Legal Opinion Letter

WLF Washington Legal Foundation

Advocate for freedom and justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302

Vol. 19 No. 2 January 29, 2010

APPELLATE COURT RULING NARROWS ATTORNEY WORK PRODUCT DOCTRINE

by
Richard Ben-Veniste and Dan Himmelfarb

The attorney work product doctrine, a qualified privilege codified in Rule 26(b)(3) of the Federal Rules of Civil Procedure, prohibits a party from obtaining, through the discovery process, documents "prepared in anticipation of litigation or for trial" by another party, unless the party seeking discovery makes a specified showing of need. Late last summer, in *United States v. Textron Inc.*, a sharply divided U.S. Court of Appeals for the First Circuit, sitting en banc, held that "tax accrual work papers" are not protected by the work product privilege. The decision is highly consequential and may well be reviewed by the Supreme Court.

In preparing financial statements, publicly traded companies must calculate reserves to account for contingent tax liabilities, including estimates of potential liability if the IRS challenges positions taken in the company's tax return. When estimating this potential tax liability, the company's lawyers prepare "work papers" that explain the reserve entries to the independent auditor that is required by federal securities law to certify financial statements. In *Textron*, the work papers consisted of spreadsheets listing the dollar amount of each disputable item and the percentage likelihood of a successful IRS challenge, together with back-up materials.

Because this information is not typically identified in a company's tax return, the work papers can enable the IRS, as the Supreme Court has put it, to "pinpoint the 'soft spots' on a corporation's tax return"—assuming, that is, that the IRS can gain access to the papers. Although the IRS does not automatically seek these materials, it can do so under IRS regulations when a company has engaged in specified "tax avoidance" transactions. In reviewing Textron's 2001 tax return, the IRS determined that a subsidiary of the company had engaged in several such transactions and issued an administrative summons seeking Textron's work papers for that tax year. When Textron refused to comply, the government filed a petition for enforcement in Rhode Island district court.

The district court denied the petition, finding that the papers were protected work product. The court reasoned that a document is prepared "in anticipation of litigation" (the language of Rule 26(b)(3)) when it is prepared "because of" the prospect of litigation and that Textron's work papers satisfy that standard because they "would not have been prepared at all 'but for' the fact that Textron anticipated the possibility of litigation with the IRS." The government appealed, and a divided panel of the First Circuit affirmed. The government then petitioned for rehearing en banc. The First Circuit granted the petition, vacated the panel decision, and reversed by a three-to-two vote.

Richard Ben-Veniste is a senior partner in the Washington, D.C. office of the law firm Mayer Brown LLP. He specializes in civil litigation, white-collar criminal cases, and congressional investigations. **Dan Himmelfarb** is a partner in the Washington, D.C. office of Mayer Brown LLP. He is a member of the firm's Supreme Court & Appellate practice.

In an opinion by Judge Boudin, the en banc majority held that Textron's tax accrual work papers were not protected work product. Rather than being prepared "in anticipation of litigation," the majority concluded, the papers were created "to support financial filings and gain auditor approval" and thus were prepared "in the ordinary course of business." The majority believed that "[e]very lawyer who tries cases knows the touch and feel of materials prepared for a current or possible . . . law suit" and that "[n]o one with experience of law suits would talk about tax accrual work papers in those terms." In a strongly worded dissent, Judge Torruella took the position that the papers were protected work product because "Textron was acting to anticipate and analyze the consequences of possible litigation." He complained that "[l]ower courts deserve more guidance than a simple reassurance that a bare majority of the en banc court knows work product when it sees it."

The *Textron* decision will have serious consequences for publicly traded companies, especially if it is followed by other courts. *First*, as the dissent pointed out, access to tax accrual work papers enables the IRS to "identify weak spots and know exactly how much [a company] should be willing to spend to settle each item." *Second*, as the dissent also explained, the absence of work product protection will inevitably lead "attorneys who identify good faith questions and uncertainties in their clients' tax returns . . . to avoid putting [that information] in writing, thus diminishing the quality of representation." *Third*, there is no obvious alternative privilege that would shield the work papers from disclosure. Any otherwise applicable attorney-client or tax-practitioner privilege, for example, would likely be waived (as it was in this case) by virtue of the materials' disclosure to the company's accountants. *Fourth*, although the IRS currently seeks tax accrual work papers only when a company has engaged in specified "tax avoidance" transactions, that restraint is entirely self-imposed. In the current environment, in which corporations are politically unpopular, the First Circuit's removal of an obstacle to access may result in pressure to loosen further the regulatory restrictions on seeking these materials. *Fifth*, there is no obvious basis for limiting *Textron's* holding to requests for tax accrual work papers. As the dissent observed, "[n]early every major business decision by a public company" has "a legal dimension" that requires analysis of "anticipated litigation," and under the majority's decision that "work product is not protected." *Sixth*, there is no obvious basis for limiting *Textron's* holding to requests for documents by the government. The work product doctrine applies to *any* party, and it goes without saying that plaintiffs' lawyers will not exercise the same restraint as the government in seeking materials that are unprotected under the First Circuit's decision.

Textron has filed a petition for certiorari. Although the Supreme Court grants only a tiny fraction of certiorari petitions, the prospects for further review here are far better than in a typical case. To begin with, the question whether the work product doctrine protects against disclosure of tax accrual work papers and similar materials is one of recurring and far-reaching importance, for the reasons identified above. Beyond this, there is a circuit conflict on the more general question of what it means for a document to be prepared "in anticipation of litigation" and thus entitled to work product protection. Several circuits apply a "because of" test; the Fifth Circuit applies a less protective "primary purpose" test; and, in light of the *Textron* decision, it is not clear what test now governs in the First Circuit. Indeed, the dissenting judges in *Textron* ended their opinion with a plea for Supreme Court review. "The time is ripe," they said, "for the Supreme Court to intervene and set the circuits straight on this issue which is essential to the daily practice of litigators across the country." The business community is hoping that the Court accepts this invitation.

ISBN 1056 3059