

Client Alert

Latham & Watkins Tax Department

US v. Deloitte LLP: D.C. Circuit Deals Setback to IRS Effort to Obtain Work Product Protected Material

On June 29, 2010, the US Court of Appeals for the District of Columbia Circuit in *United States v. Deloitte LLP*,¹ ruled that the government could not obtain from a company's financial auditor material that was protected work product. The *Deloitte* decision confirms that the disclosure of work product, such as an opinion by a company's outside tax counsel, to a company's financial auditor does not waive the protected confidentiality. Equally important, work product material remains protected from disclosure to a company's adversaries even if memorialized in the auditor's workpapers.

Deloitte is the first significant setback to the ongoing efforts by the IRS to obtain work product that may be included in tax accrual workpapers, and the decision may affect the type of information that the IRS is permitted to obtain in future audits of corporate returns with the soon-to-be-finalized Schedule UTP (Uncertain Tax Position Statement). Perhaps most important to tax controversy litigation, because the Tax Court applies the decisions of the D.C. Circuit on evidentiary issues, the *Deloitte* decision will limit the types of evidence that may be used by the IRS in Tax Court cases.

The *Deloitte* Decision

The D.C. Circuit decided two key legal questions: (1) whether documents created by an independent auditor and memorializing potential litigation risks may contain protected work product; and (2) whether work product protection is necessarily waived when documents are shared with an independent auditor. The court rejected the government's position on both issues.

The *Deloitte* case arose out of a tax litigation between the government and several Dow Chemical Company-affiliated entities. The government subpoenaed documents from Dow's auditor, Deloitte, which withheld three documents at Dow's instruction on grounds that they were protected work product. The government then sought to have the US District Court for the District of Columbia compel Deloitte to produce the three documents.

The first document was a draft memorandum prepared by Deloitte following a meeting between Dow employees, Dow's outside counsel and Deloitte auditors to discuss the potential for tax litigation over a series of transactions entered into by Dow and the necessity of

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accounting for such a possibility in the financial audit. The other two documents, which the government conceded were work product, were a memorandum and accompanying flow chart created by a Dow employee and in-house counsel, and a tax opinion prepared by Dow's outside counsel. The government contended that the Deloitte memorandum could not be work product on two grounds: (i) because it was created by Deloitte; and (ii) because it was generated as part of the routine financial audit process and not in anticipation of litigation. The government also asserted that the disclosure of the tax opinion and Dow documents to Deloitte waived work product protection.

The "Because of" Test Cannot Ignore a Document's Content

The D.C. Circuit rejected the government's linear argument that a document prepared by an auditor for purposes of a financial audit cannot be work product. In so doing, the court affirmed the majority view that documents created "because of" the prospect of litigation are protected work product and rejected the IRS' argument that the inquiry must focus solely on the *function* of the document (*i.e.*, for use in a financial statement audit) and disregard its *content* (*i.e.*, whether it contained protected work product material): "In short, a document can contain protected work-product material even though it serves multiple purposes, so long as the protected material was prepared because of the prospect of litigation."² The D.C. Circuit, however, remanded the case for an *in camera* review of the Deloitte memorandum to determine whether the entire document or only a portion of it was, in fact, work product.

The D.C. Circuit's analysis of the application of the "because of" test stands in stark contrast to the First Circuit's en banc decision in *United*

*States v. Textron, Inc.*³ There, the First Circuit held that a company's tax accrual workpapers reflecting the evaluation by in-house and outside counsel of tax return positions were not protected work product and thus were discoverable by the IRS. Despite stating that it was applying the "because of" test, the First Circuit afforded protection only if the document had been "prepared for use in possible litigation."⁴ The court found that because the workpapers at issue were created pursuant to accounting requirements rather than "for use" in potential litigation, they were not protected from disclosure. The Supreme Court denied *Textron's* petition for certiorari shortly before the *Deloitte* decision.

The D.C. Circuit distinguished *Textron* by noting that the First Circuit based its conclusion "on the court's examination of the particular documents at issue" and stated that *Textron* did not preclude the possibility that some documents prepared during the financial audit process may be work product protected. The D.C. Circuit also noted that the dissent in *Textron* had made a "strong argument" that the First Circuit, in fact, had applied a new "for use" test rather than the "because of" test.⁵

Disclosure to an Independent Auditor Does Not Necessarily Waive Work Product Protection

The D.C. Circuit specifically addressed whether the disclosure of work product to a company's independent auditor waives work product protection, a question not reached by the First Circuit in its en banc *Textron* decision. As a general matter, work product protection is waived when disclosure is inconsistent with the maintenance of confidentiality from the disclosing party's adversary, including conduits to that adversary. Notwithstanding the "public watchdog" role played by independent auditors and the fact that the auditor may be required to disclose information received

to the IRS, SEC and other authorities in a variety of circumstances, the D.C. Circuit rejected the government's argument that disclosure to a company's independent auditor is always a waiver of work product protection.

In reaching this conclusion, the D.C. Circuit noted that the auditor, Deloitte, was not Dow's potential adversary in the anticipated litigation (*i.e.*, the tax litigation) and that Deloitte, in fact, would have been required under applicable AICPA rules to withdraw from the engagement had there been even the threat of litigation between an auditor and the company. The D.C. Circuit also found that companies have a reasonable expectation of confidentiality under applicable AICPA professional conduct rules forbidding auditors from disclosing their clients' confidential information without the specific consent of the client.

Deloitte's Effect on Tax Controversies

Deloitte will not be the last word on the dispute between companies that are SEC registrants and the IRS over the ability of the IRS to obtain work product from the company or the company's auditor. This decision and likely future cases, however, will further sharpen the 28-year-old conflict among the circuits over the work product test. The government acknowledged, but viewed as not troublesome, this long-standing conflict in its opposition to certiorari in the *Textron* case.⁶

Some of the potential tax controversy implications of the *Deloitte* decision are highlighted below:

- *Tax Court litigation* – The Tax Court applies the rules of evidence applicable to nonjury trials in the US District Court for the District of Columbia. The *Deloitte* decision is the law of the circuit and therefore will govern discovery disputes over work product protection in Tax Court cases.
- *IRS document requests related to the new Schedule UTP* – The IRS

is finalizing its new Schedule UTP that will require a corporation to provide detailed information on its tax reserves as part of its federal income tax return. The *Deloitte* decision may influence not only what information the IRS could require on the form — particularly as part of a “concise description” of an uncertain tax position — but also what documents a corporate taxpayer could be required by the IRS to provide during audit in support of the information reported on this schedule. The IRS has stated repeatedly that it is not using the new Schedule UTP to obtain protected information, but the *Deloitte* decision and its focus on content illustrates that it may be difficult for the IRS to ensure that it does not run afoul of that stated objective in identifying the information to be provided on the form.

- *Assertion of work product may impose document retention obligations* – Although *Deloitte* provides broader protection of protected work product material that is disclosed to independent auditors, claiming that protection comes with a potentially significant cost. A company's assertion that it anticipated litigation at a certain point in time will trigger corresponding document retention obligations, which must be adhered to in order to avoid a spoliation claim by the IRS. Specifically, a party to a litigation may be subject to sanctions if it has destroyed documents — even inadvertently — that are relevant to a pending or reasonably foreseeable litigation on the theory that it has deprived another party's ability to use those documents as evidence.⁷ Thus, the consequences of asserting work product protection with respect to materials provided to an outside auditor are that a taxpayer will likely be required to preserve all documents relevant to the same subject matter, or else face spoliation claims.
- *The government's effort to limit work product protection may tilt the playing field* – Work product protection is

available to all litigants, including the government. The government's attempts to narrow work product protection could adversely affect the government's own ability to protect its documents under that doctrine. The government in recent cases, however, appears to be relying increasingly on the deliberative process privilege — a protection available only to the government — to avoid disclosing documents sought by taxpayers in tax controversies. Work product protection was created in part to eliminate “sharp practices” among litigants, and it remains to be seen how courts will entertain government arguments to limit work product protection if the government attempts to deny taxpayer's access to similar government documents on other grounds unavailable to taxpayers.

Conclusion

The *Deloitte* decision both clarifies the boundaries of work product protection in the Tax Court and in D.C. District Court, and raises the bar for challenges to work product claims more broadly. It also explicitly recognizes a policy favoring the availability of public companies to share sensitive analyses with their outside auditors with less fear that such disclosure will waive work product protection. The decision's influence on the resolution of these issues, including in future tax controversies, is likely to be significant. However, this remains a fluid area and caution should remain the watchword in providing confidential information to outside financial auditors. We can expect the boundaries of work product protection to continue to evolve as the protection continues to be tested under different factual circumstances.

Endnotes

- ¹ No. 09-5171 (D.C. Cir. June 29, 2010).
- ² Slip Opinion at 13.
- ³ 577 F.3d 21 (1st Cir 2009) (*en banc*), *cert. denied*, 78 USL.W. 3687 (May 24, 2010). Latham & Watkins LLP has published several prior Client Alerts on the *Textron* case. See *US v. Textron: Tax Accrual Workpapers Are Work Product, But Further Proceedings Necessary On Whether Disclosure To Auditors Waives Protection*, Latham & Watkins LLP Client Alert No. 799 (February 5, 2009); *First Circuit Considers Whether Tax Accrual Workpapers Shared with Auditors are Protected Work Product*, Latham & Watkins LLP Client Alert No. 698 (April 24, 2008); *Textron and Workpaper Confidentiality*, Latham & Watkins LLP Client Alert No. 625 (Sept. 5, 2007). Latham & Watkins LLP also submitted an amicus curiae brief on behalf of the US Chamber of Commerce in support of *Textron's* petition for certiorari by the Supreme Court.
- ⁴ See *Textron*, 577 F.3d at 32 (Torruella, J., dissenting).
- ⁵ Slip Opinion at 13.
- ⁶ Brief for the United States in Opposition, *Textron Inc. and Subsidiaries, Petitioner, v. United States*, On Petition for a Writ of Certiorari to the United States Court of Appeals for the First Circuit, pp. 13, 16-17 (No. 09-750).
- ⁷ See *Consolidated Edison Company of New York Inc. v. United States*, 90 Fed. Cl. 228, 249-63 (2009).

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