US First Circuit Changes Course In *Textron*; Holds Tax Accrual Workpapers Are Not Protected After All

As we described in our January 28, 2009, Client Update,[1] a majority of a three-judge panel of the Court of Appeals for the First Circuit held that the work product doctrine could protect the schedules and supporting documentation behind a company's reserve for contingent tax liabilities, known as "tax accrual workpapers," from IRS discovery. *U.S. v. Textron, Inc.*, 553 F.3d 87 (1st Cir. 2009) (the "panel majority opinion"). This panel majority opinion, however, was subsequently withdrawn as the IRS successfully sought a rehearing *en banc*, which was heard by all five active First Circuit judges in June. *United States v. Textron, Inc.*, 560 F.3d 513 (1st Cir. 2009).

The First Circuit has now issued its *en banc* decision. By a 3-2 vote, the court held that Textron's tax accrual workpapers were not protected as work product after all. *U.S. v. Textron, Inc.*, Dkt. No. 07-2631 (1st Cir. August 13, 2009) (the "*en banc* majority opinion"). The decision has significant implications for taxpayers' ability to protect their tax accrual workpapers from discovery and also has important work product implications for non-tax lawyers as well.

Background of the Case

Textron involves an IRS administrative summons seeking Textron's tax accrual workpapers, composed of its master tax reserve schedule, certain supporting schedules, and explanatory notes. Textron argued that the workpapers reflected its in-house lawyers' analysis and litigation assessment of each tax issue and so should be protected from discovery under the work product doctrine.

The work product doctrine, as embodied in Federal Rule of Evidence 26(b)(3), protects from discovery documents prepared "in anticipation of litigation or for trial." Courts have applied different tests to interpret the phrase "in anticipation of litigation." A minority of courts apply a stringent test under which documents are protected only if they were created for the "primary purpose" of assisting in litigation. By contrast, in an earlier opinion, the First Circuit had adopted the more widely endorsed "because of" standard. *Maine v. United States Dept. of Interior*, 298 F.3d 60 (1st Cir. 2002). Under this standard, work product protection applies if the document fairly can be said to have been created "because of" the prospect of litigation. The First Circuit said in *Maine*, however, that work product protection does not attach to documents that are prepared to satisfy legal or regulatory obligations in the ordinary course of business, or that would have been created in essentially the same form irrespective of the litigation.

The Rhode Island district court, applying *Maine*, held that Textron's workpapers had in fact been prepared "in anticipation of litigation" under the "because of" test. The district court reasoned that the assessments of potential exposure that were contained in the workpapers would not have been prepared but for the fact that the company anticipated litigation with the IRS. In fact, the court observed that if the company had not anticipated a dispute with the IRS, it would not have been necessary to record a tax contingency reserve or to prepare workpapers supporting such a reserve for its independent auditor to review. On appeal, the panel majority opinion affirmed the district court's holding that the tax accrual workpapers were protected by the work product doctrine, remanding on a narrower question of waiver.

The *En Banc* Majority Opinion

On rehearing, however, the First Circuit changed its course. The *en banc* majority opinion stated that no work product privilege may attach because the workpapers were independently required by statutory and audit requirements applicable to every company that files audited financial statements with the SEC. The *en banc* majority found no evidence that the tax accrual workpapers had been prepared "for use in" litigation. According to the *en banc* majority, "[e]very lawyer who tries cases knows the touch and feel of materials prepared for a current or possible . . .law suit." Continuing, the court concluded that "[a]ny experienced litigator would describe the tax accrual workpapers as tax documents and not as case preparation materials."

The Dissent

In a strongly worded dissent, two judges disagreed with the *en banc* majority's application of the "in anticipation" standard. The dissent said that the *en banc* majority had applied neither the "because of" test adopted in *Maine* nor the more restrictive "primary purpose" test. Rather, in the dissent's view, the *en banc* majority had created a third, even more restrictive test under which only documents prepared "for use in" litigation would be protected.

The dissent observed that the other circuit courts applying the "because of" standard had rejected the *en banc* majority's narrow rule that the document must be prepared for use in litigation. The dissent noted that the leading case on this point, *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998), analyzed a document created for the "dual purposes" of: (i) assisting in a business decision (a non-protected purpose) and (ii) assessing the likely outcome of litigation (a protected purpose). In *Adlman*, the Second Circuit stated that "[n]owhere does Rule 26(b)(3) state that a document must have been prepared *to aid* in the conduct of litigation in order to constitute work product…The text of Rule 26(b)(3) does not limit its protection to materials prepared to assist at trial." *Id.* at 1198 (emphasis original).

The dissent observed that, to the extent the *en banc* majority's analysis extends work product protection only to the types of documents that any "experienced litigator would describe" as "case preparation materials," this "dangerously suggests that this court can, from its general knowledge, offer an expert opinion as to how such documents are always seen by 'experienced litigators.'" The dissent likened this standard to Supreme Court Justice Stewart's "famously unhelpful" test for identifying obscenity ("I know it when I see it") and said that the district courts deserve more concrete guidance in order to apply Rule 26(b)(3).

The dissent also observed that the *en banc* majority opinion assumed — without analysis — that the term "litigation" includes only trial in a court room setting, seemingly in contradiction of both Rule 26(b)(3) itself and well-established law. This narrow definition is also a change from the panel majority opinion, which recognized that work product protection could attach at earlier points in time. The panel majority opinion had stated that, while not all dealings with the IRS during an audit are "litigation," the "resolution of disputes though adversary administrative processes, including proceedings before the IRS Appeals Board, meets the definition of litigation."

The dissent concluded by saying that the "time is ripe" for the Supreme Court to intervene and adopt a consistent standard for interpreting Rule 26(b)(3), which is essential to daily litigation practice throughout the country.

Conclusion

It remains to be seen whether the US Supreme Court will resolve these competing applications of the "in anticipation" standard and clarify the meaning of the term "litigation" in the administrative tax dispute context. In the meantime, however, *Textron* introduces serious concerns for all corporate tax departments that assess uncertain tax positions affecting their financial statements.

Moreover, these concerns are not limited to work product created by or for the company's Tax Department. The *en banc* majority's approach means that litigation opponents may be able to discover a company's analysis of the hazards posed by the claim if the analysis is prepared in connection with auditor review

or other business uses aside from trial team preparation.

Endnote

[1] See our previous Client Update "US First Circuit Holds Textron May Have Waived Work Product Protection on its Tax Reserve Workpapers," available at http://www.mayerbrown.com/publications/article.asp?id=6071&nid=6.

For more information concerning the implications of the Textron *opinion, please contact your regular Mayer Brown lawyer, or one of the following lawyers.*

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