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Second Circuit Determines That Tax Memo Shared Between Taxpayers and Banks Is Protected Under the Common Interest Doctrine and Subject to Work-Product Protection

On November 10, 2015, the US Court of Appeals for the Second Circuit unanimously held in a published opinion that (i) the attorney-client privilege was not waived by appellants-taxpayers who shared a group of documents, including a 58-page tax memorandum, with a consortium of banks having a common legal interest with the taxpayers in the tax treatment of a corporate refinancing and restructuring transaction; and (ii) the work-product doctrine protected documents analyzing the tax treatment of the transaction prepared in anticipation of litigation with the IRS. *Schaeffler, et al., v. United States*, No. 14-1965-cv, 2015 US App. LEXIS 19617 (2d Cir. Nov. 10, 2015). This ruling, which vacated and remanded Magistrate Judge Gabriel Gorenstein's denial of taxpayers' petition to quash an IRS summons, is one of the most favorable privilege decisions in years as it clarifies and broadens common interest doctrine protection for communications among accountants, lawyers and bankers who have, or whose clients' have, a common commercial and legal interest in the tax consequences of a transaction and for parties who are engaged in a "common legal enterprise" with the holder of the privilege. It also reaffirms Supreme Court and Second Circuit precedent concerning work-product protection for documents created in anticipation of litigation.

A. Background

In *Schaeffler*, the taxpayers petitioned to quash an IRS summons for a tax memorandum and related documents prepared by taxpayers' accounting firm in connection with a complex refinancing and corporate restructuring transaction in 2008 by the Schaeffler Group, an automotive and industrial parts supplier incorporated in Germany, in an attempt to acquire a minority interest in a target German company through a tender offer for its stock. To finance the tender offer, the Schaeffler Group executed an eleven-billion Euro loan agreement with a consortium of banks. With the announcement of Lehman Brothers' bankruptcy only two days before the end of the tender offer acceptance period, the stock price of the target company declined drastically, resulting in a significantly higher than expected number of shareholders who accepted the offer. Moreover, the Schaeffler Group was prohibited under German law from withdrawing its tender offer. These events threatened the Schaeffler Group's solvency and its ability to meet its payment obligations with its lenders under the loan agreement. Accordingly, the Schaeffler Group and the bank consortium sought to refinance the acquisition debt and restructure the Schafeffler Group, which resulted in various potential tax consequences for the Schaeffler Group, including for the majority owner of the parent of the Schaeffler Group in his personal capacity (collectively, the "taxpayers").

The taxpayers believed an IRS audit and potential litigation as to at least some of the US tax consequences of the proposed refinancing and restructuring was likely, and therefore engaged outside tax and legal advisors to assist with the US tax implications of the transactions and possible future litigation with the IRS. As part of its engagement, Ernst & Young LLP ("E&Y") prepared a memorandum for the taxpayers that identified potential US tax consequences of the proposed transactions, identified and analyzed potential IRS challenges to the Schaeffler Group's treatment of the transactions, and analyzed the relevant statutory provisions, US Treasury regulations, judicial decisions and IRS rulings (the "Tax Memo"). The Schaeffler Group also retained Dentons US LLP to advise it on the federal tax implications of the transactions and potential litigation with the IRS. The bank consortium and its outside counsel worked closely with the Schaeffler Group's outside tax advisors at E&Y in effectuating the transactions and analyzing the US tax consequences of the transactions. In this regard, the Schaeffler Group and the bank consortium signed an agreement whereby they agreed to share privileged, protected and confidential documents, including their analyses, in an effort to protect and not to waive those privileges, protections or the confidentiality of the information. After the execution of that agreement, the Schaeffler Group shared the Tax Memo and other documents with the bank consortium.

The IRS, in conjunction with an audit of the taxpayers' tax returns for 2009 and 2010, issued a number of document demands requesting all tax opinions and analyses that discussed the US tax consequences of the Schaeffler Group's restructuring, and, eventually, it issued an administrative summons to E&Y requiring it to provide all legal opinions that it provided to parties outside the Schaeffler Group. Although it produced several thousand documents, the taxpayers petitioned to quash the IRS summons on the grounds that it sought legal opinions and other confidential advice protected by both the work-product doctrine and the attorney-client privilege, as extended to E&Y by the federal tax practitioner privilege.

With respect to their privilege claim, the taxpayers argued that no privilege waiver of the Tax Memo and related documents occurred when they were provided to the bank consortium because the Schaeffler Group and the consortium had a common legal interest. The taxpayers also maintained that the Tax Memo and related documents were subject to work- product protection because they were prepared in anticipation of litigation. The District Court, however, disagreed, holding that attorney-client and tax practitioner privileges were waived when the Tax Memo was shared with the bank consortium. In particular, the District Court held that there was no "common legal interest" because the bank consortium's interest was commercial rather than legal. Op at *6. The District Court also rejected the taxpayers' claim that the Tax Memo and related documents were protected under the work-product doctrine because, according to the District Court, the documents did not specifically refer to litigation and the detailed analyses and advice provided to the taxpayers would have been provided even if they had not anticipated an audit or litigation with the IRS. *Id*. at *8-*9.

B. Non-Waiver of Attorney-Client Privilege

On appeal, The Second Court noted that while the attorney-client privilege is generally waived by voluntary disclosure of the communication to another party, the privilege is not waived by disclosure of communications to a party that is engaged in a "common legal enterprise" with the holder of the privilege. Op at *12. According to the Court, the dispositive issue was "whether the Consortium's common interest with [the taxpayers] was of a sufficient legal character to prevent a waiver by the sharing of those communications." *Id* at *13. The Court held that it was.

At the outset, the Court made clear that parties may share a common legal interest even if there is no ongoing litigation at the time of the shared communications between the parties. Thus, the relevant issue for the Court was whether the communications were made in the course of an ongoing common enterprise and intended to further the enterprise. Analyzing the facts at issue, the Court determined that because of the threat of insolvency and default, the taxpayers and the bank consortium "had a strong common interest" in obtaining particular tax treatment of the refinancing and restructuring. Op. at *8-*9. The Court determined that "[taxpayers] and the [bank consortium] could avoid this mutual financial disaster by cooperating in securing a particular tax treatment of a refinancing and restructuring. Securing that treatment would likely involve a legal encounter with the IRS." *Id*. at *14. Moreover, the Court found that the bank consortium "needed 'access to confidential tax information and analyses' to 'assess its credit exposure for potential tax liabilities'" of the Schaeffler Group's majority shareholder. *Id* at *15. Accordingly, both parties "had a strong common interest in the outcome of that legal encounter." *Id*. at *14.

The Court also observed that no caselaw in the Second or other circuits compelled it to hold that the bank consortium's interest in the taxpayers' obtaining favorable tax treatment for the refinancing and restructuring transactions was not a sufficient common legal interest. Op at *18. Thus, "[a] financial interest of a party, no matter how large, does not preclude a court from finding a legal interest shared with another party where the legal aspects materially affect the financial interests." *Id*. In support of its reasoning, the Court noted that the bank consortium's legal interest was evidenced by how it "essentially insured" the taxpayers, including by extending credit and subordinating its debt, and retaining control over decisions by the Schaeffler Group's majority shareholder concerning the IRS, including whether to pay taxes, to sue for a refund or to settle. The Court then pointed to the fact that in an analogous context several courts outside of the Second Circuit have held that an insurer and an insured may maintain a common legal interest in the outcome of a litigation even if their defenses are not aligned. *Id*. at *18-*19.

C. Application of Work-Product Doctrine

The Second Circuit separately addressed the issue of whether the work-product doctrine applied to the Tax Memo and related documents, noting at the outset that the work-product immunity, if applicable, was not waived by sharing those documents with E&Y. Op at *17. The Court concluded that the District Court had erred and that the Tax Memo and related documents were protected by the work-product doctrine because they contained "legal analysis that falls squarely within [*Hickman v. Taylor*, 329 US 495 (1947)]'s area of primary concern-analysis that candidly discusses the attorney's litigation strategies [and] appraisal of likelihood of success." *Id*. at *25 (brackets in original).

Citing *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998), the Court determined that work-product doctrine protected the documents because they were specifically aimed at addressing tax issues that may arise in an anticipated audit and subsequent litigation, including the strengths, weaknesses and likely outcomes of potential legal arguments. Op at *20. In analyzing *Adlman*, the Court drew a distinction between documents prepared or obtained "because of" the prospect of litigation, on the one hand, and documents created "irrespective of the litigation," on the other hand. *Id*. at *20-21 (internal citations omitted). Addressing the facts at hand, the Court found that the Tax Memo "was specifically aimed at addressing the urgent circumstances arising from the need for a

refinancing and restructuring and was necessarily geared to an anticipated audit and subsequent litigation," which was "highly likely." *Id*. at *21

The Court further disagreed with the District Court's reasoning that E&Y would have been compelled by professional standards, tax laws and regulations to provide the same tax advice to the taxpayers even in the absence of anticipated litigation. Op. at *22-*23. Noting the level of detail contained in the Tax Memo, the Court rejected the notion that the taxpayers would have sought the same level of detail as part of an "annual routine tax return with no particular prospect of litigation." *Id*. at *23.

D. Looking Forward

The *Schaeffler* decision is significant because it clarifies the scope of the common interest privilege for communications involving accountants, lawyers and bankers in situations where they and their clients have a common commercial and legal interest in the tax consequences of a transaction. It also is a strong reaffirmation of the *Hickman* and *Adlman* work-product decisions and supports a liberal interpretation of what constitutes "anticipation of litigation" in the work-product context. Although the Second Court's analysis pertained to the specific facts in the case, the decision supports application of the work-product doctrine where the size, complexity and ambiguity of the tax treatment of the transaction heightens the likelihood of IRS scrutiny of the transaction.

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