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Attorney-Client Privilege

Steptoe's J. Walker Johnson and Cameron Arterton write that the recent ruling of the Second Circuit Court of Appeals in *Schaeffler v. United States* strongly suggests the work product doctrine retains vitality, especially as it relates to tax accrual work papers. The authors review how *Schaeffler* follows other decisions that reject the reasoning of the First Circuit's *United States v. Textron Inc.*

The Work Product Doctrine Is Alive and Well

BY J. WALKER JOHNSON AND CAMERON ARTERTON

As all litigators know, the work product doctrine protects some documents prepared in anticipation of litigation from compelled disclosure. As a result of conflicting case law in recent years, the strength of the work product doctrine, especially as it relates to tax accrual work papers, has been uncertain.

A recent decision by the U.S. Court of Appeals for the Second Circuit strongly suggests this important judicial principle retains vitality.

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In 2009, the First Circuit in *United States v. Textron Inc.*[1] broke from a long line of work product precedent. The court on rehearing decided that tax accrual work papers aren't protected against disclosure to the Internal Revenue Service by the work product doctrine.

In the words of the dissent, the *Textron* majority abandoned the widely used ''because of'' test, which asks whether a document was prepared because of the prospect of litigation and, instead, imposed ''a 'prepared for' test, asking if the documents were 'prepared for use in possible litigation.' ''

After the *Textron* decision was issued and the U.S. Supreme Court denied certiorari, fears were expressed regarding the health of the work product doctrine, both as related to tax accrual work papers and more generally. The *Textron* dissent called the result ''a significant expansion of the IRS's power'' and stated that ''more important are the ramifications beyond this case and beyond even the case of tax accrual workpapers in general.'' One commenter lamented that under *Textron* the ''whole adversarial system would be undermined.''[2]

District Court Rejects Protection in 'Schaeffler'

In May 2014, the U.S. District Court for the Southern District of New York held that legal opinions created by

[1] *United States v. Textron Inc.*, 2009 BL 171820, 577 F.3d 21 (1st Cir. 2009) (en banc), cert. denied, 2010 BL 115516, 130 S. Ct. 3320 (2010).

[2] Michele M. Henkel, Textron Eviscerates the 60-Year-Old Work Product Privilege, 125 Tax Notes 237, 242 (2009).

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the petitioner's tax advisers weren't protected under the work product doctrine, seemingly justifying post-*Textron* fears.

In *Schaeffler v. United States*,[3] the taxpayers, Georg Schaeffler and the Schaeffler Group, an affiliated group controlled by Schaeffler, were in the business of manufacturing and distributing automotive and industrial components. In July 2008, the Schaeffler Group made a tender offer to buy shares of Continental AG (Conti), another German supplier of automotive parts. By the time the tender offer expired in September 2008, the market price of Conti shares had collapsed, with the result that a greater-than-expected number of shareholders accepted the offer. As a result, the Schaeffler Group ended up owning considerably more Conti shares than anticipated.

Schaeffler Group's acquisition of Conti was funded by a consortium of banks and, as a result of the response to the tender offer, the taxpayers had concerns about their ability to service that debt. Accordingly, they undertook substantial debt refinancing and restructuring measures.

Because of the complexity of the refinancing, the taxpayers sought tax advice from outside tax advisers. The advisers prepared a memorandum on the tax implications, including identification of potential IRS challenges to the transactions. During consultations about the restructuring, the taxpayers shared the memorandum with the bank consortium.

The district court held that work product protection was unavailable because the taxpayers would have sought the same tax advice even if litigation wasn't anticipated.

Subsequently, when the IRS requested various documents as part of an audit of the taxpayers' income tax returns, the taxpayers asserted that the tax advice was protected work product. The IRS then issued a summons to the tax adviser and the taxpayers filed a petition in the U.S. district court to quash the summons.

The magistrate judge hearing the case denied the petition, holding that work product protection was unavailable because the taxpayers would have sought the same tax advice even if litigation wasn't anticipated.[4]

Second Circuit Reverses

In a unanimous opinion issued in November, however, the Second Circuit reversed the district court in *Schaeffler*, holding that the tax advice was protected by the work-product doctrine,[5] and noting that the district court's rationale would deny work product protection to tax analyses in all transactions, indefensibly punishing taxpayers seeking to comply with the tax law.

Significantly, in its discussion of the work product doctrine, the Second Circuit strongly affirmed its prior decision in *United States v. Adlman*.[6]

In *Adlman*, the Second Circuit considered whether the work product doctrine protected ''a litigation analysis prepared by a party or its representative in order to inform a business decision which turns on the party's assessment of the likely outcome of litigation expected to result from the transaction,'' which is an analysis similar to that performed in tax accrual work papers.[7] The court ruled that ''work product protection should not be denied to a document that analyzes expected litigation merely because it is prepared to assist in a business decision.''[8]

Schaeffler reaffirms that *Textron* hasn't unalterably changed the work product landscape and sealed the fate of tax accrual work papers.

'Textron' Restricted to First Circuit

Even before the Second Circuit's *Schaeffler*, courts have recognized that while *Textron* is binding precedent in the First Circuit,[9] it isn't elsewhere. For example, in *Salem Fin., Inc. v. United States*,[10] the U.S. Court of Federal Claims stated that ''[i]t is an unsettled question whether tax reserves and associated workpapers are prepared in anticipation of litigation, such that they constitute protected work product.'' The court noted that the ''Federal Circuit has not ruled directly on this issue, and there is no controlling Supreme Court precedent.''

As recognized in *Salem Financial*, courts outside the First Circuit are free to reject *Textron*. Thus, the U.S. District Court for the Northern District of Alabama's decision in *Regions Fin. Corp. v. United States*,[11] holding that the taxpayer's tax accrual workpapers were protected by the work product doctrine, also remains good law.

Adlman, in particular, was recognized as a leading case and cited favorably prior to the *Textron* decision. For example, in *United States v. Roxworthy*,[12] the Sixth Circuit Court of Appeals cited *Adlman* for the proposition that ''a document can be created for both use in the ordinary course of business and in anticipation of litigation without losing its work-product privilege.''[13] The

[3] *Schaeffler v. United States*, 2014 BL 147275, 22 F.Supp.3d 310 (S.D.N.Y. 2014) (the district court also held attorney-client privilege inapplicable).

[4] The magistrate also ruled that the taxpayers waived attorney-client privilege when they shared the memorandum with the bank consortium because the consortium had ''no common legal interest.''

[5] *Schaeffler v. United States*, 2015 BL 369990 (2d Cir. 2015).0 The Second Circuit also ruled that attorney-client privilege hadn't been waived because the bank consortium and the taxpayers had a strong common interest in the outcome of any challenge by the IRS.

[6] *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998).

[7] Id. at 1197.

[8] Id. at 1199.

[9] *Santander Holdings USA, Inc. v. United States*, 2012 BL 200011, Civ. No. 09-11043-GAO (D. Mass. 2012) (''In this circuit it is settled that tax reserve workpapers are generally not entitled to work product protection . . . .'')

[10] *Salem Fin., Inc. v. United States*, 102 Fed. Cl. 793 (2012).

[11] *Regions Fin. Corp. v. United States*, 2008 BL 305695 (N.D. Ala. 2008)

[12] *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006).

[13] Followed in *United States v. Eaton Corp.*, 2012 BL 206369 (N.D. Ohio 2012).

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court also stated that ''here, the IRS would appear to obtain an unfair advantage by gaining access to KPMG's detailed legal analysis of the strengths and weaknesses of [the taxpayer's] . . . position. This factor weighs in favor of recognizing the documents as [work product] privileged.''[14]

Post-'Textron' Findings Of Work Product Protection

Subsequent to the *Textron* decision, courts have continued to express the same view, distancing themselves from the *Textron* majority. In *United States v. Deloitte, LLP*,[15] the D.C. Circuit held that a document prepared by a taxpayer's auditor was protected work product, despite the fact that it was prepared ''as part of the routine audit process.'' The court found *Textron* ''distinguishable'' and then stated that ''[m]oreover, [the] . . . dissenting 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.''[16]

In *Salem Financial*, the Court of Federal Claims evidenced a similar anti-*Textron* inclination, citing the *Textron* dissent and stating that the ''Court is sympathetic to the public policy considerations counseling toward application of the work product doctrine to tax reserve documents.''

Recently, in *Wells Fargo & Co. v. United States*,[17] the U.S. District Court for the District of Minnesota also found that tax accrual work papers contained work product protected information.

It is true that the court rejected the taxpayer's claim that its mere identification of uncertain tax positions (UTPs) and related factual information was work product protected, holding that this information was created in the ordinary course of business. On this issue, the court cited *Textron* when it observed that the ''mere identification of which tax positions a company should analyze under [Financial Accounting Standards Board Interpretation No.] 48 is too far removed from any litigation to be protected by work product or considered created 'because of' litigation.''

Importantly, however, the *Wells Fargo* court did protect as work product ''recognition and measurement analysis'' reflected in the tax accrual work papers (TAWs). This analysis included ''settlement figures, the strengths and weaknesses of Wells Fargo's case, and assessments of Wells Fargo's chances of prevailing in litigation.'' Citing and quoting *Deloitte*, the court ruled that ''material developed in anticipation of litigation can be incorporated into a document produced during an audit without ceasing to be work product.''

And, echoing *Roxworthy* and *Salem Financial*, the court stated that ''[a]llowing the IRS access to Wells Fargo's recognition and measurement analysis in the TAWs would provide a window into the legal thinking of Wells Fargo's attorneys on active litigation strategy, running counter to the purpose of the work product doctrine.''

Greater Basis for Countering 'Textron'

In sum, even before *Schaeffler*, the *Textron* dissent's contention that the *Textron* majority created a new standard that ''ignores a tome of precedents from the circuit courts and contravenes much of the principles underlying the work-product doctrine'' has rung true with other courts.

Further, the Second Circuit's strong affirmation in *Schaeffler* of its decision in *Adlman* gives reason to believe that when a tax accrual work papers issue is again litigated, courts in the Second Circuit and elsewhere will rely on *Schaeffler* and *Adlman* as a basis to disagree with the result in *Textron*.

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[14] 457 F.3d 590, at 595.

[15] *United States v. Deloitte, LLP*, 2010 BL 147265, 610 F.3d 129, at 135 (D.C. Cir. 2010).

[16] Id. at 138.

[17] *Wells Fargo & Co. v. United States*, 2013 BL 149935 (D. Minn. 2013) .