

United States v. Textron: First Circuit, Sitting *En Banc*, Denies Work Product Protection to Tax Accrual Workpapers

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In a dramatic reversal from a January 21, 2009 panel opinion,¹ the Court of Appeals for the First Circuit, in a 3-2 split, vacated the district court's decision in *United States v. Textron Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007). *United States v. Textron Inc.*, No. 07-2631 (1st Cir. Aug. 13, 2009) (*en banc*). The First Circuit sitting *en banc* held that work product protection does not apply to Textron's tax accrual workpapers because they were prepared in the ordinary course of business as required by statute, independent of pending litigation. The work product doctrine generally prevents discovery of documents that are "prepared in anticipation of litigation or for trial." This opinion potentially narrows the work product doctrine by requiring that documents be prepared **for use** in litigation rather than **because of** the possibility of litigation.

In making its determination, the First Circuit contrasted tax accrual workpapers with "the materials that lawyers typically prepare for purposes of litigating cases." The court concluded that, because tax accrual workpapers are required by statute for financial reporting purposes and are not useful in litigation, they were not protected by the work product doctrine.

The majority opinion was drafted by Judge Boudin, who had authored the dissenting panel opinion issued in January. Judges Torruella and Lipez, who were in the majority for the panel opinion, drafted a vigorous dissent.

Case Background

In connection with an audit of Textron's corporate income tax liability for the years 1998 through 2001, the Internal Revenue Service (the "IRS") issued an administrative summons pursuant to section 7602 of the Internal Revenue Code. Textron refused to comply with the summons, arguing that the documents sought were protected under the work product doctrine. The IRS brought suit to enforce the summons, which sought workpapers and all documents under the control of Textron or its independent auditor, Ernst & Young ("E&Y").

¹ *United States v. Textron Inc.*, 553 F.3d 87 (1st Cir. 2009); see also Dewey & LeBoeuf's Client Alert on the panel opinion, "First Circuit Affirms That Tax Accrual Workpapers Are Entitled to Work Product Protection," Jan. 22, 2009, available [here](#).

The district court conducted an evidentiary hearing on the types of documents that were the subject of the workpapers at issue and Textron's basis for its work product claim. The district court agreed with Textron's work product claim, rejected Textron's other defenses, and found that Textron's disclosure of its workpapers to E&Y did not constitute a waiver of work product protection. The IRS appealed the district court's decision to the Court of Appeals for the First Circuit.

In January 2009, a three-judge panel of the First Circuit held that Textron's tax accrual workpapers were protected by the work product doctrine and that Textron and E&Y were not adversaries for purposes of waiving work product. The case was remanded for the district court to determine the discoverability of workpapers created by E&Y and whether Textron had the legal right or ability to obtain these documents from E&Y. The IRS successfully moved for a rehearing *en banc* to allow the full court to weigh in on the issues.

Majority Opinion

The majority framed the issue as whether a document that "is not in any way prepared 'for' litigation but relates to a subject that might or might not occasion litigation" could be protected by the work product doctrine. In reaching its conclusion, the majority focused on (1) the history and meaning of the work product doctrine; (2) the nature of tax accrual workpapers; (3) the legal precedent in the First and Fifth Circuits on the work product doctrine; and (4) the policy reasons behind the work product doctrine.

According to the majority, the history of the work product doctrine demonstrates that work product materials are in the nature of materials created for use at trial. Such materials typically include witness reports, interrogatories, draft briefs, and outlines of cross examinations. The majority traced the work product doctrine to the U.S. Supreme Court decision in *Hickman v. Taylor*, 329 U.S. 495 (1947), and its origin in English common law. According to the court, the purpose of the doctrine was to avoid discouraging thorough preparation for trial and, therefore, documents that were produced in the ordinary course of business were not protected.

In analyzing the nature of tax accrual workpapers, the majority found that Textron's tax accrual workpapers were not prepared for use in litigation, but for calculating the reserves needed to cover any liabilities resulting from potential litigation. Relying on the testimony of witnesses, including the former chief auditor of the Public Company Accounting Oversight Board, the majority concluded that the ostensible purpose of tax accrual workpapers is to prepare financial statements. Textron's witnesses countered that there would be no tax accrual workpapers if there was no possibility of litigation. The

majority, however, found that, given Textron's experience, the vast majority of the issues for which reserve estimates had been created would never be litigated. Therefore, Textron created tax accrual workpapers even when the possibility of litigation was "remote."

Even more importantly, under the standards for work product protection set by the majority, tax accrual workpapers would not be protected because they would not be useful in future litigation. The court supported its conclusion by noting the dearth of information in the case on the utility of such workpapers in actual litigation. In addition, the majority commented that "any experienced litigator would describe the tax accrual workpapers as tax documents and not as case preparation materials."

The majority primarily relied on the First Circuit case of *Maine v. United States Dep't of the Interior*, 298 F.3d 60 (1st Cir. 1998), in which the court held that a document is protected if the document had been prepared because of the prospect of litigation. The majority stated that its holding does not alter the holding in *Maine*. Rather, the majority "affirmed" its holding in *Maine* by concluding that Textron's tax accrual workpapers were prepared in the ordinary course of business such that the exception to work product protection applied.

The only other circuit court decision to address the status of tax accrual workpapers is *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982). The *Textron* court conceded that the Fifth Circuit employed in *El Paso* a "primary purpose" test, which involves determining whether documents were created for the primary purpose of assisting in litigation, in contrast to the "because of" test that had been adopted by the First Circuit in *Maine*. The court noted approvingly, however, that the Fifth Circuit had found that the "sole function" of tax accrual workpapers was to support financial statements and suggested that the *El Paso* decision would have been the same irrespective of which test applied.

Finally, the court argued that public policy and equitable considerations supported its position that tax accrual workpapers should be discoverable. According to the court, the concern identified in *Hickman* that trial preparation might be hampered by discovery was not implicated in the present case because tax accrual workpapers must be prepared by exchange-listed companies and accounting standards would ensure that workpapers are prepared diligently even if such workpapers are discoverable. Because the underpayment of taxes "threatens the essential public interest in revenue collection," discovery of Textron's materials by the IRS was, in the view of the court, equitable.

Dissenting Opinion

Judge Torruella authored a strenuous dissenting opinion in which he asserted that the majority had adopted a new “prepared for” standard to determine when a document was created in anticipation of litigation while purporting to follow the “because of” test announced in *Maine*. Further, the dissent argued that the majority failed to follow the district court’s factual finding that Textron’s workpapers would not have been prepared “but for” expected litigation.

The dissent described the “because of” test adopted by the First Circuit in *Maine*, which protects documents that, while not created to assist in litigation, were nonetheless prepared because of anticipated litigation. The dissent stated that the majority’s focus on whether documents were “prepared for” litigation was explicitly rejected in *Adlman*, the Second Circuit case that the First Circuit followed in *Maine*. Because Federal Rule of Civil Procedure 26 protects documents “prepared in anticipation of litigation or for trial,” the dissent reasoned that applying work product only to case preparation materials reads “anticipation of litigation” out of the rule. The dissent also noted that the fact that tax accrual workpapers can contain varied information undercuts the majority’s definitive statement that tax accrual workpapers are not trial preparation materials.

As indicated in *Maine*, where documents are prepared in the ordinary course of business, such documents are not dual purpose documents entitled to work product protection. However, the dissent argued that the majority’s opinion effectively treats dual purpose documents as if they were prepared primarily for business reasons. Specifically, the dissent asserted that the majority disregarded the district court’s finding that, while Textron’s tax accrual workpapers were created for financial reporting purposes, the workpapers would not have been created “but for” the anticipation of litigation because reserves would have been unnecessary unless Textron expected litigation. With respect to the Fifth Circuit decision in *El Paso*, the dissent indicated that tax accrual workpapers were not protected in that case precisely because the “primary purpose” standard does not protect dual purpose documents.

The dissent was troubled that, while companies would continue to prepare tax accrual workpapers, attorneys would be hesitant to describe in detail their mental impressions given the lack of work product protection. In particular, the dissent highlighted the fact that under the majority’s opinion, the IRS can now obtain the legal memoranda and other materials supporting Textron’s workpapers.

The dissent indicated that the majority’s narrowing of the work product doctrine in the tax context will have an effect on all work product

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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disputes and commented that the Supreme Court should determine the applicable standard. Until such time, the dissent noted that companies often analyze anticipated litigation when making business decisions and stated that “[c]orporate attorneys preparing such analyses should now be aware that their work product is not protected in this circuit.”

Clients should consult with tax counsel on the significant implications this decision may have, not only with respect to their tax accrual workpapers, but with respect to other tax documents hitherto believed to be privileged.

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