"U.S. v. Textron: What to Make of Attorney Work Product for Regulatory Lawyers after the Supreme Court's Cert. Denial?"

Dennis J. Ventry, Jr.
UC Davis School of Law

The Federal Bar Association, Section on Taxation
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I want to thank the FBA for the opportunity to speak to its members on what I ***still*** think is the most important federal tax case in recent memory, even if the Supreme Court doesn't share my enthusiasm. In fact, I'm optimistic that the cert. denial will actually prompt an ***ongoing*** discussion over the implications of attorney work product not only in the tax context but also in the larger regulatory context.

So with that in mind, I want accomplish three things today:

(1) I want to offer a few comments on the discussion that's already transpired;
(2) I want to talk about how the government has responded so far to its *en banc* victory in *Textron*, including its "uncertain tax position" proposal; and lastly
(3) I want to generate a discussion on ***improving*** the work product doctrine in the context of modern regulatory practices such as tax.

But before we begin, and in full disclosure, I've written a couple articles on this subject which the government relied on in brief, and which the *en banc* First Circuit cited favorably. So I guess I have a dog in this fight, but I'm ***considerably more interested*** in crafting a work product doctrine that can more effectively meet the challenges of regulatory practices going forward.

(1) Comments on Previous Discussion (use as appropriate)

The question before the *en banc* First Circuit—and the one the Supreme Court presumably focused on—was whether a company's tax accrual workpapers are protected from discovery by the work product doctrine. That is, "Are these documents created in reasonable anticipation of litigation?" Well, in my opinion, current law is quite clear on the question of whether workpapers deserve work product doctrine immunity. And the answer—at least as the doctrine is currently conceived—is ***no***. Corporate TPs create these documents because they **have to** in order to comply with federal securities law. They exist exclusively because of financial accounting and disclosure requirements regardless of any prospect for future litigation. They are ***disclosure*** documents, not ***litigation*** documents.

Traditional work product analysis requires a **temporal inquiry**. It compels asking and answering for each and every purportedly privileged item, "Why did the applicant prepare this material?" Indeed, it requires revisiting the moment a document was created to glean the author's intent. That workpapers might discuss the likelihood of litigation or contain analyses that become the subject of litigation does not affect the causality of their creation. Such analyses might receive work product protection if contained in other documents, but their appearance in documents created for regulatory purposes does not transform them ***or*** the documents in which they are contained into materials created in anticipation of litigation.

In fact, a strict reading of the work product doctrine tells us that even if litigation were a foregone conclusion as to issues discussed in the materials, the ***documents themselves*** are not created in anticipation of litigation when made part of tax accrual workpapers. And they certainly are not made in **objectively**

reasonable anticipation of litigation as the law requires. In fact, the connection between preparation of tax accrual workpapers and litigation is **so** attenuated that one leads to the other only a fraction of the time.

Consider Textron and its relationship with the IRS. During its last **eight** audit cycles, dating to 1959, the government proposed thousands of adjustments to Textron's reporting positions. Yet the parties resorted to litigation over disputed issues just **three** times. **In other words**, *less than 1 percent of all proposed adjustments were litigated*. Those are bad odds. As importantly, they are deficient for qualifying under the work product doctrine's objectively reasonable standard.

Now, it's important to note that the tax context provides unique challenges for work product analysis. **Especially** for ***non***-specialists who view determinations of "likelihood of success on the merits" and "litigation percentages" as ***equivalent*** to reasonably anticipating litigation. But tax professionals know otherwise. In particular, they know that these determinations are mandated not only under federal securities law, but under obligatory Treasury regulations (Circular 230), statutory obligations for both TPs and tax advisors (§§ 6662 and 6694), and professional standards promulgated by the ABA (Formal Op. 85-352), the AICPA (SRTP No. 1), and the FASB (FIN 48).

Under traditional work product analysis, it is irrelevant that documents discuss the ***likelihood*** of litigation, except insofar as the discussion was compelled by the ***<u>anticipation</u>*** of litigation. That is, the contents of workpapers examining the hazards of litigation and the likelihood that specific tax positions will fail or prevail on the merits are themselves meaningless in determining whether to grant or deny work product immunity. The only thing that matters is if the document—whatever its content—arose from an objectively reasonable anticipation of litigation.

In fact, if corporate TPs are awarded immunity under the guise of the work product doctrine simply by including discussions of likely litigation outcomes, it's hard to imagine what tax advice—legal or non-legal—would ***<u>not</u>*** qualify for work product protection. Moreover, because it is harder to waive work product protection than other legal privileges (it requires waiving to an adversary, a potential adversary, or a conduit to an adversary), tax advice would suddenly receive greater protection than non-tax legal advice.

Now **<u>none</u>** of this means the current parameters of the work product doctrine are perfect. Far from it. And we'll discuss that in a minute. But first, let me offer three [adjust appropriately] additional comments to the earlier discussion.

<u>First</u>, the nature of tax administrative processes. The dissent in the *en banc* decision equated these tax procedures with litigation such that if a TP created materials in anticipation of, say, participating in the IRS fast track settlement program those materials could be protected by the work product doctrine. <u>Now</u>, I understand that a TP's relationship with the IRS can certainly take on adversarial connotations, particularly if the investigating agent assigned to audit is contentious or somebody with whom the TP has had a difficult history or whom the TP feels lacks the technical competence to understand certain reporting positions. But as a matter of law the administrative process is **<u>not</u>** tantamount to litigation. Although the Federal Rules don't define the kind of litigation an applicant must have anticipated when it created a document, the most widely recognized authority on the subject states that litigation encompasses "a proceeding in a court or administrative tribunal in which the parties have the right to cross-examine witnesses or to subject an opposing party's presentation of proof to equivalent disputation." Tax administrative proceedings do **<u>not</u>** reflect this kind of environment. An audit proceeding, a challenge to a reporting position, the multiple levels of administrative review and dispute resolution all provide processes for the TP and the Service to resolve differences ***<u>without</u>*** resorting to litigation.

<u>Second</u>, I am not of the opinion that the *en banc* decision failed to apply the majority "because of" test or somehow created a circuit split. The opinion stated very clearly that it was following First Circuit precedent. It may have used improvident language to describe the ***<u>implications</u>*** of the "because of" test [i.e., "for use"], but both the language and the description took place squarely within First Circuit precedent. To the extent there's a split among circuits, it's existed for more than 25 years as a result of the Fifth Circuit's decision in *El Paso*.

Lastly, there are indications that as a result of Announcement 2010-9 some practitioners have been advising clients to disclose ***less*** information to auditors. And the cert. denial might in fact exacerbate this behavioral response. However, I would ***urge*** practitioners to think very carefully before proffering this kind of advice. Providing ***less*** information to auditors could prevent a TP's auditor from issuing an opinion under GAAP standards concerning a TP's finances, thereby placing the TP in violation of federal securities law, subjecting the TP's market value to decline, resulting in the TP being delisted from its exchange, and, conceivably, subjecting the practitioner to future malpractice claims.

(2) Uncertain Tax Positions

There is no doubt that a more aggressive taxing agency prompts corresponding reaction from TPs and their advisors. So let's talk for a second about the IRS proposal regarding "uncertain tax positions."

- As we all know, in late January, Commissioner Shulman announced that the Service would begin requiring business TPs to report uncertain tax positions **both** for which they've recorded a reserve in the financial statements **and** for those they haven't (either because of reliance on past IRS administrative practices or because the TP intends to litigate the position).
    - **Specifically**, the new policy would cover corporate TPs with total assets exceeding $10 million who are also subject to FIN 48 or other accounting standards relating to uncertain tax positions.
        - [International Financial Reporting Standards (IFRS), which give companies a lot more leeway in estimating tax liabilities.]
    - According to Shulman, the Service expects annual disclosure on a new schedule to include:
        - (i) a "***concise description***" of the positions involved (again, **all** positions, not just those for which a reserve is required), a

requirement that Heather Malloy (LMSB Commissioner) has defined as "a meaningful identification of an issue without going into risk"; and

    - (ii) the maximum exposure on the positions, again, without regard to risk assessments.
    - **In other words**, the Service is not interested in getting in the heads of the TP or its counsel. Rather, it's asking for ***issues***, not percentages or litigation hazards.
        - And so while the policy is more ***inclusive*** of tax positions than FIN 48, it's considerably less ***intrusive*** as to what the government is looking for.
- ***This last point regarding the proposal's inclusivity is important***.
    - Under FIN 48, TPs must record a 100% reserve for all positions they can't reach MLTN determinations. For "should" and "will" opinions, the TP has much more flexibility with respect to disclosure, and can determine on its own the amount of financial statement benefit to recognize as well as the corresponding tax benefits.
    - Well, TPs that invested in abusive tax shelters such as LILO and SILO transactions—including Textron—received "***will***" opinions for these transactions. Under FIN 48, those deals went undisclosed and undiscovered. But not anymore under the new policy.

(3) All right, let's finish up by talking about the imperfections of the work product doctrine, particularly when applied to regulatory practices.

It is obvious to me and probably many of you that strictly applying the work product doctrine in a world of mandatory disclosures can produce harsh results. In particular, TPs will ***always lose*** on the question of whether tax materials were prepared in anticipation of litigation or for some other purpose, because these documents are created for non-litigation purposes. In addition, if by complying with reporting obligations the TP can be said to have waived privileges as to future third-party litigants with respect to the contents of its disclosure documents, we've created a Catch-22 for the TP as well as a "heads the government wins, tails the TP loses" situation. In either case, the TP faces an incentive **not** to comply with the reporting requirements which could result in deficient disclosures, adverse consequences for the TP, and a weakened tax enforcement regime.

Strictly applying traditional work product analysis in the tax and regulatory context can produce other perverse results. For example, a strict application of "reasonable anticipation of litigation" extends higher levels of protection to increasingly aggressive positions and transactions; that is, to those positions the TP either fully expects to litigate or knows the government would litigate if identified in audit. Furthermore, as more and more TPs sue their tax advisors (including auditing firms) for tax shelters that blow up and are invalidated by courts, judges could conceivably find waiver of work product protection in the event the TP's auditor knew of the transactions at issue; that is, as more malpractice claims stack up against outside auditors, audit firms begin to look more and more like a potential adversary or conduit to a potential adversary.

In order to avoid these unsavory outcomes, we could consider a more nuanced and agile work product doctrine.

For instance, we might consider a sliding scale for attorney work product in not just the tax context but the larger regulatory context. Under a sliding-scale approach, if an applicant could show that its documents were not merely tangential to potential litigation, a court could grant varying degrees of protection depending on the strength of the applicant's showing. In the process, it could make more precise distinctions between protected and unprotected documents and even protected and unprotected *portions* of documents. The sliding-scale model could also provide courts a more precise instrument than current law to evaluate the discovery of facts versus the "mental impressions or opinion of counsel."

More interesting, at least to my mind, would be a modified form of ***selective or limited waiver*** for documents prepared for regulatory purposes. Typically, such waivers are sought by a company that's released privileged materials to a federal regulatory body during the course of an investigation with the hope that such disclosures will result in lenient treatment. The perennial issue is whether disclosure to the government waives the attorney-client and work product protections as to future third-party litigants. The majority of federal courts have declined to apply selective waiver, holding that waiver to the government constitutes waiver of further protection.

But **if** a selective waiver rule ***were*** to apply in the regulatory context, then generating and disclosing documents to comply with reporting requirements would not automatically constitute waiver to future third-party litigants, including the government. Thus, selective or limited waiver would allow a company to produce attorney-client or work product materials to an outside law firm, accounting firm, the SEC, or even the IRS without fear that it was also necessarily waiving future protection from a third-party discovery request.

Such a selective waiver rule would also reinforce the underlying premise of the work product doctrine as solicitous of the adversarial process. The applicant would still have to meet all the requirements to receive selective waiver and courts would still have to conduct full work product analyses, but documents originally produced for regulatory purposes would no longer be discoverable per se.