapers for the 2001 tax year. The IRS also requested that Textron provide the workpapers of Textron's outside auditor, Ernst & Young. This summons and the enforcement action that followed in the district court of Rhode Island was one of the first significant efforts by the IRS to obtain tax accrual workpapers as part of its overall campaign against what it considers to be potentially abusive tax shelters.

Textron's workpapers consisted of two parts. The first part was a spreadsheet that listed (i) each tax position considered by Textron's counsel to be arguable, (ii) estimates of litigation risks with respect to these positions, and (iii) tax reserve amounts for each position. The second part was comprised of backup documents, including the prior year spreadsheet, a draft spreadsheet, and accompanying memos from Textron's in-house counsel reflecting opinions regarding litigation risks.

After extensive briefing and an evidentiary hearing, the district court found that Textron created the workpapers to determine adequate reserves in anticipation of later controversy or litigation. The court also found that the workpapers served the purpose of showing E&Y that its reserves were appropriate, thereby facilitating E&Y's approval of the audited financial statements. (The court noted that where Textron determined there was no risk of litigation for a particular return position, no tax accrual workpaper would have been created with respect to such position.) Accordingly, the district court concluded that the workpapers were protected work product and also held that because there was no adversarial relationship between Textron and E&Y, the disclosure of the workpapers to E&Y did not constitute a waiver of the work product protection. The court distinguished the waiver of claimed attorney-client and tax practitioner privileges, which it held were waived by the disclosure to E&Y.

Administrative Tax Disputes Are Deemed Litigation

Along the way to its overall conclusion, the First Circuit answered several questions. The first was whether administrative tax disputes should be treated as litigation for purposes of work product. Here, the court reviewed the purpose of the work product doctrine first recognized by the Supreme Court in *Hickman v. Taylor*, 329 U.S. 495 (1947). The court noted that the doctrine protects our adversarial system by shielding an attorney's strategies and analyses from discovery. Thus, where there is "adversarialness," borrowing a coined word, work product serves an important balancing function to otherwise wide-ranging discovery. Slip op. 14-15. This beginning point underlies the rest

of the First Circuit's opinion. In addressing the first question, the court stated that while not all audit dealings with the IRS are adversarial, "good faith disputes regarding the proper application of tax law also arise during the audit process . . . [and] are essentially adversarial." Slip op. at 15. Thus, while audit disputes are not technically litigation, because their resolution can ultimately lead to litigation, the First Circuit concluded that the doctrine should apply to preserve the balance between the disputing parties, i.e., the taxpayer and the IRS.

Prior History of Tax Controversy Is Not Essential

The district court had noted Textron's prior history of controversies and litigation with the IRS as a factual indicator of Textron's anticipation of future litigation with regard to its arguable tax return positions. The First Circuit, however, disregarded prior controversy experience because any taxpayer can anticipate in good faith a dispute with the IRS: "A company with a history of challenging the IRS creates these documents 'because of' the same reason as any other company without such a history: the possibility of a dispute compels them to anticipate litigation so as to prepare and assess their tax reserve funds." Slip op. at 31. Of course, such anticipation should be objectively reasonable in order to qualify documents as work product. Slip op. at 30. In the case of Textron, the court stated that the process of identifying possible tax disputes in conjunction with fulfilling its public reporting requirements provided assurance of the objective reasonableness of anticipating litigation on tax positions for which Textron ultimately reserved. Slip op. at 31.

Acknowledgment That Many Issues Are Informally Resolved Short of Litigation Does Not Undermine Work Product Claims

A second concern raised by the IRS was that as a practical matter most tax disputes are resolved during the audit process far short of litigation so that Textron could not have reasonably anticipated litigating every arguable position for which it reserved. Again, because good faith tax disputes are considered litigation for purposes of the work product doctrine, the court did not consider this a relevant point. At the time Textron identified a particular return position as arguable, it anticipated the specifics of litigation regarding that position. "That Textron might ultimately decide not to dispute a specific position does not contradict the conclusion that when it estimated its litigation success, it was anticipating specific litigation." Slip op. at 30. In effect, the test proposed by the IRS would require a mental commitment on the part of the taxpayer to litigate the issue short of a complete IRS concession.[2] The court rejected this test in favor of protecting work product where such work product was created with specific issues and potential litigation in mind. Again, the notion of protecting a party's strategies and analyses underpins the court's rationale.

Dual Purpose Documents Retain Work Product Protection

The First Circuit acknowledged that Textron prepared its tax accrual workpapers in part for the purpose of satisfying its public reporting requirements. In this regard, it accepted the district court's finding that "Textron's tax accrual workpapers were prepared with dual purposes in mind." Slip op. 17, n. 4. However, under the test adopted by the First Circuit and a majority of the circuits, the presence of a nonlitigation purpose does not remove an otherwise litigation-motivated document from the protection of work product. The majority test interprets the "anticipation of litigation" element of the work product protection such that documents prepared "because of" the prospect of litigation are protected. When is a document created "because of" the prospect of litigation? The court adopts the negatively phrased answer in the Second Circuit *Adlman* case, 134 F.3d 1194 (1998). Thus, when a document "would have been prepared irrespective of litigation" a document is not created because of litigation. Slip op. at 16. In the case of Textron's workpapers, without the prospect of litigation, no workpaper evaluating litigation risks would have been created. The court restates this conclusion in the positive form: the documents were prepared "because of the risk of disputes and litigation which gave rise to a need to compute and report tax reserves." Slip op. at 18.

Once the court concluded that the workpapers were prepared for the purpose of preparing for a dispute with the IRS, i.e., that the workpapers were prepared in anticipation of litigation, it easily dealt with the IRS's points that the documents were created to "obtain a clean opinion from E&Y" or "to comply with reporting and securities obligations." Id. In short, the court did not deny that the workpapers were created in part to serve these purposes, but the presence of these motivations did not remove the document from the protection of work product. Slip op. at 19 (citing Wright, Miller & Marcus, *Federal Practice and Procedure*, Section 2024 (2008)). For the First Circuit, the reporting purpose and the litigation purpose underlying the workpapers were inextricably related because the anticipation of litigation (here anticipation of administrative tax dispute) "triggered" the reporting obligations. Slip op. at 21.

Because the First Circuit embraced the dual purpose test of work product, it dismissed the IRS's

reliance on *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982) where the Fifth Circuit applied the minority, "primary motivating purpose" test of work product. The court also distinguished *United States v. Arthur Young*, 465 U.S. 805 (1984), because that decision concerned the potential creation of a privilege-like immunity for accountants and did not address the established work product doctrine in the case of dual purpose documents such as Textron's internal workpapers.

Waiver or Non-Waiver, That is the Final Question

The final issue regarding Textron's workpapers was whether disclosure of the workpapers to E&Y waived the work product protection. Like the district court, the First Circuit followed precedent to hold that a waiver of work product does not occur if the document is disclosed to nonadversarial third parties. Like the district court, the First Circuit concluded that there was no basis upon which to conclude that E&Y, in the capacity of an outside auditor, was in an adversarial relationship with Textron. Unlike the relationship between the auditor and company in an earlier First Circuit case, *Maine v. United States Dep't of the Interior*, 298 F.3d 60 (2002), "E&Y was not auditing Textron in order to identify disputes it would have with Textron, but rather, to decide if it could issue a letter certifying Textron's financial statements. This was a cooperative not an adversarial relationship." Slip op. at 34. This is a correct distinction and an important statement regarding auditor-company relationships in the preparation of financial statements. The IRS in public statements regarding this issue wanted to frame the argument in terms of whether an auditor was, to quote one official, "in bed with the company." The First Circuit clearly did not take the bait. Cooperation does not amount to conspiracy. Accordingly, the disclosure of Textron's workpapers to E&Y did not cause Textron's workpapers to lose their work product protection.

While most readers would have expected the court to conclude its opinion at this stage, it did not. It asked the further question: whether E&Y was a conduit to the IRS. Slip op. at 35. Even though a third party who receives information may not itself be adversarial, if it is merely an intermediary to an adversary, the protection is likely waived. The key question here not directly addressed by the First Circuit is what should be considered a "conduit" for purposes of the work product doctrine. In the ordinary understanding of the word, a conduit is merely a connecting device, such as in the case of an electrical conduit. In other words, there is little doubt that if you put something in one end of a conduit it will come out the other end. That is why most courts approach this question in terms of whether the disclosure of a document to a third party "substantially increases" the opportunity for a potential adversary to obtain the document. *See* Wright, Miller & Marcus, *Federal Practice and Procedure*, §2024 (2008); *In Re Raytheon Sec. Litig.*, 218 F.R.D. 354 (D. Mass. 2003).

Because E&Y did not receive copies of Textron's workpapers for its files, there is no possibility that access to E&Y's files, by itself, would disclose Textron's actual workpapers. This did not deter the First Circuit. Instead, the court analyzed the issue in terms of whether the information contained in *E&Y's workpapers*, which may or may not be discoverable, is sufficiently revealing of information in *Textron's workpapers* so as to conclude that protection was waived as to Textron's workpapers. Slip op. at 37. This approach seems contrary to statements made by the court in other parts of its decision in which it proposed the underlying purpose of the work product doctrine of promoting fairness in the adversarial system as a limiting factor to discovery:

> Consider a document prepared to analyze a specific litigation in order to compute for an auditor how much must be retained in a litigation reserve fund. Were we to adopt the IRS position that documents created to satisfy audit reporting responsibilities were not protected, opposing counsel in the litigation might be able to discover such a memo, effectively disclosing counsel's ultimate mental impression of the case.

Slip op. at 23. By remanding the case to the district court on the question of waiver, the First Circuit may have allowed access to the workpapers inconsistent with its express analysis of the purposes of the work product doctrine. Ironically, where an outside auditor actually retained copies of work product in its audit files, a district court recently held that work product extended even to those documents, which were sought directly from the auditor through a summons enforcement action, and that no waiver occurred through the auditor's possession of those documents. *See Regions Financial Corp. v. United States*, 101 AFTR 2d 2008-2179 (D. Ala. 2008).[3]

The district court in reviewing this issue on remand should, in the authors' view, presume that Textron's workpapers remain protected work product. It does not appear to make any sense to hold that the audit firm is not an adversarial party under work product analysis, but to then require an analysis of what documents, notes, etc. the audit firm maintained with regard to the issues and reserves. How could the form of the notes or documents retained or created by the audit firm

change its role to that of an adversary and thus establish a basis for waiver? No matter what is in E&Y's files, those documents were created by E&Y and not by Textron. Any analysis of litigation risks contained in the E&Y workpapers is in the end E&Y's independent analysis as required by its own professional audit rules. Therefore, even if E&Y's analysis appears similar to that in Textron's internal workpapers, that does not convert E&Y's analysis into Textron's analysis. Where legal rules, such as cases, statutes, etc., are all public information (and no facts were withheld from the IRS), how is the district court to decide that E&Y's citation of authorities and discussion is really Textron's? In our view, the task requested by the First Circuit boils down to something of a guessing game at the expense of the work product doctrine, which might result in the IRS obtaining through the back door the documents that the First Circuit has clearly prohibited from leaving through the front door.

Textron May Be Required to Produce E&Y's Workpapers

In an apparent oversight, the district court did not address that part of the summons which requested that Textron provide E&Y's workpapers. Textron argued that the IRS belatedly raised this mistake on appeal, but the appellate court did not agree. On remand, the district court must consider whether Textron has the legal right or ability to obtain E&Y's workpapers.

Consider the Implications for State and Local Tax Matters

While not controlling, the *Textron* decision also provides some guidance applicable to state and local tax disputes. With increasing frequency, state auditors and litigation counsel are requesting the production of accrual workpapers dealing with the company's treatment of various state tax matters under dispute. Requests have ranged from those fine-tuned to a taxpayer's provisions concerning a specific transaction to broad requests for all accrual workpapers, issued independently of any specific audit activity and simply occasioned by a review of a company's SEC filings. States are not bound by the IRS's traditional policy of restraint, which has generally applied in the absence of alleged "tax shelters," and some states have specifically disavowed any such policy.

Under the rules announced in *Textron*, and the other recent cases decided in this area, taxpayers in state audits and litigation should be entitled to at least the same protection from disclosure for tax accrual workpapers, and in some states even greater protections are available under state law. To the extent state tax accrual workpapers are prepared, at least in part, in anticipation of litigation, taxpayers should vigorously assert the work-product privilege to protect them from disclosure.

FIN 48

Corporations required to keep internal tax accrual workpapers should review their current practices in light of the First Circuit's decision. In a post-FIN 48 accounting world, it would appear that the application of this case is relatively easy with respect to workpapers that establish reserves for uncertain tax positions. Under the First Circuit's reasoning, the combination of FIN 48 requirements of recognition and measurement for such uncertain positions should provide a similar guarantee of the reasonableness of anticipation of a tax dispute regarding such positions.

Footnotes

[1] The First Circuit did not review the lower court's decision that the attorney-client privilege and federal tax practitioner privilege applied to the workpapers but were waived upon disclosure to the outside auditors.
[2] The court characterized the IRS position as requiring "some specific quantum of expectation that the position at issue would mature into full-fledged litigation." Slip op. at 30.
[3] The *Regions* case is final. Though the IRS noticed appeal, in late 2008, the parties settled the tax years involved in the summons enforcement action, and the appeal became moot.