

D.C. Circuit Jabs First Circuit – Work Product Means Something In the Nation’s Capital

By Jean A. Pawlow and Kevin Spencer

On and off for the last 26 years, the Internal Revenue Service has gone toe to toe with taxpayers to try to obtain a “cheat sheet” to understand how corporate America handicaps the positions it takes on its federal income tax returns. Ever since the Supreme Court of the United States affirmed the IRS’s right to obtain tax accrual workpapers prepared by a taxpayer’s independent auditors,¹ the IRS has increasingly flexed its muscles in search of “smoking gun” documents that may reveal a taxpayer’s assessment of weaknesses in its own case. After the IRS ultimately prevailed after three rounds in *Textron*,² taxpayers wondered whether the fight was over.

Ding, ding, ding... Round Four has gone to the taxpayer. On June 29, 2010, the U.S. Court of Appeals for the District of Columbia Circuit counter punched the First Circuit and its decision in *Textron*, holding that audit work papers can contain protected work product and disclosure of documents to an outside auditor does not waive work product protection.³ After reviewing the development of the law since *Arthur Young*, this article discusses the new *Deloitte* decision.

A Short History Lesson

Despite the IRS’s victory in *Arthur Young*, the government adopted a self-imposed policy of restraint, requesting tax accrual workpapers only in “unusual circumstances.”⁴ The proliferation of so-called tax shelters, however, convinced the IRS that the key to efficient tax administration was to routinely request tax accrual workpapers where a taxpayer engaged in “listed transactions.”⁵

Not all taxpayers acceded to the IRS’s routine “Information Document Requests” seeking tax accrual workpapers. Indeed, recently there have been several battles between the IRS and corporate America over the disclosure of tax accrual work papers.⁶ The most recent clash involved *Textron, Inc.*

In *Textron I*, the district court sided with the taxpayer holding that *Textron* had not waived work-product privilege with respect to documents that included spreadsheets containing in-house counsel’s lists of return items that involved unclear law, “hazards of litigation” percentages, tax reserve amounts, and the backup.⁷ In *Textron II*, the U.S. Court of Appeals for the First Circuit affirmed the decision of the trial court, permitting *Textron* to resist the prying eyes of the IRS.⁸ Much to the dismay of corporate taxpayers everywhere, in *Textron III*, a divided *en banc* First Circuit reversed the appellate panel holding that the workpapers were *not* protected from disclosure by the work-product doctrine.⁹ Underlying the *en banc* court’s opinion was a concern that the IRS is disadvantaged in its war against large corporate tax dodgers. Despite a scathing dissent by the author of the panel opinion in *Textron II*, the Supreme Court declined an invitation to join the fray.¹⁰

Deloitte Resists IRS Request for Dow Chemical’s Workpapers

A recent decision of the D.C. Circuit Court of Appeals suggests a fundamental difference of perspective. Corporate taxpayers and their advisers are studying the decision to glean some understanding of the current state of the law.

In 2005, Dow Chemical Company filed a refund suit challenging adjustments made by the IRS to partnership returns filed by two partnerships owned by Dow. During discovery the IRS sought the work papers of Dow’s independent auditor, Deloitte & Touche LLP. Deloitte turned over all of the documents requested with the exception of three documents that Dow claimed were protected by the attorney work-product privilege. The government sought to compel the production of the documents and the battle ensued.¹¹

The documents for which the government sought disclosure included a 1993 draft memorandum prepared by Deloitte during a meeting between Dow’s employees, Dow’s outside counsel, and Deloitte employees over the potential for litigation “recording the thoughts and impressions of Dow’s attorneys concerning tax issues related to” certain transactions engaged in by the partnerships (“Deloitte Memorandum”). The remaining disputed documents were a 1998 legal and tax analysis and “flow chart” prepared by Dow’s in-house counsel and accountant; and a 2005 tax opinion prepared by Dow’s outside counsel after the transactions at issue were executed (collectively, “Dow Documents”). The Dow Documents were disclosed to Deloitte so that the accounting firm could “review the adequacy of Dow’s contingency reserves” for the questioned transactions. As is customary now under Sarbanes-Oxley and FIN 48, Deloitte apparently insisted on the disclosure of the documents “in order to provide Dow with an unqualified audit opinion for its public financial statements.”

The U.S. District Court for the District of Columbia made two specific rulings denying the government’s motion to compel production of the three documents.¹² First, the trial court ruled that the three documents were “generally protected from discovery as attorney work product because they were created in anticipation of future litigation over the tax treatment” of the partnerships. With respect to the Deloitte Memorandum, the court specifically found that the fact that “the document was created by Deloitte USA personnel is of no moment, because its contents record the thoughts of Dow’s counsel regarding the prospect of litigation.” Furthermore, the court ruled that Dow had not waived protection over the three documents because the disclosure “was not inconsistent with the maintenance of secrecy because Deloitte USA, as Dow’s independent auditor, was not a potential adversary, and no evidence suggests that it was unreasonable for Dow to expect Deloitte USA to maintain confidentiality.”¹³

D.C. Circuit Upholds the Work-Product Privilege

The government appealed the ruling, and Dow intervened in the case to assert work-product protection over the three documents. In the appeals court, the government argued that the Deloitte Memorandum was not work product because Deloitte had created it. The Dow Documents, the government conceded, were work product, but were nonetheless discoverable because Dow had waived protection by giving them to Deloitte. Alternatively, the government contended that if the court found the Deloitte Memorandum to be work product, Dow had likewise waived such protection "when it orally disclosed the information recorded therein to Deloitte."

The D.C. Circuit started with first principles. In *Hickman v. Taylor*,¹⁴ it explained, the Supreme Court first articulated the work-product doctrine, recognizing that when an attorney prepares for litigation his efforts or "work product" can be embodied in "interviews, statements, memoranda, correspondence, briefs, mental impressions, personal beliefs, and countless other tangible and intangible ways." Allowing opposing counsel to discover the attorney's preparation, the high court reasoned, would be inefficient and negatively affect "the interests of clients and the cause of justice would be poorly served."

The holding in *Hickman* was later partially codified in Rule 26(b)(3) of the Federal Rules of Civil Procedure, which shields "documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative." Although the rule refers to "tangible things," the "mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative concerning the litigation" (so-called opinion work product) must still be protected and courts have held such work product to be "virtually undiscoverable."¹⁵

The D.C. Court of Appeals made quick work of the government's argument that the Deloitte Memorandum was not work product simply because Deloitte created it. The government's argument was premised upon the theory that Deloitte could not be Dow's representative because Deloitte, as an independent auditor, served a public interest and thus owed its allegiance to Dow's creditors and stockholders.

The court disagreed, explaining that the government incorrectly focused on who created the Deloitte Memorandum and that the correct inquiry should be on the document's content — the mental impressions and conclusions of Dow's attorneys. The "government mistakenly assumes that Rule 26(b)(3) provides an exhaustive definition of what constitutes work product." It continued that "the question is not who created the document or how they are related to the party asserting work-product protection, but whether the document contains work product — the thoughts and opinions of counsel developed in anticipation of litigation."

The court also dismissed the government's argument that, because the document was created for Dow's annual accounting audit (and not in anticipation of litigation), the document cannot be work product. Indeed, the "government asserts that a document's function, not its content, determines whether it is work product."

The appeals court acknowledged that a split exists in the circuits about the appropriate standard used to measure whether a document was prepared in anticipation of litigation. For example, the

Fifth Circuit in *El Paso*,¹⁶ required that anticipation of litigation be the "primary motivating purpose" behind a document's creation. In *Textron III*, the First Circuit putatively applied the "because of" test in holding that tax accrual work papers were not work product when it found no evidence that the documents were prepared for "potential use in litigation" or that they "would in fact serve any useful purpose for Textron in conducting litigation if it arose."

In *Deloitte*, the court confirmed the D.C. Circuit has adopted the majority and more inclusive "because of" test, which asks "whether in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation."¹⁷ Accordingly, the government's reliance on *El Paso* was misplaced in the D.C. Circuit.


The government had also argued that the Deloitte Memorandum was not entitled to protection because it could be used in connection with Deloitte's audit. The appeals court held that work product is determined based upon a document's content and not its potential use. As such, the Court distinguished *Textron III* on its facts "because it turned on the court's examination of the particular documents at issue."¹⁸ "In short, a document can contain protected work-product material even though it serves multiple purposes, so long as the protected material was prepared because of the prospect of litigation." Nonetheless, because the lower court did not conduct an *in camera* review, the appeals court held that the lower court did not have a sufficient evidentiary foundation that the Deloitte Memorandum was entirely work product, and vacated that portion of the opinion and remanded the issue to the district court "for the purpose of independently assessing whether the document was entirely work product, or whether a partial or redacted version of the document could have been disclosed."¹⁹

The D.C. Circuit then turned to whether Dow had waived work-product protection with regard to the Dow Documents. The Court began explaining that "[t]o the best of our knowledge, no circuit has addressed whether disclosing work product to an independent auditor constitutes waiver." The majority of district courts that have addressed the issue, however, found no waiver. Disclosure, explained the court, does not necessarily waive work-product protection. Waiver occurs, however, if work product is voluntarily disclosed to an adversary or a conduit to an adversary.

The government contended that Deloitte was Dow's potential adversary because "disputes sometimes arise between independent auditors and their clients and because independent auditors have the power to issue opinions that adversely affect their clients." The court disagreed, finding that Deloitte could never be Dow's adversary. Under the professional rules regulating independent auditors, if such a disagreement occurred, Deloitte would have to cease being Dow's auditor. The court said the government answered the wrong question: "Here, the question is not whether Deloitte could be Dow's adversary in any conceivable future litigation, but whether Deloitte could be Dow's adversary in the sort of litigation the Dow Documents address." The court explained: "In preparing the Dow Documents, Dow anticipated a dispute with the IRS, not a dispute with Deloitte." Accordingly, Deloitte was not Dow's potential adversary.

Similarly, the court disagreed with the government's contention that Deloitte was a conduit to Dow's adversaries. "We conclude that Dow had a reasonable expectation of confidentiality because Deloitte, as an independent auditor, has an obligation to refrain from disclosing confidential client information." Furthermore, the government cannot rely on *Arthur Young*: "In this case, however, the government attempts to discover not an independent auditor's 'interpretations of the client's financial statements,' which *Arthur Young* would permit, but an attorney's thoughts and opinions developed in anticipation of litigation, which the work-product doctrine forbids."

Conclusion

The D.C. Circuit's decision in *Deloitte* is important because it is the first appeals court decision to hold that a taxpayer does not waive work-product protection simply by showing a document to its independent auditor. The case also upholds the "dual purpose" argument that a document that may have uses other than merely in preparing for litigation can be work product. Refreshingly, the court made no disparaging remarks about Dow's underlying tax dispute. Nonetheless, the law regarding work-product protection for tax documents remains in flux. Practitioners widely agree that the *Textron III* decision has created uncertainty regarding the risk of waiver resulting from disclosing tax accrual work papers to an independent auditor. The *Deloitte* decision may reduce that uncertainty for some taxpayers, but it does not eliminate it entirely. 

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1. See *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).
2. See *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009) (*en banc*) (*Textron III*).
3. *United States v. Deloitte LLP*, 2010 U.S. App. LEXIS 13226 (D.C. Cir. Jun. 29, 2010).

4. See Announcement 84-46, 1984-18 I.R.B. 18.
5. See Announcement 2002-63, 2002-2 C.B. 72; I.R.M. 4.10.20.3.2.3 (Jan. 15, 2005). If a taxpayer has not properly disclosed its participation in a listed transaction on its tax return or has claimed tax benefits from multiple listed transactions, the IRS has the discretion to request all tax accrual workpapers for all years under examination.
6. See, e.g., *Regions Fin. Corp. v. United States*, 2008 U.S. Dist. LEXIS 41940 (N.D. Ala. 2008) (slip op.).
7. *United States v. Textron, Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007) (*Textron I*). See Jean A. Pawlow, Stephen M. Ryan & Kevin Spencer, "Hands-Off My Tax Accrual Workpapers: Textron, FIN 48, and Related Issues," 59 THE TAX EXECUTIVE 421 (Fall 2007).
8. *United States v. Textron, Inc.*, 560 F.3d 513 (1st Cir. 2009) (*Textron II*). See Jean A. Pawlow & Kevin Spencer, "Adrift In A Sea on Uncertainty: Tax Accrual Workpapers Are Work Product...But Showing Them to Your Auditor May Waive the Protection," 60 THE TAX EXECUTIVE 33 (Jan.-Feb. 2009).
9. See Jean A. Pawlow & Kevin Spencer, "Third Time's Not a Charm: *En Banc* First Circuit Permits IRS to Obtain Roadmap to 'Soft Spots', On *Textron's* Returns," 61 THE TAX EXECUTIVE 333 (Fall 2009).
10. *Cert. denied*, 130 S. Ct. 3320 (2010).
11. Although the Dow tax case is being fought in a District Court in Louisiana, the subpoena was issued in the District of Columbia.
12. *United States v. Deloitte & Touche USA LLP*, 623 F. Supp. 2d 39 (D.D.C. 2009).
13. With respect to a separate category of documents, the district court also held that Deloitte USA did not have sufficient control over documents maintained at Deloitte Switzerland to compel their production.
14. 329 U.S. 495 (1947).
15. *Director, Office of Thrift Supervision v. Vinson & Elkins, LLP*, 124 F.3d 1304, 1307 (D.C. Cir. 1997).
16. *United States v. El Paso Co.*, 682 F.2d 530, 542 (5th Cir. 1982).
17. *In re Sealed Case*, 146 F.3d 881 (D.C. Cir. 1998). See *Sandra T.E. v. S. Berwyn School Dist.* 100, 600 F.3d 612, 622 (7th Cir. 2010); *In re Professionals Direct Ins. Co.*, 578 F.3d 432, 439 (6th Cir. 2009); *In re Grand Jury Subpoena*, 357 F.3d 900, 907 (9th Cir. 2004); *PepsiCo, Inc. v. Baird, Kurtz & Dobson LLP*, 305 F.3d 813, 817 (8th Cir. 2002); *Maine v. U.S. Dep't of the Interior*, 298 F.3d 60, 68 (1st Cir. 2002); *Montgomery County v. MicroVote Corp.*, 175 F.3d 296, 305 (3d Cir. 1999); *United States v. Adlman*, 134 F.3d 1194, 1195 (2d Cir. 1998); *National Union Fire Ins. Co. v. Murray Sheet Metal Co.*, 967 F.2d 980, 984 (4th Cir. 1992).
18. Indeed, the court intimated that *Textron III* is incorrect and that the court misapplied the law of the First Circuit: "Moreover, Judge Torruella's dissent opinion in *Textron* makes a strong argument that while the court said it was applying the 'because of' test, it actually asked whether the documents were 'prepared for use in possible litigation,' a much more exacting standard."
19. The court recognized that, because the document memorialized a meeting at which both Deloitte and Dow employees were in attendance, the document could contain material that was not work product.