

Client Alert

Latham & Watkins
Tax Department

D.C. District Court Applies Work Product Doctrine In Tax Case To Materials Provided To Outside Auditor

On June 9, 2009, the US District Court for the District of Columbia added to the growing body of judicial analyses of the viability of work product protection claims for documents created in anticipation of an IRS audit that have been disclosed to an independent financial auditor. The court ruled that documents reflecting the opinions, thoughts and impressions of counsel on transactions challenged by the IRS retain work product protection even though disclosed to an independent financial auditor.¹ The court, in declining to enforce a subpoena issued to Deloitte & Touche USA LLP, applied the more inclusive "because of" standard for determining whether a document was prepared in anticipation of litigation and thus subject to work product protection. Importantly, the court also confirmed that a financial auditor is not an "adversary" and, accordingly, disclosure to the auditor does not waive work product protection. The three documents at issue are representative of the documents that are frequently the subject of disputes over work product claims in tax controversy matters.

Two prior cases, *Textron* and *Regions Financial*,² have addressed similar challenges to work product protection. The US government dismissed its appeal in *Regions* after the underlying tax

matter was settled but, at the request of the government, on June 2, 2009, the First Circuit reheard the *Textron* case *en banc*.³ The district court's ruling in *Deloitte* also may not be the last word in that proceeding, and future developments in this area should be closely monitored.⁴

The Memorandum Order

The memorandum order in *Deloitte* ruled on the government's motion to compel Deloitte USA to produce documents relating to transactions entered into by Dow Chemical Company with the two partnerships involved in three underlying TEFRA cases. Deloitte USA was the financial auditor for Dow. The TEFRA cases are pending before a US district court in Louisiana, but the subpoena to Deloitte USA issued from the US District Court for the District of Columbia, presumably because the documents were to be produced in Washington, D.C.

The documents at issue— Memoranda prepared by outside and in-house counsel, and by the company's financial auditor

The dispute over work product protection centered on three documents in Deloitte USA's possession: (i) a tax

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opinion prepared by Dow's outside counsel, apparently well after the transactions at issue; (ii) an earlier legal and tax analysis prepared by Dow's in-house counsel; and (iii) a very early Deloitte USA draft memorandum "recording the thoughts and impressions of Dow's attorneys concerning tax issues related to" the transactions. The first two documents are typical of the types of documents that corporate taxpayers generate internally by in-house counsel or obtain from outside counsel. These documents then may be reviewed by a company's financial auditor, who in turn may memorialize their contents in the auditor's own internal documents. The documents at issue in *Deloitte* thus are similar to the types of documents that were at issue in *Regions Financial*. The documents in *Textron* also incorporated the thoughts and impressions of Textron's counsel but differ with respect to the process in which they were generated. Spreadsheets (which included back-up documentation) were prepared each taxable year, both as part of Textron's financial reporting process and to identify items that Textron's in-house tax counsel anticipated could be challenged by the IRS, and reflected counsels' evaluations of the litigating hazards of each item.

The district court's work product ruling

The district court in *Deloitte* made two specific work product rulings to conclude that the three documents were protected from discovery. First, the court applied the more inclusive "because of" standard, the same standard applied by the First Circuit in *Textron*, to conclude that the documents were prepared in anticipation of litigation. The government did not appear to have vigorously challenged work product protection on these grounds, and the court did not cite any authority other than the Federal Rules of Civil Procedure.⁵

The district court then turned to the question of whether the disclosure of the Dow documents to Deloitte USA

constituted a waiver of work product protection. The court noted that under the D.C. Circuit's 2001 decision in *Rockwell International Corporation*,⁶ work product protection can be waived if "such disclosure, under the circumstances, is inconsistent with the maintenance of secrecy from the disclosing party's adversary." The court then cited both *Textron* and *Regions Financial* to conclude that "Dow's disclosure to Deloitte USA was not inconsistent with the maintenance of secrecy, because Deloitte USA, as Dow's independent auditor, was not a potential adversary, and no evidence suggests that it was unreasonable for Dow to expect Deloitte USA to maintain confidentiality." Thus, Dow had not waived work product protection as a result of the disclosures.

Although the memorandum order is brief, two aspects of the case bear emphasis. First, in both *Textron* and *Regions Financial*, the taxpayers introduced evidence that their financial auditors had specifically agreed to treat the documents at issue as confidential (in addition to any professional obligation of confidentiality). These facts appear to have been particularly important to those courts' conclusions that the disclosures to the financial auditors did not constitute a waiver of the work product protection. In contrast, it appears that Dow did not introduce similar evidence, and that the district court in *Deloitte* did not require it under the circumstances. Instead, the court apparently was satisfied with merely an absence of evidence suggesting that Dow's expectation of confidentiality on the part of its financial auditor was unreasonable.

Perhaps most importantly, the memorandum order specifically concluded that a document created by the financial advisor, Deloitte USA, was subject to work product protection because it reflected "the thoughts and impressions" of Dow's counsel. This case thus addressed an important category of documents—those created by independent financial auditors that

incorporate otherwise protected work product—that were not specifically addressed by the lower court's decision in *Textron*.⁷

The “Sufficient Control” Issue

The memorandum order in *Deloitte* addressed a second issue unrelated to work product protection. Deloitte USA's Swiss affiliate was the financial auditor for the partnerships, and the subpoena served on Deloitte USA also covered documents in Deloitte Switzerland's possession. Although the district court acknowledged that Deloitte USA and Deloitte Switzerland were part of the same Swiss *verein* (membership organization) and had worked together on Deloitte Switzerland's audit of the partnerships, the court concluded that the government had failed to demonstrate that Deloitte USA had “the legal right, authority or ability to obtain documents upon demand” from Deloitte Switzerland. The memorandum order did not describe the evidence (beyond possibly the working and legal relationship between the two Deloitte entities) that the government introduced to demonstrate the requisite level of control.

Looking Forward

At this stage of the proceedings, and with the *Textron* case under review by the First Circuit *en banc*, the final contours of the work product protection afforded to documents disclosed to independent financial auditors have yet to be determined. Corporate taxpayers, however, can still take steps to increase the likelihood that tax accrual workpapers and Financial Accounting Standards Board Interpretation No. 48 (FIN 48) supporting documentation prepared by in-house and outside counsel will remain protected even if disclosed to their financial auditors. These steps include a clear understanding or definition of what constitutes tax accrual workpapers,

a negotiated and explicit agreement with the company's financial auditors concerning the nondisclosure of the company's confidential information, specific internal corporate protocols segregating and limiting access to the work product documents, and contemporaneous documentation of these steps.

Endnotes

- ¹ *United States of America v. Deloitte & Touche USA LLP*, Misc. Case No. 08-411, 2009 US Dist. LEXIS 48080 (D.D.C. June 9, 2009). Although not addressed in the memorandum order, the fact that the documents at issue had been disclosed to a third party (the independent financial auditor) waived any attorney-client privilege that may have existed.
- ² *United States v. Textron*, 507 F. Supp.2d 138 (D.R.I. 2007), *aff'd in part, vacated in part*, 553 F.3d 87, *reh'g en banc granted*, 560 F.3d 513 (1st Cir. 2009); *Regions Fin. Corp. v. United States*, No. 06-895, 2008 US Dist. LEXIS 41940 (N.D. Ala. May 8, 2008).
- ³ Latham & Watkins submitted a brief in support of *Textron* on behalf of *amici curiae* the Chamber of Commerce of the United States of America and the Association of Corporate Counsel. The *Textron* case has also been discussed in three prior Latham & Watkins *Client Alerts*.
- ⁴ An open question is how the ruling in *Deloitte*, if appealed and sustained, will affect proceedings in the US Tax Court. Under Tax Court Rule 143(a), the court is bound to follow precedent of the D.C. Circuit on evidentiary issues, but it is not clear that a ruling on attorney work product is necessarily evidentiary. For example, the Tax Court has applied Rule 143(a) in ruling on a motion *in limine* that the taxpayer had waived the attorney-client privilege and therefore could not object at trial to the testimony of its former attorney. See *Johnston v. Comm'r*, 119 T.C. 27 (2002). In contrast, recent Tax Court decisions recognizing work product protection have looked to the notes of the Rules Committee to Tax Court Rule 70(b), a rule governing the scope of discovery rather than admissibility at trial. See, e.g., *Ratke v. Comm'r*, 129 T.C. 45 (2007) (applying authority of the Ninth Circuit, the venue for appeal in that case). Although the district court's memorandum order in *Deloitte* was issued in the context of a discovery dispute, it necessarily would preclude the admissibility of the documents at trial.

⁵ Other circuits, however, apply the arguably more rigorous “primary purpose” test that looks to the “primary motivating purpose” behind the creation of a document. Whether application of that standard here would have changed the result is not clear, and the district court in *Regions Financial* held that the documents at issue in that case satisfied both the “because of” and “primary purpose” tests.

⁶ *Rockwell Intern. Corp. v. US Dept. of Justice*, 235 F.3d 598 (D.C. Cir. 2001).

⁷ Although *Regions Financial* did involve documents created by its independent financial auditor, the key document was a tax opinion prepared by tax professionals who were not involved in the financial audit.

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