2010

Tax Cases Make Bad Work Product Law: The Discoverability of Litigation Risk Assessments After United States v. Textron

Jacob A. Kling

Follow this and additional works at: https://digitalcommons.law.yale.edu/ylj

Recommended Citation
Available at: https://digitalcommons.law.yale.edu/ylj/vol119/iss7/6

This Article is brought to you for free and open access by Yale Law School Legal Scholarship Repository. It has been accepted for inclusion in Yale Law Journal by an authorized editor of Yale Law School Legal Scholarship Repository. For more information, please contact julian.aiken@yale.edu.
Tax Cases Make Bad Work Product Law: The Discoverability of Litigation Risk Assessments After United States v. Textron

In United States v. Textron, Inc., the United States Court of Appeals for the First Circuit, in a rehearing en banc, held that tax accrual work papers prepared by a corporation’s lawyers in order to calculate tax reserves for financial reporting purposes are not protected by the work product doctrine. The majority reasoned that tax accrual work papers are not created in anticipation of litigation, but rather in the ordinary course of business pursuant to the securities laws, and suggested that documents that are not “prepared for use in possible litigation” are beyond the scope of work product protection. The court also emphasized that permitting discovery of tax accrual work papers “serves the legitimate, and important, function of detecting and disallowing abusive tax shelters.”

This Comment argues that Textron’s “use in possible litigation” standard is inconsistent with precedent and, moreover, is normatively undesirable. In particular, it may deter companies, public and nonpublic, from voluntarily preparing litigation risk assessments that estimate the company’s contingent liabilities for the benefit of third parties, including potential acquirers or investors, and thereby impede socially efficient business transactions, while at the same time diminishing the accuracy of public companies’ financial statements. Moreover, the principle objections to work product protection—
including its potential to deprive the court of relevant information, to lead to the duplication of efforts in trial preparation, and to encourage overinvestment in the stakes-dividing function of litigation— are largely inapplicable to quantitative litigation risk analyses outside of the tax context. Although the first two of these objections may apply to tax accrual work papers given their usefulness in combating tax evasion, the negative economic effects of permitting discovery of litigation risk analyses, including tax work papers, suggest that work product protection is desirable on balance. Because the discoverability of litigation risk assessments is likely to interfere with the efficient functioning of the capital markets and the market for corporate control, the Supreme Court should grant Textron's petition for certiorari and affirm their protected status.

I. TEXTRON'S NEW STANDARD

The dispute in Textron began when the IRS brought an action in federal court to enforce a summons demanding that Textron produce its tax accrual work papers to facilitate the IRS's investigation of several transactions in which the company had been involved. Tax accrual work papers are documents prepared by a company's lawyers that identify potential "soft spots" on the company's tax return, estimate the probability that the company's position will be sustained, and use that estimate to recommend an amount that should be reserved as contingent tax liabilities on the company's financial statements. Publicly traded corporations like Textron are required under the federal securities laws to have audited financial statements that comply with generally accepted accounting principles (GAAP), according to which companies must report certain loss contingencies in their financial statements, including potential tax liabilities. Tax accrual work papers form the basis for the auditor's evaluation of the sufficiency of the company's tax reserves.

The majority in Textron held that the preparation of Textron's work papers was statutorily mandated and that the documents were thus created not in anticipation of litigation but rather in the ordinary course of business in order

10. Textron, 577 F.3d at 23.
to prepare financial statements and obtain a clean audit report.\textsuperscript{11} As a doctrinal matter, this reasoning is problematic. The circuits have adopted two distinct tests to determine whether a dual-purpose document that is prepared in expectation of litigation but also for a business purpose is entitled to work product protection under Federal Rule of Civil Procedure 26(b)(3). The Fifth Circuit applies a primary motivating purpose test under which a document qualifies for work product protection only if “the primary motivating purpose behind the creation of the document was to aid in possible future litigation.”\textsuperscript{12} Based on this primary purpose test, the Fifth Circuit, the only circuit to specifically address the status of tax accrual work papers prior to \textit{Textron}, also concluded that they are not work product because their primary purpose is “to back up a figure on a financial balance sheet” rather than to assist in litigation.\textsuperscript{13}

However, a majority of circuits, including the First Circuit, have rejected the Fifth Circuit’s “primary motivating purpose” test, instead interpreting the work product doctrine to cover documents prepared “because of” the prospect of litigation even if the documents were also prepared for a business purpose. In \textit{United States v. Adlman},\textsuperscript{14} a decision later followed by the First Circuit in \textit{Maine v. United States Department of the Interior},\textsuperscript{15} the Second Circuit rejected the Fifth Circuit’s primary motivating purpose test in favor of a “because of” test and held that a memorandum analyzing likely IRS challenges to a proposed reorganization and predicting the outcome of resulting litigation qualified as work product under the latter test. The court interpreted the work product doctrine to protect dual purpose documents prepared in anticipation of litigation but also “to inform a business decision influenced by the prospects of the litigation”\textsuperscript{16} provided that the documents “would not have been prepared in substantially similar form but for the prospect of that litigation.”\textsuperscript{17} Although neither \textit{Adlman} nor \textit{Maine} dealt specifically with tax accrual work papers, such work papers would seem to merit protection under the “because of” test since they would not need to be prepared but for the possibility of litigation with the IRS.\textsuperscript{18}

\begin{itemize}
\item \textsuperscript{11} \textit{Id.} at 27, 30-31.
\item \textsuperscript{12} \textit{United States v. Davis}, 636 F.2d 1028, 1040 (5th Cir. Unit A Feb. 1981).
\item \textsuperscript{13} \textit{United States v. El Paso, Co.}, 682 F.2d 530, 544 (5th Cir. 1982).
\item \textsuperscript{14} 134 F.3d 1194, 1195 (2d Cir. 1998).
\item \textsuperscript{15} 298 F.3d 60, 68 (1st Cir. 2002).
\item \textsuperscript{16} \textit{Adlman}, 134 F.3d at 1197-98.
\item \textsuperscript{17} \textit{Id.} at 1195.
\item \textsuperscript{18} One court recently held that a company’s tax accrual work papers would be protected even under the primary purpose test because the documents “would not have been created were
In the face of these contrary precedents, the majority in *Textron* appears to have crafted a new standard limiting work product protection to documents prepared for use in litigation. The court repeatedly emphasized that the work product privilege is "aimed centrally at protecting the litigation process" and that the focus of the doctrine has been on "materials prepared for use in litigation." Tax accrual work papers, the court reasoned, cannot be said to be prepared "for use in possible litigation" since they would not assist Textron in litigating against the IRS. As Judge Torruella pointed out in dissent, however, this narrow interpretation of the work product doctrine was expressly rejected in *Adlman* on the theory that Rule 26(b)(3) protects both documents "prepared . . . for trial" and those prepared "in anticipation of litigation," and an interpretation requiring that the documents be prepared to assist at trial would render the latter phrase meaningless. Thus, although the majority purported to reaffirm *Maine*, its analysis cannot be squared with the "because of" test. Instead, the opinion must be read as an attempt to eliminate work product protection for documents that are prepared in order to analyze a company's litigation prospects for a business purpose rather than for use at trial.

The majority was motivated by concern over the ability of the IRS to detect tax avoidance transactions, but its "prepared for use in possible litigation" test will likely have a negative effect on the production of litigation risk assessments for business purposes, whether or not they involve potential tax liabilities. Part II of this Comment will discuss these problems in greater detail; it will also argue that outside of the tax context the discoverability of litigation risk analyses is unlikely to produce countervailing benefits.

---

20. *Id.* at 29.
21. *Id.* at 27.
22. *Id.* at 30.
23. *Id.* at 34 (Torruella, J., dissenting) (quoting United States v. Adlman, 134 F.3d 1194, 1198-99 (2d Cir. 1998)).
24. *Id.* at 26 (majority opinion).
25. The court could have decided the case on the narrower ground that it is per se unreasonable to anticipate litigation with the IRS prior to an audit. See Dennis J. Ventry, Jr., *Protecting Abusive Tax Avoidance*, 120 TAX NOTES 857, 871 (2008). But see Terrence G. Perris, *Court Applies Work Product Privilege to Tax Accrual Workpapers*, 80 PRAc. TAX STRATEGIES 4, 10 (2008) (noting that regular tax audits often become contentious). The district court rejected...
II. TEXTRON AS BAD LAW

The dissent in Textron briefly alluded to the potentially broad ramifications of the court’s holding for litigation risk analyses prepared for business purposes. This Part argues that the court’s “use in possible litigation” standard is misguided, certainly when applied to litigation risk assessments outside of the tax context, but arguably within the tax arena as well. First, it will likely chill the preparation of these analyses and as a result reduce the quality of information available to potential investors and acquirers. Second, most of the arguments against a broad work product doctrine are inapplicable to quantitative litigation risk assessments outside of the tax context.

A. The Chilling Effect

The strongest argument against Textron’s “use” standard is that there are net social benefits associated with the creation of litigation risk assessments, whether prepared to estimate potential tax or nontax liabilities, and the holding in Textron is likely to discourage companies from preparing such analyses for fear that they will be discoverable by the company’s adversary in litigation. Indeed, in Hickman v. Taylor, the origin of the work product privilege, the Supreme Court justified the privilege in part on the ground that a contrary rule would discourage lawyers from writing things down. In Hickman, the Court was concerned with the effect this would have on the adversary system and on lawyers’ ability to prepare their cases. In the context of litigation risk assessments, such a chilling effect is concerning not because it interferes with lawyers’ ability to prepare their cases but because it decreases the amount and quality of information about a company that is available to the market, including potential third party investors.

This informational effect can take two forms depending on whether the company is required to file audited financial statements with the SEC. First, with respect to public companies that are subject to the periodic reporting requirements of the Securities Exchange Act of 1934, an accurate litigation

---

27. 329 U.S. 495, 511 (1947).
28. Id.
29. This includes companies with a class of securities that trades on a national exchange and companies with $10 million in assets and a class of equity securities held by 500 or more people. 15 U.S.C. §§ 78(a), 78l(g)(1), 78m(a) (2006); 17 C.F.R. § 240.12g-1 (2009).
risk assessment enhances the reliability of the company’s estimation of its contingent liabilities in its financial statements, which increases the efficiency of the capital markets. Because litigation risk assessments that are prepared for financial reporting purposes set forth the lawyer’s estimate of potential liability separately for each claim asserted against the company, whereas financial statements do not necessarily distinguish among each of the various claims, the discoverability of such analyses can be expected to furnish the company’s litigation adversary with useful information concerning the company’s settlement value. As such, companies may be reluctant to thoroughly and honestly investigate the company’s litigation prospects, and this reluctance will impair the accuracy of financial reporting.

The majority in Textron implicitly rejected this argument, noting that the securities laws and auditing requirements ensure that tax work papers “will be carefully prepared, in their present form, even though not protected.” The problem with this reasoning is that the applicable accounting standards only require companies to report a loss contingency (and thus to prepare a risk analysis to support its calculation) if there is a reasonable possibility that a loss has been incurred and an estimate of the possible loss can be made. Moreover, reporting is not required unless the contingent litigation liability at issue is material, meaning that the magnitude of the litigation is such that the judgment of a reasonable investor relying upon the company’s financial statements would be influenced by its inclusion. Companies enjoy some discretion in determining whether a contingent litigation liability meets these relatively nebulous standards, and the holding in Textron gives them an extra incentive to err on the side of restraint rather than full disclosure.

31. See Textron, 577 F.3d at 23.
33. Statement of Fin. Accounting Standards No. 5, supra note 9, § 10.
34. Id.
36. The Financial Accounting Standards Board considered eliminating some of this discretion by making its disclosure standards more stringent. RESEARCH AND DEV. ARRANGEMENTS, Statement of Fin. Accounting Standards Nos. 5 & 141, §§ 5-6 (Fin. Accounting Standards Bd.) (Exposure Draft 2008). These proposed amendments have not been adopted.
Second, whether or not a company is subject to the SEC's reporting requirements, assessing the scope of potential liability arising out of threatened or pending litigation is an important element of the due diligence that potential acquirers and investors conduct in evaluating a company's business.\textsuperscript{38} As to nonreporting companies, whose financial statements need not comply with GAAP,\textsuperscript{39} the decision in \textit{Textron} may deter them from preparing litigation risk assessments that they might otherwise \textit{voluntarily} furnish in connection with certain business transactions, including the sale of the company or a division or subsidiary thereof, or capital-raising transactions, such as a private placement of the company's debt or equity securities to a small number of accredited investors.\textsuperscript{40} After \textit{Textron}, even companies that must comply with the SEC's reporting requirements may be deterred from voluntarily creating litigation risk analyses in connection with such transactions when the particular litigation at issue does not meet the standards for mandatory disclosure under GAAP, which, as discussed above, only requires companies to report loss contingencies that are material, estimable, and reasonably possible to lead to an actual loss.\textsuperscript{41} This might be the case in situations in which a company is selling a division and the litigation is material to that division but not to the company as a whole, or where it is not "reasonably possible" that the litigation will lead to an actual loss but in the event that it does the magnitude of the liability would be significant. In each case, the company's public financial statements will not reflect the particular litigation liability, and the company might be reluctant to voluntarily furnish the acquirer or investor with an analysis quantifying the company's potential liability for fear that the analysis would be discoverable.

This chilling effect is problematic because litigation risk assessments can serve a number of instrumental functions in facilitating the consummation of business transactions. Potential acquirers and investors may insist upon the preparation of such assessments because they may provide them with valuable information concerning the company's litigation risks and in some cases may


\textsuperscript{39} Some nonpublic companies may be contractually required under a loan agreement to have audited financial statements.

\textsuperscript{40} Private placements are exempt from the registration requirements of the Securities Act and thus the issuer need not provide investors with audited financial statements. \textit{See} 15 U.S.C. § 77d(2) (2006); 17 C.F.R. §§ 230.501-508 (2009).

\textsuperscript{41} \textit{See supra} notes 33-34 and accompanying text.
form the basis for a cause of action under the securities laws if the company knowingly misrepresents its litigation prospects.\textsuperscript{42} Without the assurances that a litigation risk analysis can provide to potential outside investors, they may be unwilling to purchase the company’s securities or enter into a business combination with the company or, if they do so, they may value the company on a “worst case” basis. In the case of certain private company acquisitions, a written analysis of the company’s litigation risks may also influence the allocation of liability for (and as a result, the control of the defense of) the litigation as set forth in the purchase agreement. To the extent that the litigation affects the post-closing conduct of the business, either because the litigation relates to an ongoing course of conduct or because the litigation involves parties with whom the buyer will have continued dealings in the post-closing period, it might be efficient for the buyer to assume some or all of the control and risk of a particular litigation.\textsuperscript{43} But if the buyer does not have a sense of the magnitude of potential liability involved, then it may be reluctant to do so, or it may evaluate the litigation risk on a worst case basis and insist on a substantial purchase price adjustment, to which the seller is unlikely to agree. As a result, the seller may retain control of the litigation, which is an inefficient outcome. Thus, by chilling the voluntary creation of litigation risk assessments, the decision in \textit{Textron} may hinder the ability of both public and nonpublic companies to engage in socially efficient business combinations and capital-raising transactions.

\textbf{B. The Arguments Against Work Product Protection}

In light of the chilling effect that the First Circuit’s use standard is likely to have on the creation of litigation risk assessments, the question becomes whether the discoverability of such documents will produce any countervailing benefits. In particular, we might ask whether any of the arguments against a broad work product doctrine—principally, that it may impede the court’s search for truth, lead to the duplication of efforts in trial preparation, and encourage overinvestment in the stakes-dividing function of litigation—apply with special force to litigation risk assessments. This Section suggests that although some of these objections might possibly apply in the narrow context

\textsuperscript{42} See 17 C.F.R. § 240.10b-5 (prohibiting material misstatements in connection with the purchase or sale of a security).

\textsuperscript{43} For example, the buyer may be in a better position to mitigate damages or have better incentives than the seller in deciding whether to pursue litigation that might sour an important business relationship of the company. See \textit{2 Lou R. Kling \& Eileen T. Nugent, Negotiated Acquisitions of Companies, Subsidiaries and Divisions} § 15.02 (2009).
of tax accrual work papers, they are largely inapposite with respect to quantitative litigation risk assessments more generally. This observation counsels for more rather than less protection for litigation risk analyses as compared to documents actually used in litigation.

1. *The Search for Truth*

The most basic argument against the work product doctrine and in favor of permissive discovery is that, as an evidentiary privilege, the doctrine may deprive the other party and the court of information relevant to the outcome of the case.\textsuperscript{44} This may not only lead to the wrong outcome in a particular case, but can also reduce the deterrence value of litigation.\textsuperscript{45} The *Textron* majority's concern for the IRS's ability to combat tax evasion is consistent with this argument insofar as tax accrual work papers have informational value relevant to the outcome of the case because they identify for the IRS particular "soft spots" on the company's return.\textsuperscript{46}

Outside of the tax context, however, litigation risk assessments are unlikely to contain information that is relevant to the ability of the other party to put forth its strongest case or of the court to ascertain the truth. This is because by the time the opposing party seeks discovery of the risk assessment it will typically already be aware of the underlying transaction giving rise to potential liability by virtue of having brought suit. By contrast, because of the regular reporting obligations that the Internal Revenue Code imposes on companies, the IRS is in a position to benefit from tax accrual work papers even before it brings an enforcement action. Thus, tax work papers are unique in that they identify for the IRS particular claims it might otherwise not realize it has against the company.\textsuperscript{47} Outside of the tax context, a litigation risk assessment prepared for a business purpose that merely provides the lawyer's estimate of

\textsuperscript{44} See United States v. Textron, Inc., 577 F.3d 21, 31 (1st Cir. 2009) (en banc); Thornburg, supra note 6, at 1573.

\textsuperscript{45} Thornburg, supra note 6, at 1573.

\textsuperscript{46} See United States v. Arthur Young & Co., 465 U.S. 805, 813 (1984). Of course, the mere fact that a company views the proper tax treatment of the transaction in question as less than absolutely certain does not mean that the company is attempting to evade taxes; such a determination can only be made after a trial.

\textsuperscript{47} Whether forcing companies to do the IRS's work for it is consistent with the adversarial nature of our litigation system is beyond the scope of this Comment.
the probability that the company will lose the case and the expected damages if it does lose is unlikely to aid the court's search for truth.\textsuperscript{48}

If the typical litigation risk assessment is unlikely to contain relevant information, however, then this raises two questions, both of which suggest that the \textit{Textron} decision might not be as significant outside of the tax context as this Comment has argued. First, would a litigant actually seek discovery of an opposing party's litigation risk assessment? Second, if so, would discovery be denied even without work product protection?

With respect to the first question, it is clear that a litigant would seek discovery of a litigation risk analysis because although it may not be relevant in an evidentiary sense it certainly is relevant to the litigant's settlement tactics. As to the second question, although the Federal Rules of Civil Procedure limit the scope of discovery to matters relevant to a party's claim or defense,\textsuperscript{49} this is a highly permissive standard. Thus, a litigant might convince a court to order discovery of a risk assessment on the basis of minimal legal analysis contained therein even if the litigant is primarily interested in the opposing party's valuation analysis.\textsuperscript{50} As such, neither of these is a satisfying response to the chilling concern expressed in the previous Section.

\section{2. Duplication of Efforts}

In addition to the search for truth argument discussed above, another objection to the work product doctrine is that it leads to an unnecessary and inefficient duplication of effort in trial preparation.\textsuperscript{51} This argument has some traction with respect to tax work papers because even if the IRS could identify all of the holes in a company's tax return it would only be able to do so at significant cost.\textsuperscript{52} The discoverability of a company's tax accrual work papers reduces these costs considerably. But outside of the tax context the discoverability of analyses that quantify the hazards of litigation will not reduce duplicative costs in trial preparation precisely because such analyses generally lack evidentiary value and thus do not displace the need to discover facts.

\textsuperscript{48} See Thornburg, \textit{supra} note 6, at 1579 (conceding that "an attorney's opinion about the settlement value of a case might not be relevant in the discovery sense").

\textsuperscript{49} \textit{Fed. R. Civ. P. 26(b)(1)}.

\textsuperscript{50} See, e.g., Frank H. Easterbrook, \textit{Comment, Discovery as Abuse}, 69 B.U. L. Rev. 635, 641-42 (1989) (doubting the ability of judges to correctly differentiate between discovery requests likely to produce relevant information and abusive discovery requests).

\textsuperscript{51} See Thornburg, \textit{supra} note 6, at 1571.

\textsuperscript{52} See United States v. Textron, Inc., 577 F.3d 21, 31 (1st Cir. 2009) (en banc); Ventry, \textit{supra} note 25, at 871.
identify witnesses, take depositions, and the like.\textsuperscript{53} The duplication of efforts argument, therefore, does not apply to litigation risk assessments generally.

\textbf{3. Overinvestment in Litigation}

A third objection to a broad work product privilege stems from the premise that litigants tend to overinvest in the stakes-dividing function of litigation.\textsuperscript{54} This overinvestment allegedly results from the fact that, although society is indifferent (from an efficiency perspective) as to the distributional effects of a case, the parties' investment is motivated primarily by "the size of the stakes rather than by the value of the case as a precedent."\textsuperscript{55} Because a narrower work product privilege permits the opposing party to free ride on a lawyer's research,\textsuperscript{56} it reduces the value of trial preparation and mitigates the overinvestment problem.\textsuperscript{57}

Whatever its general merits,\textsuperscript{58} the overinvestment argument is unconvincing as applied to litigation risk assessments, including tax accrual work papers, for two reasons. First, to the extent that such analyses are prepared for a business purpose and do not include legal theories or strategies, their discoverability will not enable opposing counsel to free ride on the other side's research and thus will not solve the supposed overinvestment problem. More fundamentally, the cost of creating a litigation risk assessment does not qualify as investment in the stakes-dividing function of litigation but instead is incurred for business purposes and as such produces positive social benefits.

\textbf{CONCLUSION}

The decision in \textit{Textron} denies work product protection to litigation risk analyses prepared for a business purpose rather than for "use in possible


\textsuperscript{54} \textit{Id.} at 360.

\textsuperscript{55} \textit{Id.}


\textsuperscript{57} Easterbrook, \textit{supra} note 53, at 360-61.

\textsuperscript{58} To the extent that the ability of an opposing party to free ride on an attorney's research might lead to a decline in attorney preparation, it could also hinder the court's search for truth and undermine the adversary system. See, e.g., D. Christopher Wells, \textit{The Attorney Work Product Doctrine and Carry-Over Immunity: An Assessment of Their Justifications}, 47 U. PITT. L. REV. 675, 684-85 (1986).
litigation." The court's holding will likely chill the socially valuable preparation of such analyses in connection with business transactions and may reduce the accuracy of public companies' financial statements. At the same time, although some of the arguments against an expansive work product doctrine may apply in the narrow context of tax accrual work papers because of their utility to the IRS in combating tax evasion, they are mainly inapplicable to litigation risk assessments outside of the tax context. There is now effectively a three-way circuit split concerning the application of the work product doctrine to documents that quantify a company's litigation exposure for a business purpose. In light of the negative effect that the discoverability of such litigation risk analyses can be expected to have on the capital markets and on the market for corporate control, it is time for the Supreme Court to step in and affirm their protected status. Until it does, the other circuits should decline to follow Textron's lead.

JACOB A. KLING