Uncertainty in Financial Reporting, Taxes and Work Product Protection: A Critique of the First Circuit's Innovation in *UNITED STATES V. TEXTRON*

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If the facts don't fit the theory, change the theory.[1]

I. INTRODUCTION

Public companies in the United States are required by the federal securities law[2] to file financial statements with the Securities and Exchange Commission.[3] Under the Securities and Exchange Commissions Regulation S-X, these financial statements must be audited by an independent certified public accounting firm and the resulting audit report must reflect an unqualified opinion.[4] One area of concern for the public company and its auditors is contingent tax liabilities,[5] which can represent a significant source of potential liability. As part of the process of preparing the company's financial statements and justifying positions taken in those financial statements for contingent tax liabilities, the company and its attorneys must assess and quantify these contingent tax liabilities.[6] This assessment must meet the requirements of FASB Interpretation No. 48 ("FIN 48"),[7] which establishes the rules for contingent tax liabilities. The documentation required under a FIN 48 analysis is generally very detailed and provides a candid assessment of the company's tax positions.

One area of contention between public companies and the Internal Revenue Service ("IRS") has been the discoverability of this documentation. Historically, the work product doctrine (and, to a lesser extent, the attomey-client privilege) has been

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[1] Attributed to Albert Einstein (1879-1955).
[2] Securities Act of 1933, 15 U.S.C. §§ 771 - 77aa (2006); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78oo (2006).

[3] 15 U.S.C. § 78m(a) (2002).
[4] 17 C.F.R. pt. 210 (2008). An unqualified auditor's opinion is issued on the company's financial statements only when the audit has been conducted in accordance with applicable auditing standards, the auditor is independent, there is no significant limitation imposed on the auditor's procedures, and the client's financial statements are free of material departures from Generally Accepted Accounting Principles. WILLIAM F. MESSIER, JR., STEVEN M. GLOVER AND DOUGLAS F. PRAWITT, AUDITING & ASSURANCE SERVICES: A SYSTEMATIC APPROACH 22-24 (6th ed. 2008). The unqualified opinion is considered a "clean" audit report. *Id.*

[5] *See infra* notes 16-21 and accompanying text.
[6] *See infra* notes 22-30 and accompanying text.
[7] ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES, FASB Interpretation No. 48 (Fin. Accounting Standards Bd. 2006).

used to provide significant protection against discovery of these documents.[8] However, in a recent case, *United States* v. *Textron,*[9] the First Circuit Court of Appeals introduced a new and exceedingly narrow test for determining whether these types of documents are protected under the work product doctrine.[10] As discussed in detail below, the First Circuit's test is too narrow and operates to make poor public policy.[11]

Part II of the article discusses the application of FIN 48 to a company's determination of disclosure requirements for contingent tax liabilities. Part III discusses the work product doctrine and the various tests used to determine whether documents have been prepared "in anticipation of litigation or trial," as required under Federal Rule of Civil Procedure 26(b)(3). Part IV provides a critique of the problems with the new test established by the First Circuit in *Textron,* including a discussion of the policy concerns that test raises.

II. FIN 48 - ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES

Since 1973, the primary sources of financial accounting principles that govern the preparation of financial statements for public companies have been issued by the Financial Accounting Standards Board ("FASB").[12] Generally Accepted Accounting Principles ("GAAP") is "a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice . . . and . . . provide a standard by which to measure financial presentations."[13] GAAP is structured in a hierarchy of authority, with FASB Statements of Financial Accounting Standards ("SFASs") and Interpretations ("FINs") included in the highest and most authoritative category.[14] Thus, the FASB is the organization recognized as setting accounting and reporting standards in the United States.[15]

[8] *See infra* notes 31 -45 and accompanying text.

[9] 577 F.3d 21 (1st Cir. 2009).

[10] The First Circuit's decision appears to be, at least in part, based on the court's determination that the documents at issue should be available to the Internal Revenue Service based on "the need to assist the IRS in its difficult task of reviewing Textron's complex return." *Id.* at 36 (Torruella, J., dissenting). As the dissent recognizes, this type of "outcome determinative reasoning is plainly unacceptable." *Id.*

[11] *See infra* notes 93-115 and accompanying text.

[12] Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, 28 Fed. Reg. 2261 (Dec. 20, 1973), *available at* http://www.sechistorical.org/collection/papers/1970/1973_1220_SECAccounting.pdf.

[13] The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles," Statement on Auditing Standards No. 69, AU Sec. 411.02 (Am. Inst, of Certified Pub. Accountants 1992).

[14] The Hierarchy of Generally Accepted Accounting Principles, Statement of Fin. Accounting Standards No. 162 (Fin. Accounting Standards Bd. 2008).

[15] Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Release Nos. 32-8221 and 34-47743 (April 25, 2003) *available at* http://www.sec.gov/rules/policy/33-8221.htm (indicating that the FASB accounting standards are recognized as "generally accepted" for United States, security laws). For a recent examination of a proposal for the United States to move to a new set of international accounting standards, *see* Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal Of A Quixotic Quest,* 87 N.C. L. REV. 1 (2008).

With regard to pending litigation generally, the relevant accounting standard is Statement of Financial Accounting Standard No. 5 - Accounting for Contingencies ("SFAS No. 5"),[16] which provides the criteria for determining whether or not a company must accrue or disclose loss contingencies.[17] Under these standards, a loss contingency is defined as "an existing condition, situation, or set of circumstances involving uncertainty...to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur."[18] While SFAS No. 5 does not provide specific guidance related to the disclosure of potential losses from litigation against an enterprise as of a particular balance sheet date, the inclusion of an extensive example involving unresolved litigation within an interpretation [19] of SFAS No. 5 issued by the FASB indicates that pending litigation has been an important type of loss contingency for several decades.[20]

Under SFAS No. 5, a potential loss resulting from pending litigation is to be accrued when it is "probable that one or more future events will occur confirming the fact of the loss" and when "the amount of the loss can be reasonably estimated."[21] Until 2006, contingencies for tax liabilities were treated under the general rule set forth in SFAS No. 5. That treatment changed with the issuance of FIN 48.[22]

Under FIN 48, disclosure of a contingent liability for a tax position must be determined under a two-step analysis.[21] The first step involves a technical examination of the tax position to determine if the liability should be recognized.[24] Recognition is required where the company determines that it is more likely than not that a tax position will be sustained upon examination, including resolution of audit, appeal or litigation.[25] The second step involves measuring the liability.[26] The tax position is measured as the "largest amount of benefit that is greater than 50 percent likely of being realized."[27] Thus, the issuer of the financial statements must

[16] ACCOUNTING FOR CONTINGENCIES, Statement of Fin. Accounting Standards No. 5 (Fin. Accounting Standards Bd. 1975).

[17] *Id.*

[18] *Id.* atFAS5-2,t 1.

[19] Reasonable Estimation of the Amount of a Loss, FASB Interpretation No. 14 (Fin. Accounting Standards Bd. 1976).

[20] *Id.* at FIN 14-2 - FIN 14-3, 4-6.

[21] FAS No. 5, *supra* note 16, paragraph 8. Commentators have described the process as a sequential decision-making process, first determining whether the amount is material, and if so, determining whether the occurrence of a future loss is "probable" or "reasonably possible," and, finally, determining whether the future loss is "remote." Joseph Aharony & Amihud Dotan, *A Comparative Analysis of Auditor, Manager and Financial Analyst Interpretations of SFAS 5 Disclosure Guidelines*, 31 J. OF BUS. Fin. & ACCT. 475,475-76 (2004).

[22] FASB Interpretation No. 48, *supra* note 7.

[23] *Id.* at 5. For a discussion of the application of FIN 48, *see* Cherie J. Henning, William A. Raabe & John O. Everett, *FIN 48 Compliance: Disclosing Tax Positions in an Age of Uncertainty*, THE TAX ADVISER, January 2008, http://www.aicpa.org/taxadv/online/toc0108.htm.

[24] FASB Interpretation No. 48, *supra* note 7, at 5,1H| 5-7.

[25] *Id.* at 5, f 6.

[26] *Id.* at 5,1(8.

[27] *Id.*

affirmatively establish to the satisfaction of its auditors its right to the tax positions and allowances it has taken with regard to potential tax liabilities.[28]

In making the FIN 48 analysis, the company's files typically include legal analysis considering the arguments that the parties are likely to make in a challenge to the position.[29] The documentation would include detailed analysis of the legal authorities supporting the positions and a candid assessment of the risks inherent in the taxpayer's position.[30] As one commentator describes it, this type of documentation "reflects the thought processes of the taxpayer and its advisers as they evaluate potential disputes with the tax authorities" and serves as "the proverbial 'roadmap' for the tax examiner's audit."[31] Understandably, companies are concerned about the potential disclosure of this type of analysis to the Internal Revenue Service.[32] While such documents are disclosed to auditors and therefore not generally protected by the attorney client privilege,[33] they may be protected under the work product doctrine.

III. THE WORK PRODUCT DOCTRINE

A. *In General*

One of the fundamental tenants of the practice of law is the confidentiality provided by the attomey-client privilege and the work product doctrine.[34] The work product doctrine protects from discovery and disclosure documents prepared "in anticipation of litigation" by or for another party, or by or for that other party's

[28] Phillip C. Cook, *Practical Suggestions to Enhance the Work Product Protection of Client Tax Accrual and FIN 48 Workpapers*, 23 Practical Tax Lawyer 33, 34 (2009).

[29] *Id.* at 34.

[30] *Id.*

[31] *Id.*

[32] The 1RS, on the other hand, does not view these documents as a roadmap. According to the Large and Mid-Size Business Division Field Examiner's Guide, while FIN 48 disclosures give the 1RS "a somewhat better view of a taxpayer's uncertain tax positions . . . [they] still do not have the specificity that would allow a perfect view of the issues and amounts at risk." LMSB Field Examiner's Guide, LMSB-04-0507- 045, Q & A #1, available at http:// www.irs.gov/businesses/corporations/article/0,,id=171859,00.html.

[33] The attomey-client privilege protects confidential communications between a client and his attorney from disclosure in any civil or criminal proceeding. Upjohn Co. v. United States, 449 U.S. 383, 389 (1981). The attomey-client privilege may be waived if the privileged communications are made available to a third party outside the attomey-client relationship. *See* In re John Doe Corp., 675 F.2d 482, 488-89 (2d Cir. 1982) (involving waiver based on disclosure of internal report to outside auditors and underwriters). For a detailed discussion of the scope of the waiver of the attomey-client privilege, *see* Byron F. Egan, *Communicating With Auditors After the Sarbanes-Oxley Act*, 41-FALL TEX. J. BUS. L. 131,182-87(2005).

[34] The focus of this article is on the work product doctrine. The work product doctrine is separate and distinct from the attomey-client privilege, which protects confidential communications between a client and his attorney from disclosure in any civil or criminal proceeding, subject to certain exceptions. *See Upjohn*, 449 U.S. at 389. For a detailed discussion of the applicability of the attomey-client privilege to tax matters, *see* Claudine Pease-Wingenter, *Does The Attorney-Client Privilege Apply To Tax Lawyers?: An Examination Of The Return Preparation Exception To Define The Parameters Of Privilege In The Tax Context*, 47 WASHBURN L. J. 699 (2008).

representative.[35] The work product doctrine protects an attorney's thought processes, legal analysis and trial preparation work from disclosure.[36] While the underlying facts regarding an issue are not protected by the work product doctrine,[37] what is protected is "the work performed, materials generated and considerations of the lawyers in connection with the investigation and any recommendations to the company."[38] The theory behind the doctrine is that attorneys should be allowed to prepare for trial without fear that their work will be required to be turned over to the other party through discovery requests.[39] As one court stated it, the purpose of the work product doctrine is to "preserve a zone of privacy in which a lawyer can prepare and development legal theories and strategy 'with an eye toward litigation' free from unnecessary intrusion by his adversaries."[40] The common law rule was codified in Federal Rule of Civil Procedure 26(b)(3), which provides as follows:

> [A] party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial . . . only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.[41]

As Rule 26(b)(3) makes clear, the work product protection may be overcome where a party can show substantial need and the inability without undue hardship to obtain equivalent material by other means. Moreover, where the material sought includes mental impressions, conclusions, opinions or legal theories, the burden is even greater, with some courts interpreting this requirement as "nearly absolute protection.

The work product protection is subject to waiver, but on a limited basis.[43] For example, merely disclosing information subject to the work product protection to a third party with a common interest will not result in a waiver.[44] Likewise,

[35] Hickman v. Taylor, 329 U.S. 495 (1947); F.R.C.P. 26(b)(3).

[36] *Hickman*, 329 U.S. at 510-11.

[37] David M. Brodsky, *Updates on the Corporate Attorney-Client Privilege*, 8 SEDONA CONF. J. 89, 92 (2007).

[38] *Id.*

[39] *Hickman*, 329 U.S. at 511.

[40] United States v. Adlman, 134 F.3d 1194, 1196 (2d Cir. 1998).

[41] FED. R. CIV. PROC. 26(b)(3).

[42] *See* In re Grand Jury Subpoena, 220 F.R.D. 130, 145 (D. Mass. 2004).

[43] *See* Egan, *supra* note 33, at 191.

[44] United States v. Gulf Oil Corp., 760 F.2d 292, 296 (Temp. Emer. Ct. App. 1985).

disclosure subject to a confidentiality agreement has been found to avoid waiver, given that the agreement is evidence of an attempt to protect the information for disclosure to the opposing party.[45] However, widespread disclosure could lead to a waiver, as could disclosure to a government agency,[46] particularly where the agency is an adversarial party.[47]

B. *The "In Anticipation of Litigation or Trial " Requirement*

In order to be subject to work product protection, materials must be prepared "in anticipation of litigation or trial."[48] Courts have applied two different tests in determining whether documents meet this requirement.[49] These tests use either a "primary purpose" approach or a "because of' approach.[50]

1. The "Primary Purpose" Test

Under the primary purpose approach, a document is prepared in anticipation of litigation only if it is prepared principally or exclusively to assist in litigation.[51] This approach was adopted by the United States Court of Appeals for the Fifth Circuit in *United States* v. *El Paso Company?*[2] In that case, the IRS issued a summons for various internal documents, including a "tax pool analysis" that summarized El Paso's contingent liability for additional taxes.[53] These tax pool analyses were prepared in-house or by outside auditors and indicated those areas where the company had taken a tax position that, upon challenge, negotiation or litigation, might require the payment of additional taxes. These analyses were conducted to comply with the requirements of the Securities and Exchange Commission regulations and the New York Stock Exchange requiring that

[45] Egan, *supra* note 33, at 191 (citing Blanchard v. EdgeMark Financial Corp., 192 F.R.D. 233, 237 (N.D. 111. 2000)).

[46] *See* EdgeMark, 192 F.R.D. at 237. In recent years, there has been much discussion of the efforts by the United States Department of Justice and other federal regulatory agencies to induce corporations and other business entities to waive the attomey-client privilege and work product protection, particularly in the context of criminal investigations. For a detailed discussion of these efforts and the public criticism of these policies that followed, *see* Brodsky, *supra* note 37, at 94-98.

[47] United States v. Jones, 696 F.2d 1069, 1072 (4[1]*[1] Cir. 1982). For a more detailed discussion of waiver, *see* Egan, *supra* note 33, at 191 n.260.

[48] Fed. R. Civ. Proc. 26(b)(3).

[49] Ricardo Colón, *Caution: Disclosures of Attorney Work Product to Independent Auditors May Waive the Privilege*, 52 Loy. L. Rev. 115, 125-26 (2006) (citing In re Raytheon Sec. Litig., 218 F.R.D. 354, 357 (D. Mass. 2003)).

[50] Colón, *supra* note 49, at 126(citing United States v. Adlman, 134 F.3d 1194, 1200 (2d Cir. 1998)) (discussing the two interpretations of the term "in anticipation of litigation").

[51] *Adlman,* 134 F.3d at 1198, n.3.

[52] United States v. El Paso Company, 682 F.2d 530 (5[h] Cir. 1982). For other cases that have applied the primary purpose approach, *see* United States v. Gulf Oil Corp., 760 F.2d 292, 296-97 (Temp. Emer. Ct. App. 1985); In re Kidder Peabody Sec. Litig., 168 F.R.D. 459, 462 (S.D.N.Y. 1996); Martin v. Valley Nat'l Bank of Arizona, 140 F.R.D. 291 (S.D.N.Y. 1991).

[53] *El Paso,* 682 F.2d at 533.

independent accountants verify a public company's financial statements through an audit.[54] In determining whether the work product doctrine applied to protect against disclosure of these tax pool analyses, the Fifth Circuit adopted the standard it had set forth in an earlier case,[55] finding that the work product doctrine would not apply unless "the primary motivating purpose behind the creation of the document was to aid in possible future litigation."[56] Applying that standard to *El Paso,* the Fifth Circuit found that the primary motivation for preparing El Paso's tax pool analyses was not to prepare for litigation over the company's tax returns, but rather to anticipate for financial reporting purposes what the impact of litigation might be on the company's tax liability.[57] As the court stated, "[b]usiness imperatives, not the press of litigation, call these documents into being."[58]

2. The "Because of' Test

Under the because of approach, a document is prepared in anticipation of litigation if it is created because of the prospect of litigation or because it analyzes the outcome of litigation.[59] This broader "because of' approach is the more widely accepted standard for determining whether a document that has both litigation and business purposes was prepared in anticipation of litigation.[60] Two cases in particular are critical to understanding this broader approach to the issue.

In *United States* v. *Adlman,*[6'] the United States Court of Appeals for the Second Circuit decided whether a memorandum was prepared by a corporation's outside accounting firm at the request of an in-house attorney for the corporation to evaluate tax consequences of a proposed corporate reorganization transaction upon expected litigation with the IRS. The fifty-eight-page memorandum contained legal analysis of likely IRS challenges to the transaction, including legal theories or strategies for the corporation to adopt in response, recommended preferred methods of structuring the transaction, and predictions about the outcome of the litigation.[6-] The critical issue, according to the court, was whether the study would become ineligible for work product protection where the primary purpose of the study was to

[54] Mat 534.

[55] United States v. Davis, 636 F.2d 1028 (5th Cir. 1981). *Davis* was significantly different from *El Paso* in that in Davis, the materials sought were documents created in the course of preparation of a tax return, which involved no showing of anticipation of litigation.

[56] *Davis,* 636 F.2d at 1040.

[57] *El Paso,* 682 F.2dat543.

[58] *Id.* at 543.

[59] United States v. Adlman, 134 F.3d 1194, 1202 (2d Cir. 1998).

[60] *See* United States v. Roxworthy, 457 F.3d 590 (6th Cir. 2006); United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998); In re Grand Jury Proceedings, 604 F.2d 798 (3d Cir. 1979); National Union Fire Ins. Co. v. Murray Sheet metal Co., 967 F.2d 980 (4th Cir. 1992); Binks Mfg. Co. v. National Presto Indus., Inc., 709 F.2d 1109 1118-19 (7th Cir. 1983); Simon v. G.D. Searle & Co., 816 F.2d 397, 401 (8 Cir. 1987); Senate of Puerto Rico v. U.S. Dep't of Justice, 823 F.2d 574, 586 (D.C. Cir. 1987). *See also* Colon, *supra* note 49, at 125-26 (citing *Adlman,* 134 F.3d at 1200).

[61] 134 F.3d 1194 (2d Cir. 1998).

[62] *Adlman,* 134 F.3d at 1195.

assess the desirability of a business transaction that would give rise to litigation if the transaction was undertaken.[63] The Second Circuit rejected the primary purpose approach adopted by the Fifth Circuit, indicating that Rule 26(b)(3) does not require "that a document must have been prepared to *aid* in the conduct of litigation in order to constitute work product, much less *primarily or exclusively* to aid in litigation."[64] Further, according to the court, the rule specifically grants special protection to documents that contain opinion work product, and, where the rule explicitly established a special level of protection against disclosure, it would undermine its purposes if they were excluded from protection merely because they were prepared to assist in making a business decision from which litigation was expected.[65] The Second Circuit concluded that the fact that a document's purpose is business-related is irrelevant to the question whether it should be protected as work product.[66] Rather, the court adopted a test that treats a document as prepared in anticipation of litigation if "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."[67] The court went on to note that this standard is not meant to bring within work product protection documents prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation.[68] The court also noted that its rule does not mean that documents prepared because of the prospect of litigation will necessarily be protected against discovery, but that the document is then eligible for protection, subject to the trial court's examination of the other party's showing of substantial need for the document and an inability to obtain its contents otherwise without undue hardship.[69]

In the second case, *United States v. Roxworthy*,[10] the IRS sought discovery of two memoranda prepared by the taxpayer's accounting firm analyzing the tax consequences of transactions entered into by the taxpayer, Yum Brands, Inc., relating to creation of a captive insurance company and related stock transfers.[71] The memoranda included the accounting firm's analysis of the possible arguments that the IRS could make against Yum's tax treatment of the transactions as well as Yum's possible counter-arguments.[72] The Sixth Circuit joined the majority of other circuit courts and adopted the "because of' test as the standard for determining whether documents were prepared in anticipation of litigation.[73] In addition, the court set

[63] *Id.* at 1195.

[64] *Id.* at 1198 (emphasis in original).

[65] *Id.* at 1199.

[66] *Id.*

[67] *Id.* at 1202 (quoting Charles Allan Wright, Arthur R. Miller and Richard L. Marcus, 8 FEDERAL PRACTICE AND PROCEDURE, § 2024, at 343 (1994))(emphasis added by court).

[68] *Adlman*, 134 F.3d at 1202.

[69] *Id.*

[70] United States v. Roxworthy, 457 F.3d 590 (6lh Cir. 2006).

[71] *Id.* at 592.

[72] *Id.*

[73] *Id.* at 593.

forth a two-part test for determining whether the "because of' test is met: first, the document must have been "created because of the party's subjective anticipation of litigation, as contrasted with the ordinary business purpose," and, second, the "subjective anticipation of litigation was objectively reasonable."[74] In *Roxworthy,* the court found that the memoranda at issue were indeed created because of a subjective anticipation of litigation and that they were prepared based on a "specific transaction that could precipitate litigation, the specific legal controversy that would be at issue in the litigation, the opposing party's opportunity to discover the facts that would give rise to the litigation, and the opposing party's general inclination to pursue this sort of litigation."[75] Thus, the court found that the memoranda met both the subjective and objective requirements of the test and were therefore eligible for work product protection.[76]

C. *United States* v. *Textron* and the First Circuit's New "Prepared For" Test

In *United States* v. *Textron'*[11] the United States Court of Appeals for the First Circuit considered the application of the work product doctrine to tax accrual work papers prepared by attorneys and others in Textron's tax department to support the company's calculation of tax reserves for its audited financial statements. These tax accrual work papers include and take into account estimates of Textron's potential liability if the IRS decides to challenge debatable positions taken by the [78]
taxpayer in its return.

In *Textron,* the IRS determined that a Textron subsidiary had engaged in nine transactions substantially similar to those the IRS has determined to be tax avoidance transactions.[79] The transactions at issue were sale-in, lease-out (so-called "SILO") transactions, in which a tax exempt organization (such as a charity or a city- owned transit authority) transfers depreciation and interest deductions (which are of no use for tax purposes to a tax exempt entity) to other taxpayers who use them to shelter income from tax.[80] The IRS issued an administrative summons for the tax accrual work papers, and Textron refused to produce them, claiming they were

[74] *Id.* at 594.

[75] *Id.* at 600.

[76] *Id.* at 601.

[77] 577 F.3d 21 (1st Cir. 2009).

[78] *Id.* at 22-23. As other courts have recognized, these tax accrual work papers represent a significant resource for the IRS "by 'pinpointing] the 'soft spots' on a corporation s tax return by highlighting those areas in which the corporate taxpayer has taken a position that may, at some later date, require the payment of additional taxes* and providing 'an item-by-item analysis of the corporation s potential exposure to additional liability.'" *Id.* at 23 (citing United States v. Arthur Young & Co., 465 U.S. 805, 813 (1984)).

[79] *Id.* at 23-24. These listed tax avoidance transactions are designated in Treasury Department regulations. *See* Treas. Reg. § 1.6011-4(b)(2) (2009).

[80] *Textron,* 577 F.3d at 242. Where the only motive of SILO transaction is tax avoidance, it can be disregarded by the IRS for tax purposes. *See* AWG Leasing Trust v. United States, 592 F.Supp.2d 953, 958 (N.D. Ohio 2008). For a detailed discussion of these types of transactions, *see* Shvedoc, *Tax Implications of SILOs, QTEs, and Other Leasing Transactions with Tax-Exempt Entities* 10-12, CRS Report for Congress (Nov. 30, 2004).

protected under the attomey-client, tax practitioner and work product privileges. The IRS brought an enforcement action in United States District Court.[82] The court determined that any protection provided by the attomey-client and tax practitioner privileges were deemed waived because Textron had shared the contested documents with its accountants, Ernst and Young.[83] However, the court found that the documents were protected by the work product privilege, noting that the estimated hazards of litigation percentages and the calculation of tax reserve amounts would not have been prepared "but for" Textron's anticipation of the possibility of litigation with the IRS, and that they were therefore prepared "because of' the prospect of litigation.[84] The IRS appealed, and a divided panel of the United States Court of Appeals for the First Circuit upheld the district court's decision.[85] The First Circuit then granted an IRS petition for rehearing *en banc.*[86]

En banc, the First Circuit issued an opinion that establishes a new test for determining whether a document is prepared in anticipation of litigation. Under this new "prepared for" test,[87] documents are protected by the work product privilege only if they are prepared for use in possible litigation. The First Circuit stated that the work product privilege is "aimed centrally at protecting the litigation process . . . , specifically work done by counsel to help him or her in litigating a case."[88] The court also stated that "[e]very lawyer who tries cases knows the touch and feel of materials prepared for a current or possible *(i.e.,* "in anticipation of') law suit. ... No one with experience of law suits would talk about tax accrual work papers in those terms."[89]

The First Circuit also noted that work product protection does not apply to documents "prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation."[90] According to the court, the Textron tax accrual workpapers were prepared not to assist in litigation but to comply with the securities laws and accounting requirements for audited financial statements.[91] The court concluded that there was no evidence that the tax accrual work papers in *Textron* were prepared "for potential use in litigation if and when it should arise" or that they would in fact serve any useful purpose for Textron in conducting litigation if it arose, and, as such, the court determined that the tax accrual work papers were not protected by the work product privilege.[92]

[81] *Textron,* 577 F.3d at 24.

[82] *Id.*

[83] United States v. Textron, Inc., 507 F.Supp.2d 138, 152 (D.R.I. 2007), *vacated,* 577 F.3d 21 (1st Cir. 2009).

[84] *Id.* at 150.

[85] *Textron,* 577 F.3d at 26.

[86] *Id.*

[87] The dissent referred to the new test set forth in the majority opinion as a "prepared for test". *Id.* at 32 (Torruella, J., dissenting).

[88] *Id.* at 30-31, (citing Coastal States Gas Corp. v. Dep't of Energy, 617 F.2d 854, 864 (D.C. Cir. 1980)).

89 *Id.* at 30.

90 Id. (quoting Maine v. United States Dep"t of Interior, 298 F.3d 60, 70 (1" Cir. 2002)).

[91] *Id.* at 31.

[92] *Id.* at 30-32.

IV. The Problems with the "Prepared For" Test

The new test established by the First Circuit in *Textron* raises significant concerns about the proper application of the work product doctrine. These concerns are discussed in greater detail below.

A. *Conflict with the Language of Rule 26(b)(3)*

The first concern with the First Circuit's "prepared for" test is that it conflicts with the express language of Rule 26, which protects documents "prepared in anticipation of litigation or for trial."[93] The language of the rule should be read according to its plain meaning.[94] Moreover, the language of the rule should be read so as to make each part of the language meaningful.[95] As the *Textron* dissent notes, there is no reason to think that the term "anticipation of litigation" was meant to have the same meaning as the term "for trial."[96] Indeed, the language of the rule specifically uses the conjunction "or," suggesting that the two terms must have different meanings.[9] To require, as the "prepared for" test does, that a document receives work product protection only if it is prepared for use at trial completely ignores the phrase "in anticipation of litigation." Such a reading violates well-established rules of statutory construction and effectively rewrites the language of Rule 26.

Moreover, the focus on the "for trial" language of Rule 26 makes the protection overly restrictive in terms of its scope. As one commentator has suggested, the question of work product protection involves two separate questions: first, what constitutes "litigation," and, second, what does it mean to be prepared "in anticipation" of that litigation.[98] While the "prepared for" test considers (incorrectly, in our opinion) the second test, it does not address the first. Indeed, it appears to assume that the term "litigation" is limited to judicial proceedings. Such an assumption ignores the numerous court decisions that have applied the work product doctrine more broadly to include governmental investigations,[99] grand jury subpoenas,[100] and alternative dispute resolution proceedings.[11]" Thus, the "prepared for" test, as formulated by the First Circuit, is far too narrow in its application.

[93] FED. R. CIV. PROC. 26(b)(3).

[94] *Textron*, 577 F.3d at 35 (Torruella, J., dissenting)(citing Carcieri v. Salazar, 129 S.Ct. 1058,1066 (2009)).

[95] *Id.*

[96] *Id.* at 36 (Torruella, J., dissenting).

[97] *Id.* at 35 (citing Carcieri v. Salazar, 129 S.Ct. 1058, 1066 (2009)).

[98] Charles M. Yablon & Steven S. Sparling, *United States* v. *Adlman: Protection for Corporate Work Product?*, 64 BROOK. L. REV. 627,636-37 (1998).

[99] *See id.* at 636 (citing Martin v. Monfort, Inc., 150 F.R.D. 172, 173 (D.Colo. 1993) (finding the term "in anticipation of litigation" includes an investigation by a federal agency when there are reasonable grounds to anticipation litigation will arise).

[100] *See id.* (citing Upjohn Co. v. United States, 449 U.S. 383, 397 (1981); United States v. Rockwell Int'l, 897 F.2d 1255 (3d Cir. 1990))(applying the work product doctrine to a case involving an IRS summons).

[101] *See id.* (citing Samuels v. Mitchell, 155 F.R.D. 195, 200 (N.D. Cal. 1994)(finding arbitration is sufficiently adversarial to constitute litigation) and Reavis v. Metropolitan Property & Liab. Ins., 117 F.R.D. 160 (S.D. Cal. 1987) (applying work product to documents created during negotiations to avoid litigation)).

B. *Conflict with the Rationale Behind Work Product Protection*

Understanding the rationale behind the establishment of work product protection is critical to understanding why the test established by the First Circuit is incorrect. The primary justification for the work product doctrine is, as one commentator describes it, "that it preserves the privacy of preparation that is essential to the attorney's adversary role."[102] The function of the doctrine then is to "preserve the benefits of adverse representation without frustrating the goals of open discovery"[103] and to "emphasize the need to protect the privacy of the attorney's mental processes."[104] As the dissent in *Textron* notes, the fundamental concern of the work product doctrine is in "protecting an attorney's 'privacy, free from unnecessary intrusion by opposing parties and their counsel.'"[105] Viewed from this perspective, a broader application of the work product doctrine makes sense. Limiting the protection to documents "prepared for" litigation allows an opposing party to enter into the attorney's thought process in all cases where documents have been prepared for future litigation which, though possible or even likely, has not yet been commenced. The attorney's thoughts and impressions and assessment of the client's position are precisely the kind of information that should be protected by the work product doctrine. In *Textron,* for example, the documents the IRS sought to discover would give the IRS an unfair advantage, because it would "be able to immediately identify weak spots and know exactly how much Textron should be willing to spend to settle each item."[106] This type of disclosure would give the IRS an unfair advantage in the subsequent litigation.[107] It is precisely this type of unfair advantage that the work product doctrine seeks to avoid.

It is also worth noting that just because a document is protected under the work product doctrine, that does not necessarily mean it will not have to be produced. Rule 26(b)(3) recognizes that a protected document may still be subject to disclosure where a party can show a substantial need for the materials in the preparation of his case and that he is unable without undue hardship to obtain the substantial equivalent of the materials by other means.[108] This "safety valve" supports both the rationale behind the work product doctrine and a broader test for recognizing documents that initially are subject to its protection.

[102] Jeff A. Anderson, Gena E. Cadieux, George E. Hays, Michael B. Hingerty, & Richard J. Kaplan, *Special Project: The Work Product Doctrine,* 68 CORNELL L. REV. 760, 784 (1983).

[103] Yablon & Sparling, *supra* note 98, at 785 (citing Hickman v. Taylor, 329 U.S. 495, 511 (1947) as well as numerous cases from various United States Courts of Appeals).

[104] *Id.* (citing *Developments in the Law - Discovery,* 74 HARV. L. REV. 940, 1027-28 (1961)).

[105] *Textron,* 577 F.3d at 35 (citing *Hickman,* 329 U.S. at 510).

[106] *Id.* at 36.

[107] *See* United States v. Roxworthy, 457 F.3d 590, 595 (6th Cir. 2006) (discussing the unfair advantage the IRS would gain by gaining access to detailed legal analysis of the strengths and weaknesses of the taxpayer's position).

[108] Fed. R. Civ. Proc. 26(b)(3).

C. *Policy Concerns*

The First Circuit's adoption of the new "prepared for" test also raises concerns from a public policy standpoint. These policy concerns relate to the impact of the new test on the ability to provide competent legal advice, the predictability of work product protection, and the accuracy of financial statement reporting.

1. Impact on Ability to Provide Competent Legal Advice

As both the *Adlman* court and the dissent in *Textron* point out, an attorney's ability to provide competent legal advice to clients could be impaired by a rule that fails to adequately protect the attorney's work product.[109] Quoting *Hickman* v. *Taylor,* the *Adlman* court described the problem as follows:

> Were the attorney's work accessible to an adversary, the *Hickman* court cautioned, "much of what is now put down in writing would remain unwritten" for fear that the attorney's work would redound to the benefit of the opposing party. Legal advice might be marred by "inefficiency, unfairness and sharp practices," and the "effect on the legal profession would be demoralizing." Neither the interests of clients nor the cause of justice would be served, the court observed, if work product were freely discoverable.[110]

This concern regarding the effect of freely discoverable work product on an attorney's ability to provide competent and effective legal advice is equally valid where work product, though not freely discoverable, is subject to excessively limited protection. Indeed, the "prepared for" test articulated by the First Circuit in *Textron* raises this very concern. Attorneys preparing documents in a corporate setting involving a transaction that has a strong chance of resulting in litigation are likely to limit what they put in writing for fear that a court would determine the documents were not "prepared for" litigation purposes, due to their concurrent business purpose. In today's increasingly complex business world, requiring attorneys to operate from their own memories is both foolish and dangerous. The different tests that apply among the various United States Courts of Appeals contribute to this concern and to increased costs for clients by requiring attorneys to operate differently depending upon where their clients are located.

2. Impact on Predictability of Work Product Protection

This fear that a court could later determine that documents were not "prepared for" litigation purposes also undermines a second policy consideration - predictability. Predictability is an important policy goal under Rule 26(b)(3). As

[109] *Textron*, 577 F.3d at 37-38; United States v. Adlman, 134 F.3d 1194, 1197 (2d Cir. 1998).

[110] *Adlman*, 134 F.3d at 1197 (quoting *Hickman*, 329 U.S. at 511)(eitations omitted).

one commentator describes it, "[pjredictabilty allows lawyers and other agents of a party to safely create materials that they reasonably know will be protected."[111] Decreasing the degree of predictability for work product protection is likely to raise the temptation for both attorneys and their clients to limit what they put into writing and, in some cases, create some imaginary connection between their documents and some ongoing litigation. This approach does not benefit either the spirit of the work product doctrine nor the policies behind it.

3. Impact on Accuracy of Financial Statement Reporting

A final policy consideration, and the one that is perhaps most important from the perspective of this article, is the effect this test is likely to have to the accuracy of financial statement reporting. As discussed earlier, FIN 48 requires recognition of a contingent liability for a tax position where the company determines that it is more likely than not that the tax position will be sustained upon examination, including resolution of audit, appeals or litigation.[112] The tax position is measured as the "largest amount of benefit that is greater than 50 percent likely of being realized."[113] Thus, the issuer of the financial statements must affirmatively establish to the satisfaction of its auditors its right to the tax positions and allowances it has taken with regard to potential tax liabilities.[114] The client's documentation of its tax positions for FIN 48 purposes would include detailed analysis of the legal authorities supporting the positions and a candid assessment of the risks inherent in the taxpayer's positions.[115]

The concerns expressed earlier about attorneys generally are particularly applicable here. If clients and their attorneys are concerned that the FIN 48 documentation is likely to be readily available to the 1RS because it is deemed not to be "prepared for" litigation purposes, the resulting documentation will be inadequate. Both the quality of the analysis and the quantity of documentation available to the auditor will be affected. The result is likely to be an inadequate assessment of the taxpayer's contingent tax liabilities, resulting in inaccurate financial statements.

These inaccuracies are in distinct conflict with the policy goals of financial accounting for public companies. From an accounting perspective, financial reporting is based on the concept that information is needed to make investment, credit and similar business decisions and that the objectives of financial accounting are therefore to ensure the usefulness of such information for those purposes.[116] To be useful, such information must be both relevant and reliable.[117] Relevance is based

[111] Thomas Wilson, *The Work Product Doctrine: Why Have an Ordinary Course of Business Exception*?, 1988 COLUM. BUS. L. REV. 587, 598 (1988).

[112] *See supra* notes 22-28 and accompanying discussion.

[113] *Id.*

114Id.

[115] *See supra* notes 29-33 and accompanying discussion.

[116] Fin. Accounting Standards Bd., Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information 11-12, 27-30 (2008).

[117] *Id.* at 12,133.

on the predictive value and feedback value of the information as well as its timeliness,[118] while reliability is based on the accuracy of the information.[119] Taken together, this emphasis on relevance and reliability makes clear that the overriding policy goal of financial accounting for public companies is accurate and timely financial statement disclosure. Given this goal, these inaccuracies seem particularly unsatisfactory from a policy perspective.

V. CONCLUSION

For the past sixty years, the work product doctrine has provided protection from discovery for documents containing an attorney's thoughts and legal analysis. The zone of privacy created by the work product doctrine has been an import principle allowing attorneys to provide effective and competent representation of their clients.

In *Textron*, the First Circuit adopted a new test based on the court's perceived need to make the documents at issue available to the Internal Revenue Service. Unfortunately, the "prepared for" test set forth by the First Circuit in *Textron* establishes a new and dangerous precedent. Not only does the test conflict with the law established in the vast majority of other circuits (the "because of' test), it goes significantly further than the existing minority test (the "primary purpose" test). The test directly conflicts with the language of Rule 26(b)(3) and is contrary to the rationale of the work product doctrine. Moreover, given the significant public policy concerns, especially the likely impact of the new test on the accuracy financial statement reporting, the "prepared for" test announced by the First Circuit should be reconsidered.

118 *Id.* at 15-

119 *Id.* at 18-23,11158-89.