

Client Alert.

July 29, 2010

United States v. Deloitte LLP: **Work Product Redeemed, *Textron* Rebuffed**

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On June 29, 2010, the U.S. Court of Appeals for the District of Columbia affirmed a lower court opinion upholding Dow Chemical's assertion of work product protection regarding three documents that were in the files of its outside auditor, Deloitte LLP. The circuit court also remanded for further consideration of one of the documents in light of its decision.

This is an important decision in three respects: (1) it is the first federal circuit decision on the question of work product protection in the context of financial audits after the First Circuit's decision in *Textron*,¹ (2) it is the first federal circuit decision on the question of waiver of work product in the context of public company financial audits,² and (3) it affects the rules of evidence for Tax Court cases.³

The decision's importance goes far beyond these points. It is a clearly written decision that reminds the bar and judiciary of the proper scope of the work product protection. Its analysis shines a much needed light on critical distinctions in stark contrast to the First Circuit in *Textron* which merrily rolled over established notions of work product. We briefly recount the relevant facts below.

Dow filed suit in district court regarding the tax treatment of certain affiliated partnerships (the "Chemtech partnerships"). In the course of the litigation, the Department of Justice subpoenaed Deloitte, Dow's outside auditor, to produce its files related to Deloitte's review and audit of Dow's reserves with respect to the tax treatment of the Chemtech partnerships. Dow instructed Deloitte to refuse to produce three documents in its audit files on grounds of work product protection. The Government thereafter moved to compel Deloitte to produce the documents in the federal district court of the District of Columbia.

The three documents at issue were (i) a July 1993 draft memorandum created by Deloitte based on a meeting with Dow's attorneys regarding possible litigation of the tax treatment of the Chemtech partnerships, (ii) a September 1998 analysis created by Dow's in-house counsel and (iii) a June 2005 tax opinion from Dow's outside counsel. The Government conceded that the latter two documents were work product. However, the Government argued that the Deloitte memorandum was not work product and that work product was waived as to the latter two Dow documents because they were in Deloitte's audit files. The circuit court, like the district court below, disagreed and held that the Deloitte memorandum contained work product and that no waiver occurred. The decision breaks down into two major parts. The first is a discussion of why the Deloitte memorandum contains protected work product. The second is a discussion of why work product protection was not waived.

¹ For our discussion of that decision (which became final after the Supreme Court denied *Textron*'s petition for certiorari on May 24, 2010) please see <http://www.mofo.com/news/updates/files/15900.html>.

² The original panel decision in *Textron* did discuss this issue but that decision was vacated.

³ See Tax Court Rule 143(a) (Rules of evidence applicable to bench trials in the D.C. district court are applied in Tax Court proceedings).

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WORK PRODUCT PROTECTS INTANGIBLE CONTENT

The first and obvious argument of the Government was that the Deloitte memorandum as a threshold matter could not be protected work product because Federal Rule of Civil Procedure 26(b)(3) requires that work product must be created by a party or party representative. Deloitte was acting in the capacity of a public auditor when it received information at the July meeting. Therefore, the Government argued, Deloitte was not acting as a representative of Dow when it created the memorandum, citing *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984) (contrasting the role of counsel to that of outside auditor).

On this point, the court returned to first principles, namely, *Hickman v. Taylor*, 329 U.S. 495 (1947), and focused not on the author of the memorandum but on its contents, i.e., Dow's counsel's mental impressions:

[I]n *Hickman*, the Court explained that the attorney's "mental impressions" were protected from discovery, so that he could not be forced to "repeat or write out" that information in discovery. *Id.* at 512-13. Thus *Hickman* provides work-product protection for *intangible* work product *independent* of Rule 26(b)(3).

Slip op. at 8 (emphasis added). Rule 26(b)(3) protects documents and tangible things, but the core purpose of the common law *doctrine* is to protect an attorney's mental impressions about his case. In short, the circuit court decided that work product protection should not turn on the difference between written or oral expression of an attorney's mental impressions: "The work product privilege does not depend on whether the thoughts and opinions were communicated orally or in writing, but on whether they were prepared in anticipation of litigation." *Id.* at 9. As the court noted, *Hickman* wanted to ensure effective advocacy in our adversarial system and allowing opposing parties access to such mental impressions would be significantly deleterious to that system. In the court's view, any other result would undermine our adversarial system by forcing disclosure of those impressions. It cited three decisions in support of its conclusion. These decisions extend work product protection to the intangible mental impressions of counsel in these instances: (i) discussions between a witness, counsel and non-testifying expert, (ii) an assistant U.S. attorney's intentions regarding possible prosecutions, and (iii) trial counsel's work product despite "advice of counsel defense." These cases show the power and scope of the work product doctrine and how courts generally reject any imprudent limitations. Thus, the court held that the Deloitte memorandum contained a written record of Dow's counsel's intangible work product.

WORK PRODUCT IS DETERMINED THROUGH EXAMINATION OF A DOCUMENT'S CONTENTS

The Government argued next that documents created in the context of a financial audit cannot be work product because they are not created in anticipation of litigation. Thus, because the function of the Deloitte memorandum was to assist in the financial audit, it could not have been created in anticipation of litigation and therefore cannot be work product. For the Government, the ostensible function of a document completely defines its purpose regardless of the contents. The D.C. Circuit saw this argument for what it was, namely, an exaggerated rule that even *Textron* does not support.

First, the court reminded the Government that the appropriate test for determining whether a document is created "in anticipation of litigation"—the key element of work product—is what is known as the "because of" test. Simply stated, this test asks whether the document was created "because of" the prospect of litigation and does not require actual or threatened litigation at the time of its creation. Under this test, a document's temporal proximity to actual litigation is not a deciding factor. Indeed, even if litigation never occurs, work product may still protect the document so long as there is an objectively and subjectively reasonable anticipation of litigation at the time of the document's creation. *See, e.g., United*

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States v. Roxworthy, 457 F.3d 590 (6th Cir. 2006). Moreover, under this test a document can be created for non-litigation purposes and still retain work product protection so long as it also was created for a litigation-oriented purpose. This is known as the “dual purpose” rule, a corollary of the “because of” test. Slip op. at 12-13. See also *United States v. Adlman*, 134 F.3d 1194 (1998) (pre-transaction tax opinion is potential work product); *Roxworthy* (penalty protection memorandum is work product).

Certainly documents that are created prior to litigation require additional scrutiny to determine whether they are protected work product. However, mere reference to the ostensible function of such a document is not enough under the “because of” test. This test considers the contents of the document as well as evidence about the circumstances of its creation.

Turning to the Deloitte memorandum, the circuit court noted that this same “because of” standard applies to intangible work product. Thus:

for the Deloitte memorandum, the question is whether it records information prepared by Dow or its representatives because of the prospect of litigation.

Slip op. at 10. It certainly was a critical fact that Dow’s counsel discussed the prospect of litigation with Deloitte in the July 1993 meeting.⁴ However, the fact that the general purpose for the meeting was to assist the outside auditor in its financial audit did not remove the work product nature of statements made at that meeting. The memorandum was essentially treated as a dual-nature memorandum created by Deloitte for use in its audit that also contained litigation-related statements of counsel. Viewing the memorandum in this way is akin to the analysis of the now-vacated original First Circuit *Textron* decision in which the majority described the effort to prepare the tax accrual workpapers as required because Textron anticipated litigation of the particular return position and therefore had to establish an adequate reserve. Thus, the oral statements of Dow’s counsel in the Deloitte memorandum were made “because of” litigation and deserved protection as work product.⁵

TEXTRON—DISTINGUISHED, LIMITED AND CRITICIZED

The Government probably felt it had an ace in the hole with the recently decided *en banc* decision in *Textron*. The D.C. Circuit summed up its analysis of that decision in three points:

- 1) Distinguishable. The First Circuit was addressing the particular documents at issue before it – internal tax accrual workpapers which, according to the First Circuit, had no litigation-oriented relevancy at all. Slip. op at 13.
- 2) Limited to its facts. The First Circuit “did not exclude the possibility that other documents prepared during the audit process might warrant work product protection.” *Id.*
- 3) Outside the majority rule. The First Circuit noted that the dissent in *Textron* made a “strong” argument that the majority did not apply the “because of” test, even though it claimed it was doing so. *Id.* It is worth

⁴ Dow provided a declaration from its Director of Taxes, William Curry, to supply the factual context for the Deloitte memorandum as well as the two Dow documents. In reviewing the major recent work product cases, *Roxworthy*, *Textron*, and *Regions Financial*, the importance and specificity of supporting declarations cannot be overemphasized. Please see our discussion of this point in our update on the *Regions Financial* case here: <http://www.mofo.com/news/updates/files/13891.html>.

⁵ In that regard we recommend that companies consider appropriate memorialization of the purpose of such meeting through a letter which schedules a meeting or an agenda for the meeting.

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reflecting on how the D.C. Circuit panel might have reacted to the dissent's characterization of the majority's decision in *Textron* as misleading and corruptive of proper appellate jurisprudence. Brother and sister judges normally do not resort to this sort of language to express their disagreement and surely the D.C. Circuit took note.

Though the *Textron* decision is not a model of clarity, it is reasonable to conclude that there is a certain fundamental difference between the two courts regarding the starting point for analyzing work product issues. As we have discussed, the D.C. Circuit began with the premise that the common law doctrine protects intangible work product. The First Circuit begins with an inquiry into a document's ostensible purpose. Thus, for the D.C. Circuit its beginning point allows it to isolate the contents of the Deloitte memorandum from its ostensible purpose. The First Circuit, on the other hand, viewed the rest of the analysis through the lens of the ostensible purpose of the document without adequately considering whether the contents of *Textron's* workpapers separately merited protection.

The D.C. Circuit concluded its analysis of the Deloitte memorandum by instructing the lower court to review the Deloitte memorandum on remand and determine to what extent portions of that memorandum do not include Dow's counsel's mental impressions. The remand poses something of a practical problem for the lower court given that memoranda of meetings can present a record of statements and thoughts that are intertwined and incapable of being extracted in any easy manner. In any event, Dow should feel fairly confident that its counsel's litigation views will be excised from whatever is ultimately provided to the Government.

DISCLOSING WORK PRODUCT TO OUTSIDE AUDITORS IS NOT A WAIVER

Following the trend in various district court decisions, the D.C. Circuit concluded that Deloitte's possession of the two Dow documents did not constitute a waiver of the work product protection.⁶ Although this was not an unexpected result, the D.C. Circuit took care to address several nuances not addressed in prior decisions.

It first addressed the Government's argument that disclosure to Deloitte constituted a waiver because public companies occasionally get into disputes with their auditors who can, to the detriment of the company, issue a qualified opinion. The standard for waiver of work product, noted the court, is disclosure to an adversary or conduit to an adversary. Slip op. at 15-16. The court found that Deloitte was neither an adversary nor a conduit.

In concluding that the auditor was not an adversary, the court pointed to professional standards of conduct that require auditor independence. These standards provide that actual or threatened litigation with the attest client would compromise independence and require withdrawal of the auditor. The court went on to consider whether the threat of a qualified audit opinion constituted the requisite adversary status to warrant a waiver of work product and concluded that this was not the type of possible conflict that is inconsistent with work product protection. Of course, there is always the possibility of a future conflict between two parties, but this too, the court opined, was not enough to warrant waiver. None of these conflicts or potential conflicts are such that disclosures to the auditor "undercut the adversary process." *Id.* at 16-17.

The court then engaged in a refinement of the analysis: "[T]he question is not whether Deloitte could be Dow's adversary in any conceivable future litigation, but whether Deloitte could be Dow's adversary in the sort of litigation the Dow

⁶ The court did specifically consider whether there was a waiver with respect to the intangible work product contained in the Deloitte memorandum but the analysis regarding the Dow documents is clearly sufficient to answer that question in the negative.

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Documents address.” Id. at 17. Work product is defined with respect to particular anticipated litigation so that disclosure where the recipient has some stake in that litigation is the only relevant fact supporting a conclusion of waiver. Where the recipient does not have a stake in that litigation there should be no waiver.

The court next considered whether Deloitte was a conduit to an adversary. The concept of conduit implies a certain necessity such that the placement of an item in a conduit necessarily conveys that item to the conduit’s destination. In the work product context, courts have generally considered the obligations to maintain confidentiality on the part of the recipient to determine whether the recipient is a conduit.⁷ Thus, if the recipient is bound by confidentiality, whether through an agreement or by internal standards, the disclosing party can reasonably rely on upon those obligations and the recipient will not be considered a conduit.

In the case of Deloitte, the court focused on the code of professional conduct applicable to all certified public accountants, specifically Rule 301 of the AICPA code of conduct, which provides that an accountant will not disclose any confidential client information without consent. This ethical obligation formed the basis for Dow’s reasonable expectation that Deloitte would keep information it received confidential. Slip op. at 20.

The court then addressed three arguments of the Government. First, the Government argued that Deloitte’s ethical obligations were not strong enough to warrant Dow’s reasonable expectation of secrecy because Deloitte is bound to comply with valid subpoenas or summonses. The answer is that work product is always a defense to a summons. The Government then argued that Deloitte could force Dow to disclose confidential information in its financial statements, or that Deloitte itself could be required to provide information in the case of an SEC proceeding or if there were illegal acts. Again, the court noted that nothing in these situations allowed a third party to overcome the work product protection: “[T]he government has neither pointed to any regulatory provision nor posited any specific circumstance under which Deloitte would be required to disclose attorney work product like that contained in the Dow Documents.” Id. at 21. Finally, the Government relied upon *Arthur Young* for the proposition that a public accountant’s interpretation of a company’s financial statements should not be kept confidential for the sake of the investing public. The court responded by saying that *Arthur Young* did not require that attorney work product be disclosed. Indeed, as was pointed out by the original panel decision in *Textron*, *Arthur Young* addressed the creation of a new accountant work product rule, and did not cite Rule 26(b)(3) nor consider the circumstances of attorney work product that becomes associated with the outside auditor’s workpapers in the course of an audit. Accordingly, the court distinguished *Arthur Young* and concluded that Deloitte was not a conduit to the IRS or other Dow adversaries.

PRACTICAL CONSIDERATIONS

Some practical advice is suggested by the decision:

- Keep a record regarding the purpose of meeting with outside auditors and intention to discuss litigation evaluations as part of the meeting agenda.
- Supplement existing ethical requirements of confidentiality for accountants regarding their attest client files with a specific agreement between the client and auditor setting forth conditions of confidentiality.⁸

⁷ The court also notes that “selective disclosure,” in which a party discloses some information to an adversary, can cause waiver of the work product protection. This circumstance does not apply in this case because Deloitte is not an adversary.

⁸ We note that many state business and profession codes impose confidentiality as a matter of law not just ethics.

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- Request that the auditor segregate from its own audit workpapers work product documents received from the company.
- Request that any use of such work product in the audit workpapers be specifically identified to the company.

WHAT IF ATTORNEY STATEMENTS FIND THEIR WAY INTO THE AUDITOR'S WORKPAPERS?

The Deloitte decision raises the question of whether work product should protect all recordings of attorney's mental impressions wherever found in the auditor's workpapers and not just those in separate memoranda. For example, what if the auditor in drafting its own workpapers instead of merely attaching the specific client memo or analysis as backup repeats various parts of that analysis in its own write-up? *Arthur Young* provides that there is no accountant work-product like protection for an outside auditor's own workpapers. However, *Arthur Young* itself never addressed either the common law doctrine of work product or Rule 26(b)(3). Under the analysis of the D.C. circuit, this type of "cut and paste" replication of the audit client's work product should receive equal protection and be redacted before any auditor workpapers are provided to the IRS.

UNCERTAIN TAX POSITIONS

The IRS is currently considering finalization of the draft Form UTP, a document that the Chief Counsel has described as a "game-changer." The IRS has received numerous, mostly negative, comments regarding the proposal. In particular, the draft Form's requirement that a taxpayer identify the uncertain position, the rationale for why it is uncertain and the maximum tax adjustment relating to that position seems to be the equivalent of asking the taxpayer to give the IRS exactly the type of information that should be protected by the work product doctrine. Does the D.C. Circuit opinion provide a rationale for asserting work product with respect to the information requested on the draft Form UTP? Certainly the requirement of stating the rationale and identifying a position as uncertain is requesting at some level a company's internal legal analysis regarding the strengths and weaknesses of the particular position. If we consider the D.C. Circuit's decision as a redemption of the core purpose of the common law work product doctrine, it would appear there is a potential for such a rationale.

REVISITING ATTORNEY-CLIENT PRIVILEGE

Most practitioners conclude that the disclosure of attorney-client privileged material to an outside auditor waives the privilege. There is certainly a solid basis for that inasmuch as generally third parties who are not assisting the attorney in rendering legal advice either as clerical or *Kovel* agents are considered outsiders to the privileged group. Auditors are not assisting in-house counsel or other counsel in rendering legal advice. Accordingly, the district court in *Textron* held that the attorney-client privilege (and section 7525 tax advisor privilege) had been waived when Textron showed its outside auditor its internal workpapers. The issue was not even raised on appeal.

But should that be the end of the discussion? In the highly transparent world of public companies, it seems punitive to also require public companies to give up the oldest and most important of evidentiary privileges merely because they are accountable to the investing public. Indeed, it would seem more important to preserve such protections for the sake of the investing public. Alternatively, should privilege be treated as waived when disclosure is required by certain laws? The spirit of this argument is at play in the Deloitte decision regarding work product inasmuch as public companies are required to divulge their internal analyses in order to obtain unqualified opinions and maintain their public listings. Public accountant review is built into our regulatory system and actions in accordance with that system should not be treated as having the collateral affect of waiver. The D.C. Circuit addresses the point indirectly:

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Furthermore, we are mindful that independent auditors have significant leverage over the companies whose finances they audit. An auditor can essentially compel disclosure by refusing to provide an unqualified opinion otherwise. Finding waiver based on such disclosures could well encourage the sort of “[i]nefficiency, unfairness and sharp practices” that *Hickman* sought to avoid. For example, it might discourage companies from seeking legal advice and candidly disclosing that information to independent auditors. Moreover, the government has not proffered any good reason for wanting the Dow Documents other than its desire to know what Dow’s counsel thought about the Chemtech partnerships. Granting discovery under these circumstances would undercut the adversary process and let the government litigate “on wits borrowed from the adversary,” *Hickman*, 329 U.S. at 516 (Jackson, J., concurring).

Slip op. at 22. Can the same argument be made for rejecting the waiver of the attorney-client privilege or at least rejecting a possible argument that disclosure of the information causes subject-matter waiver of the privilege? Subject-matter waiver would entitle the discovering party to all communications on the particular topic, not just those that involve the outside auditor, and so would seem to be excessively punitive solely because the company is complying with securities laws and regulations.⁹ Such a result would seem to thwart a fundamental goal of the attorney-client privilege to encourage uninhibited communication between client and counsel similar to the D.C. Circuit’s concern noted above regarding the potential frustration of the goal of work product to protect our adversarial system.

STATE TAX CONSIDERATIONS

The “practical considerations” and advice discussed above apply equally in the context of state tax audits and disputes, where there have also been broadened requirements for disclosure to outside auditors and attempts by state taxing agencies to obtain documents that should be covered by the attorney-client or work-product privilege. While cases decided under the federal rules discussed in *Deloitte* may not be controlling in state courts or administrative tribunals, the basic principles of the work product doctrine, as articulated by the United States Supreme Court in *Hickman v. Taylor*, are generally applicable in state courts, and in some states arguably even greater protection is available under state law. For example, New York’s statute provides that “[t]he work product of an attorney shall not be obtainable.” N.Y.C.P.L.R. § 3101(c). It also provides that “materials otherwise discoverable . . . prepared in anticipation of litigation or for trial by or for another party, or by or for that other party’s representative (including an attorney, consultant, surety, indemnitor, insurer or agent), may be obtained only upon a showing that the party seeking discovery has substantial need of the materials . . . and is unable without undue hardship to obtain the substantial equivalent of the materials by other means.” N.Y.C.P.L.R. § 3101(d)(2). Similarly, California law provides that (a) “[a] writing that reflects an attorney’s impressions, conclusions, opinions, or legal research or theories is not discoverable under any circumstances” and (b) “[t]he work product of an attorney, other than a writing described in subdivision (a), is not discoverable unless the court determines that denial of discovery will unfairly prejudice the party seeking discovery in preparing that party’s claim or defense or will result in an injustice.” Section 2018.030 of the California Code of Civil Procedure.

After the First Circuit decision in *Textron*, some state revenue departments indicated an intention to rely on that decision to institute broader discovery requests. This decision by the D.C. Circuit in *Deloitte* should slow that momentum, and

⁹For another discussion of this topic, see Prof. Dennis Ventry, *U.S. v. Textron: What to Make of Attorney Work Product for Regulatory Lawyers after the Supreme Court’s Cert. Denial?*, (May 25, 2010) at <http://taxprof.typepad.com/files/ventry.pdf>.

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serve to demonstrate that the broad protections for attorney-client privilege and work product materials, recognized by the majority of the federal circuits and clearly provided by many state laws, are still valid and should be firmly asserted.

WILL THE GOVERNMENT SEEK CERTIORARI?

We are not aware of any public statements by the Government to this effect. It would put the Government in the interesting position of arguing circuit conflict. A mere three and a half months ago it argued to the Supreme Court in the *Textron* certiorari briefing that there was no conflict because no other circuit court had reached a different conclusion regarding the application of work product to internal tax accrual workpapers. If the Government decides to seek certiorari, how will it characterize the D.C. Circuit's opinion as a conflict? It would be inconsistent for it to point to the longstanding underlying circuit conflict regarding the appropriate test for work product because it rejected that as a basis for circuit conflict in its brief to the Supreme Court in *Textron*. In any event, the Government has 90 days after entry of judgment or denial of rehearing request which means we should find out the answer before the end of the year.

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