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REPORT

JURISDICTION AND PROCEDURE

First Circuit Reverses Course in Closely Watched Work Product Case; Establishes Broad New Standard That Could Extend Outside Tax Area

By Robert W. Pommer III

In the highly anticipated decision in *United States v. Textron, Inc.*,[1] the United States Court of Appeals for the First Circuit, sitting *en banc*, held that tax accrual workpapers were not protected by the work product doctrine. By a slim 3-2 majority, the court appeared to adopt a new standard that, in the words of the dissent, ''has thrown the law of work-product protection into disarray.''[2] While having immediate implications in tax disputes, the decision could extend to other legal analyses created to assist with Securities and Exchange Commission reporting obligations or provided to a company's outside auditors. Indeed, at oral argument, counsel for the government asserted: ''Whatever test this Court applies will apply outside the tax realm. We recognize that.''[3]

This article analyzes the potential impact of *Textron* outside the tax realm. While it remains to be seen whether the majority opinion was correctly decided or will be widely followed, the decision is ripe for appeal to the Supreme Court.[4] In the meantime, corporate counsel may be wise to take additional precautions to address the uncertainties created by the decision.

Background on the Case. *Textron* concerned the scope of attorney work product protection over tax accrual workpapers, which provide support for a taxpayer's financial statement reserves.[5] These workpapers are especially sensitive because they often contain an analysis, prepared by counsel, of the taxpayer's exposure to certain of its most complicated tax positions that may

[1] *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009) (en banc).

[2] *Id.* at 43 (Torruella, J. dissenting).

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[3] Transcript of June 2, 2009 *En Banc* Rehearing (''Hearing TR''), at 7.

[4] Textron's petition for *certiorari* is due to be filed by November 11, 2009.

[5] As publicly company, Textron undergoes periodic audits of its federal tax returns. Pursuant to IRS Announcement 2002-63 and Section 4.10.20.3.1 of the Internal Revenue Manual, the IRS's policy is to request tax accrual workpapers only when there are listed transactions (with specific rules regarding the scope of the request) or when there are ''unusual circumstances.''

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be challenged by the IRS. In Textron's case, the workpapers evaluated its chances of prevailing in litigation, in percentage terms, and recommended the dollar amounts that should be reserved to reflect the possibility that Textron might not prevail in litigation.[6]

In analyzing whether Textron's workpapers were prepared ''in anticipation of litigation,'' the district court considered the two competing standards for determining work product.[7] Under the narrow ''primary purpose'' test adopted only in the Fifth Circuit, documents are work product only if ''the **primary motivating purpose** behind the creation of the document was to aid in possible future litigation.''[8] Under the more inclusive ''because of'' test adopted by the majority of jurisdictions, documents are work product if they were prepared ''**because of anticipated litigation** and would not have been prepared in substantially similar form but for the prospect of that litigation.''[9] Following First Circuit precedent in *Maine v. United States Department of the Interior,*[10] the district court applied the ''because of'' test and held that Textron's workpapers were protected.[11]

On appeal, a divided panel upheld the district court's determination. However, that decision was later vacated when a majority of the five judges on the First Circuit voted to hear the case *en banc*.

The En Banc Majority Opinion. By a narrow 3-2 majority, the *en banc* decision vacated the district court decision and held that Textron's tax accrual workpapers were not protected work product. According to the majority, the work product doctrine extends only to documents ''prepared *for use* in possible litigation.''[12] Thus, because the tax accrual workpapers were created to make accounting entries, prepare financial statements, and obtain a clean audit opinion, the work product doctrine did not apply:

> To sum up, the work product privilege is aimed at protecting work done for litigation, not in preparing financial statements. Textron's work papers were prepared to support financial filings and gain auditor approval; the compulsion of the securities laws and auditing requirements assure that they will be carefully prepared, in their present form, even though not protected.[13]

The majority noted that its decision was ''informed by the language of rules and Supreme Court doctrine, direct precedent, and policy judgments.''[14]

The majority first looked to the Supreme Court's 1947 decision in *Hickman v. Taylor*. The materials at issue in *Hickman* involved statements from witnesses to an accident that were obtained by an attorney ''with an eye toward the anticipated litigation.''[15] In holding that the materials were protected by a qualified privilege, the Court reasoned that the integrity of the adversary process required that a lawyer be permitted to work within an essential zone of privacy ''free from unnecessary intrusion by opposing parties.''[16]

Beyond tax accrual workpapers, the majority opinion in *Textron* could impact a host of legal analyses that are required for corporate governance, regulatory compliance, financial reporting, and independent audit purposes.

The *Textron* majority relied on *Hickman* to conclude the work product doctrine was intended to protect only materials that lawyers ''typically prepare for the purpose of litigating cases.'' According to the majority, ''[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. They are the very materials catalogued in *Hickman v. Taylor* and the English precedent with which the decision began.''[17] The majority further observed that ''[a]ny experienced litigator'' would conclude that Textron's workpapers were simply tax documents and not case preparation materials.[18] According to the majority, Textron's workpapers had only one purpose: ''to support a financial statement and the independent audit of it.''[19]

The majority further purported to follow and ''reaffirm'' its prior precedent in *Maine*.[20] In particular, the majority focused on the observation in *Maine* that the work product doctrine does not extend to '''documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation.' ''[21] The majority also relied on the advisory committee notes to Fed. R. Civ. P. 26, which provide that ''[m]aterials assembled in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other nonlitigation purposes are not under the qualified immunity provided by this subdivision.''[22] The majority thus concluded: ''*Maine* applies straightforwardly to Textron's tax audit work papers — which were prepared in the or-

[6] *United States v. Textron, Inc.,* 507 F. Supp. 2d 138, 142-43 (D.R.I. 2007) (''*Textron I*'').

[7] *Id.* at 149-50.

[8] *United States v. El Paso Co.,* 682 F.2d 530, 542 (5th Cir. 1982) (quoting *United States v. Davis*, 636 F.2d 1028, 1040 (5th Cir. 1981)) (emphasis added).

[9] *United States v. Adlman,* 134 F.3d 1194, 1195 (2d Cir. 1998) (emphasis added).

[10] *Maine v. United States Dept't. of the Interior,* 298 F.3d 60, 68 (1st Cir. 2002). The court in *Maine* adopted the ''because of'' test articulated in a leading case from the Second Circuit, *United States v. Adlman,* 134 F.3d 1194 (2d Cir. 1998).

[11] *Textron I,* 507 F. Supp. 2d at 150.

[12] *United States v. Textron, Inc.*, 577 F.3d 21, 27, 29 (1st Cir. 2009).

[13] *Id.* at 31-32.

[14] *Id.* at 28.

[15] *Hickman v. Taylor*, 329 U.S. 495, 498 (1947).

[16] *Id.* at 510-11.

[17] *Textron,* 577 F.3d at 30.

[18] *Id.* at 28.

[19] *Id.* at 30.

[20] *Textron*, 577 F.3d at 26 (''We now conclude that under our own prior *Maine* precedent-which we reaffirm *en banc*-the Textron work papers were independently required by statutory and audit requirements and that the work product privilege does not apply.'').

[21] *Textron*, 577 F.3d at 30 (quoting *Maine,* 298 F.3d at 70, quoting *Adlman,* 134 F.3d at 1202).

[22] Fed. R. Civ. P. 26 advisory committee notes (1970); *accord Hickman,* (quoting English precedent that ''[r]eports . . . if made in the ordinary course of routine, are not privileged'').

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dinary course of business — and it supports the IRS position.''[23]

Finally, the majority considered ''the underlying policy of the [work product] doctrine and other prudential considerations.''[24] For example, the majority observed that ''[t]he practical problems confronting the IRS in discovering under-reporting of corporate taxes, which is likely endemic, are serious.''[25] The majority concluded that underpayment of taxes ''threatens the essential public interest in revenue collection'' and that production of Textron's tax accrual workpapers could provide a ''blueprint to Textron's possible improper deductions.''[26] The majority further noted that ''IRS access [to tax accrual workpapers] serves the legitimate, and important, function of detecting and disallowing abusive tax shelters.''[27] These policy concerns undoubtedly contributed to the decision because, as the majority stated, ''how far work product protection extends turns on a balancing of policy concerns rather than application of abstract logic.''[28]

The Dissenting Opinion. In a sharply worded dissent, Judge Torruella criticized the majority for ignoring prior precedent and adopting a new ''prepared for'' standard for determining work product.[29] In fact, the test adopted by the majority represents ''an even narrower variant of the widely rejected 'primary motivating purpose' test'' that was ''specifically repudiated'' by the First Circuit in *Maine*.[30] According to the dissent, the majority also disregarded the fundamental principles underlying the work product doctrine, brushed aside the actual text of Rule 26(b)(3), and misrepresented and ignored the district court's factual findings.

The launching point for the dissent, which it described as ''fatal to the majority's position,'' was the First Circuit's prior endorsement of the ''because of'' test.[31] The dissent argued that the majority's new rule is ''blatantly contrary'' to prior precedent.[32] The majority purported to follow and reaffirm the ''because of'' test in *Maine* while at the same time rejecting that test's protection for dual purpose documents.[33] In fact, the majority opinion failed to even acknowledge that *Maine* expressly endorsed the view that ''documents prepared for dual purposes of litigation and business or agency decisions'' are clearly within the scope of Rule 26 as protected work product.[34] The dissent characterized this failure to acknowledge the dual purpose holding in *Maine* as ''simply stunning.''[35]

Among other things, the dissent concluded that the majority ''reads too much into one sentence from *Maine*'' and the advisory committee notes to the Rule 26.[36] The proviso that there is no protection for documents created for business, regulatory, or ''other nonlitigation purposes'' does not suggest that the mere presence of a business or regulatory purpose should somehow override a litigation purpose, should one exist. The dissent noted, however, that ''[u]nder the majority's interpretation, the exception swallows the rule protecting dual purpose documents.''[37]

In addition to First Circuit precedent, the dissent analyzed the text of Rule 26(b)(3). Limiting work product protections to documents prepared **for use** in litigation, the dissent concluded, is at odds with the text and the underlying policies of the rule: '' 'Nowhere does Rule 26(b)(3) state 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.' ''[38] Instead, the rule expressly states that the work-product privilege applies not only to documents ''prepared . . . for trial'' but also to those ''prepared in anticipation of litigation.''[39] As noted by the dissent, there is no reason to believe that ''anticipation of litigation'' was meant as a synonym for ''for trial;'' however, the majority opinion reads the ''anticipation of litigation'' language right out of the rule.[40]

The dissent also criticized the majority's discussion of *Hickman v. Taylor*. The fundamental policy concern underlying that decision was to protect the adversarial process and permit an attorney to maintain an essential zone of privacy ''free from unnecessary intrusion by opposing parties and their counsel.''[41] The dissent observed that the policies underlying the work product doctrine apply equally to dual purpose documents, which contain confidential assessments of litigation strategies and chances.[42] There is no basis to deny protections to a document that analyzes expected litigation merely because it is prepared to assist in a business decision.[43]

The dissent finally challenged the majority's characterization of the nature and purpose of the workpapers. The dissent observed that the majority, without record support, concluded that ''[a]ny experienced litigator would describe the tax accrual work papers as tax documents and not as case preparation materials.''[44] The dissent also noted the majority ignored the district court's findings that (i) the documents served the dual purposes of evaluating litigation risk and preparing financial statements, and (ii) Textron would not have established the reserves or prepared the associated work-

[23] *Textron*, 577 F.3d at 30.
[24] *Id.* at 28.
[25] *Id.* at 31.
[26] *Id.*
[27] *Id.* at 32.
[28] *Id.* at 26.
[29] *Id* at 32. Judge Torruella was also the author of the original panel majority decision. His dissenting opinion was joined by Judge Lipez.
[30] *Id*.
[31] *See Maine,* 298 F.3d at 68 (''In light of the decisions of the Supreme Court, we therefore agree with the formulation of the work-product rule adopted in *Adlman* and by five other courts of appeals.'').
[32] *Textron,* 577 F.3d at 34.
[33] *Id.* at 26, 33-34.
[34] *Maine*, 298 F. 3d at 68 (citing *Adlman*, 134 F. 3d at 1198).
[35] *Textron,* 577 F.3d at 34.
[36] *Id.* at 41-42 (citing *Maine,* 298 F.3d at 70, *Adlman,* 134 F.3d at 1202).
[37] *Textron,* 577 F.3d at 42.
[38] *Id.* at 41-42 (quoting *Adlman*, 134 F.3d at 1198-99).
[39] *Textron,* 577 F.3d at 34.
[40] *Id.* at 35.
[41] *Hickman,* 329 U.S. at 510.
[42] *Textron,* 577 F.3d at 35-36 (citing *Adlman,* 134 F.3d at 1200).
[43] *Textron,* 577 F.3d at 36.
[44] *Id.* at 28. While the dissent found this ''I know it when I see it'' test reminiscent of Justice Stewart's ''famously unhelpful test for identifying obscenity,'' the dissent stated that this ''dangerously suggests'' that an appellate court can use its general knowledge to ''offer an expert opinion as to how such documents are always seen by 'experienced litigators.' '' *See Textron,* 577 F.3d at 34 n.12, 39-40.

papers but for the fact that Textron anticipated the possibility of litigation with the IRS.[45]

Implications of Ruling on Other Reserves. Beyond tax accrual workpapers, the majority opinion in *Textron* could impact a host of legal analyses that are required for corporate governance, regulatory compliance, financial reporting, and independent audit purposes. For example, the majority's new rule potentially opens the door for a party in a litigation to discover an adversary's analysis of the business risks of that litigation, including the amount of money set aside as a litigation reserve. In fact, the requirements under GAAP for the creation of litigation reserves are similar to that required of tax reserves. In both situations, documents are created assessing the likelihood of success in litigation and analyzing the company's legal strategies and options to assist in evaluating the estimated reserves. In both situations, the supporting documentation reveals the attorney's mental impressions, thoughts, and conclusions about the legal claim. While much of the oral argument addressed the larger concerns of whether adopting the IRS position would have undesirable consequences beyond the tax arena,[46] the majority opinion did not even consider the implications of its new rule.[47]

The concern over the litigation reserves is of particular interest and has been addressed in other cases. For example, the Second Circuit in *Adlman* discussed a typical scenario whereby a company's independent auditor requests a memorandum prepared by company counsel estimating the likelihood of success in litigation and analyzing the company's legal strategies and options to assist in evaluating the estimated litigation reserves. The court concluded that, in this scenario, ''the company involved would require legal analysis that falls squarely within *Hickman*'s area of primary concern — analysis that candidly discusses the attorney's litigation strategies, appraisal of likelihood of success, and perhaps the feasibility of reasonable settlement.''[48] Accordingly, the work product doctrine should apply.

Other courts applying the ''because of'' test have held that individual litigation reserve documents are privileged under the ''because of'' test.[49] As noted by the Eighth Circuit in *Simon v. G.D. Searle & Co.*, ''individual case reserve figures reveal the mental impressions, thoughts, and conclusions of an attorney in evaluating a legal claim. By their very nature they are prepared in anticipation of litigation and, consequently, they are protected from discovery as opinion work product.''[50] The same conclusion has been reached even under the ''primary motivating purpose'' test.[51] Yet under the majority opinion, such analysis might not fall within the narrow prepared for use in litigation standard.

Are There Limits to the Textron Holding? The majority opinion in *Textron* potentially opens the door to discovery of documents reflecting the mental impressions, tactical considerations, and legal analysis of an attorney — the very type of core documents the work product doctrine was designed to protect. Ultimately, the majority's new test for determining work product could hinder a company's ability to seek legal counsel. Instead of promoting full and frank discussions with counsel and the auditors, the rule adopted by the majority will have the opposite effect.[52]

There are, however, limits to the majority opinion. First, *Textron* concerned only the work product doctrine and not the attorney client privilege. The district court had found that Textron waived attorney client privilege by providing the tax accrual workpapers to its independent public accountants.[53] However, absent a waiver, internal legal analyses of litigation risks are still protected by the attorney client privilege irrespective of the applicability of the work product doctrine. Thus, as a result of *Textron*, companies should be mindful of waiver issues and exercise greater caution when sharing documents with the outside auditors.

Second, the *Textron* decision clearly would not be applicable in those jurisdictions that have adopted the ''because of'' test. The ''prepared for'' test adopted by the majority is directly contrary to the ''because of'' test, which has been adopted by all of the Circuit Courts of Appeal except for the Fifth Circuit (which has adopted the ''primary purpose'' test) and the Tenth and Eleventh Circuits (which have not yet expressly decided the issue).[54] As the dissent argued, the majority opinion

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[45] *Id.* at 39.

[46] For example, counsel for the IRS was pressed during arguments whether there was a ''limiting principle'' to the agency's position. Counsel ultimately conceded that there was no such limiting principle noting: ''if it is required by the SEC rules, then necessarily it cannot be protected by the work product privilege.'' Hearing TR at 9. ''Whatever test this Court applies will apply outside the tax realm. We recognize that.'' *Id.* at 7.

[47] *See Textron,* 577 F.3d at 37-38.

[48] *Adlman,* 134 F.3d at 1200.

[49] *See Frank Betz Assocs.*, 226 F.R.D. 533, 535 (D.S.C. 2005) (documents relating to individual reserves were privileged work product); *Gen. Elec. Capital Corp. v. DirectTV, Inc.*, 184 F.R.D. 32, 35-36 (D. Conn. 1998) (while documents reflecting individual reserve amounts would be privileged work product, documents reflecting only aggregate reserves are not); *Gutter v. E.I. Dupont DeNumours & Co.*, 1998 WL 2017926, at *1-2 (S.D. Fla. May 18, 1998) (documents relating to individual but not aggregate reserves are privileged work product).

[50] *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 401 (8th Cir. 1987).

[51] *In re Pfizer Inc. Secs. Litig.*, 1993 WL 561125, at *4 (S.D.N.Y. 1993). *See also Regions Fin. Corp. v. United States,* 2008 WL 2139008, at *5-*6 (N.D. Ala. May 8, 2008) (finding tax accrual workpapers were protected work product even under the primary purpose test).

[52] As cautioned by the Supreme Court in *Hickman*, if such internal legal analyses were open to discovery by an adversary, ''much of what is now put down in writing would remain unwritten.'' 329 U.S. at 511.

[53] *Textron I,* 507 F. Supp. 2d at 152. For the same reasons, the district court held that Textron waived the tax practitioner privilege.

[54] *See, e.g.*, *Maine*, 298 F.3d at 68 (1st Cir.)(adopting *Adlman*'s ''because of'' test); *Adlman*, 134 F.3d at 1202-03 (2d Cir.); *In re Grand Jury Proceedings*, 604 F.2d 798, 803 (3d Cir. 1979); *Nat'l Union Fire Ins. Co. of Pittsburgh v. Murray Sheet Metal Co.*, 967 F.2d 980, 984 (4th Cir. 1992); *United States v. Roxworthy*, 457 F.3d 590, 593-94 (6th Cir. 2006) (adopting *Adlman*'s ''because of'' test); *Binks Mfg. Co. v. Nat'l Presto Indus., Inc.*, 709 F.2d 1109, 1118-19 (7th Cir. 1983); *Simon*, 816 F.2d at 401 (8th Cir.); *In re Grand Jury Subpoena,* 357 F.3d 900, 907-08 (9th Cir. 2004) (praising and following *Adlman*); *Senate of Puerto Rico v. United States Dep't of Justice,* 823 F.2d 574, 586 n. 42 (D.C. Cir. 1987); also *El Paso,* 682 F.2d at 542-43 (5th Cir.) (''primary purpose'' test). State courts are likely to rely on the federal case law in their circuit in determining whether tax accrual workpapers are prepared in anticipation of litigation. *See, e.g., Commissioner of Revenue v. Comcast*

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in *Textron* may simply be viewed ''as a dangerous aberration in the law of a well established and important evidentiary doctrine.''[55]

Third, the decision may also be viewed, as the dissent characterized, ''outcome determinative'' and driven by policy concerns specific to IRS related disputes.[56] Among other things, the majority noted that the IRS adopted a new approach for seeking tax accrual workpapers ''in the wake of Enron and other corporate scandals.''[57] It further noted ''tax collection is not a game'' and under-reporting of corporate taxes ''is likely endemic.''[58] The majority opinion must thus be viewed in the context of what it saw as the IRS's ''legitimate, and important, function of detecting and disallowing abusive tax shelters.''[59]

Fourth, the *Textron* decision may be limited by the majority's characterization of the specific facts at issue. Although the majority made broad proclamations about the general nature of tax accrual workpapers, the determination of whether a particular document is prepared ''in anticipation of litigation or for trial'' has always been a fact specific determination.[60] At the outset, the majority framed the issue as ''one in which a document is not in any way prepared 'for' litigation but relates to a subject that might or might not occasion litigation.''[61] Thus, the way the majority framed the issue may itself limit the holding in future cases. For example, a district court following *Textron* could find that a document had a dual purpose — that it was prepared for use in litigation and the ordinary course of business — and thus arguably protected under the *Textron* holding. In fact, the majority's assertion that it was reaffirming the ''because of'' test in *Maine* itself creates great uncertainty as to how its holding should be applied in the First Circuit going forward.

Finally, there still may be another chapter to write before the Supreme Court. The circuit courts are already split between the ''primary motivating purpose'' and ''because of'' tests. The majority's new ''prepared for'' use in litigation test has ''thrown the law of work-product protection into disarray'' and created a further split among the circuits.[62] As the dissent points out, ''[t]he time is ripe for the Supreme Court to intervene and set the circuits straight on this issue which is essential to the daily practice of litigators across the country.''[63]

Conclusion. The full reach and longevity of *Textron* is yet be determined. In the interim, companies should consider additional precautions when dealing with sensitive documents that may be provided to the outside auditors. In particular, companies should consider implementing (if none currently exist) clear standards for handling work product and other sensitive materials. Documents that are work product should clearly be labeled as being prepared in anticipation of litigation, and access to such materials should be limited. Workpapers used for financial reporting purposes should be segregated, and there should be a clear understanding as to what exactly constitute the workpapers. For example, drafts and backup materials may not necessarily be required to be in the workpapers.[64] Likewise, care should be attended to any request from the auditors for litigation or other legal analyses, especially if the auditors ask the company to create such analyses to support the audit. Any document prepared at the request of the auditors for their audit may be viewed as being created for a business purpose that would not be subject to work product protections. While no procedures are foolproof, these steps may mitigate the risk that sensitive work product and legal analyses inadvertently be subject to discovery.

Corp., 901 N.E.2d 1185, 1203-05 (Mass. 2009) (holding that tax accrual workpapers were prepared in anticipation of litigation and therefore protected).

[55] *Textron*, at 43.

[56] *Id.* at 36.

[57] *Id.* at 23.

[58] *Id.* at 31.

[59] *Id.* at 32.

[60] *See, e.g., Simon*, 816 F.2d at 410.

[61] *Textron*, 577 F.3d at 26; *see also id.* at 30 (''the only purpose of Textron's papers was to prepare financial statements'').

[62] *Id.* at 43.

[63] *Id.*

[64] Textron's tax accrual workpapers, which were shared with the auditors, included ''backup materials'' such as drafts, notes, emails, and other memoranda written by Textron's in-house tax attorneys ''reflecting their opinions as to which items should be included on the spreadsheet and the hazard of litigation percentage that should apply to each item.'' *Textron I*, 507 F. Supp. 2d at 143-44. As noted by the dissent, these documents go beyond the numbers used to compute a total reserve and are not documents required by regulatory rules. *Textron*, 577 F.3d at 37.