Are Auditor Work-Papers Discoverable? The D.C. Circuit Joins the Fray

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In the United States, the "work-product" doctrine ensures that attorneys can effectively prepare for litigation and trial by protecting their notes, preparatory materials, and internal analyses from discovery. The Supreme Court recognized long-ago that giving opposing counsel access to such work product would cause serious problems:

[M]uch of what is now put down in writing would remain unwritten. An attorney's thoughts, heretofore inviolate, would not be his own. Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial. The effect on the legal profession would be demoralizing. And the interests of the client and the cause of justice would be poorly served.

Hickman v. Taylor, 329 U.S. 495, 511 (1947). At the federal level, the work-product doctrine was subsequently partially codified in Federal Rule of Civil Procedure 26(b)(3), which states that, ordinarily, "a party may not discover documents and tangible things that are prepared in anticipation of litigation" by the opposing party or its representative.

Unlike the protection afforded by the attorney-client privilege, voluntary disclosure of attorney work-product to an independent third party does not necessarily waive work-product protection. *See, e.g., United States v. American Telephone & Telegraph Co.*, 642 F.2d 1285, 1299 (D.C. Cir. 1980). Generally, voluntary disclosure waives the work-product protection only when it is inconsistent with the disclosing party's expectation of secrecy from its adversary. *Rockwell International Corp. v. U.S. Department of Justice*, 235 F.3d 598, 605 (D.C. Cir. 2001).

One area in which application of the work-product doctrine can be particularly important, and controversial, is auditor materials. Especially in securities, tax, and financial fraud cases, auditor workpapers can constitute critical evidence. Before June 2010, the two circuit courts to address the issue had held that tax workpapers in the possession of auditors were *not* protected from discovery by the work-product doctrine, even if they addressed potential litigation and reflected attorney advice.

In *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009) *(en banc), cert. denied, Textron v. United States,* 130 S. Ct. 3320 (2010), the IRS issued an administrative summons to Textron to allow the IRS to examine books, papers, and other data that might be relevant to its inquiry. 577 F.3d at 24. Textron refused to produce certain workpapers, including spreadsheets showing (1) amounts in controversy, (2) the estimated probability of a successful challenge by the IRS, and (3) resulting reserve amounts, as well as supporting e-mail messages and notes. *Id.* at 25. Textron admitted to having shown the withheld documents to its independent auditor, but it had physically retained them. *Id.*

The district court had rejected the IRS's attempt to enforce the summons. It held that the documents were work product because they included legal analysis and were prepared "because of" the prospect of litigation. *Id.* at 25-26 (*citing United States v. Textron Inc.*, 507 F. Supp. 2d 138, 150 (D.R.I. 2007)). On appeal, a divided three-judge panel of the First Circuit affirmed that ruling. *Id.* at 26. However, an *en banc* panel reversed the three-judge panel, holding that the workpapers were not protected because they were created as part of an independent audit, not for "potential use in litigation." *Id.* at 30.

The Fifth Circuit earlier reached the same conclusion in *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982). There, the IRS sued to enforce summonses seeking "all analyses prepared by the El Paso Company regarding potential tax liabilities and tax problems." *Id.* at 533. The company refused to produce any documents, asserting, among other things, work-product protection. The district court enforced the summons and the Fifth Circuit affirmed, requiring El Paso to produce tax accrual workpapers that it had prepared internally and shared with its independent auditor. The Fifth Circuit recognized that creating the workpapers "involve[d] weighing legal arguments, predicting the stance of the IRS, and forecasting the ultimate likelihood of sustaining El Paso's position in court." *Id.* at 543. Nevertheless, the court found that the workpapers were not protected by the work-product doctrine because they were not prepared primarily "to ready El Paso for litigation over its tax returns," but "to anticipate, for financial reporting purposes, what the impact of litigation might be on the company's tax liability." *Id.* at 543.

United States v. Deloitte

But in June 2010, the D.C. Circuit reached the opposite conclusion in *United States v. Deloitte LLP*, 610 F.3d 129 (2010). In

2005, Dow Chemical Company filed suit in Louisiana, challenging IRS adjustments to tax returns filed by four Dow subsidiaries. During discovery, the IRS subpoenaed documents from Dow's outside auditor, Deloitte & Touche USA, LLP. Because the IRS required the production of documents in the District of Columbia, the subpoena issued from that district court. At Dow's request, however, Deloitte withheld three documents on the basis of the work-product doctrine. They were (1) a memorandum prepared by Deloitte that summarized a meeting between Dow employees, Dow's outside counsel, and Deloitte employees concerning the possibility of litigation, and the necessity of accounting for such a possibility in an ongoing audit; (2) a memorandum prepared by Dow's in-house counsel and given to Deloitte; and (3) a tax opinion prepared by Dow's outside counsel and also provided to Deloitte. The IRS moved to compel their production.

The district court denied the motion. It held that the memorandum prepared by Deloitte was work product, having been "prepared because of the prospect of litigation with the IRS over the tax treatment of [one of the subsidiaries]." *United States v. Deloitte & Touche USA LLP*, 623 F. Supp. 2d 39, 40 n.1 (D.D.C. 2009). Even though Deloitte prepared the document, not Dow or its counsel, "its contents record[ed] the thoughts of Dow's counsel regarding the prospect of litigation." *Id.* The district court rejected the IRS's argument that Dow's disclosure of the three documents to Deloitte waived work-product protection, finding that the disclosure was not inconsistent with maintaining secrecy of the documents. Deloitte was not a potential adversary, and nothing suggested that it was unreasonable for Dow to expect Deloitte to maintain confidentiality. *Id.* at 41.

On appeal, the IRS argued that the Deloitte memorandum could not be work product because it was created by Deloitte, not Dow or its representative, and it was generated as part of the routine audit process, not in anticipation of litigation. The D.C. Circuit disagreed. Under *Hickman*, the relevant question is not *who* created the document, but rather *whether the document contains work product*, i.e., "the thoughts and opinions of counsel developed in anticipation of litigation." Deloitte, 610 F.3d at 136. Because the *Deloitte* memorandum recorded the thoughts of Dow's counsel, the fact that it was prepared by Deloitte did not foreclose work-product protection. *Id.*

The court then turned to a more difficult question: whether the Deloitte memorandum was entitled to work-product protection even though it was generated as part of an annual audit. Writing for the majority, Chief Judge Sentelle opined that Federal Rule of Civil Procedure 26(b)(3) only partially codifies the work-product doctrine. While Rule 26(b)(3) addresses "documents and tangible things," the doctrine prescribed by the Supreme Court was much broader, extending to "'intangible' things" such as theories, mental impressions, and opinions. The "work product" is not documents, but the mental impressions and opinions memorialized in documents. Therefore, the "in anticipation of litigation" inquiry should focus not on the function of the document, but on its contents. "[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." *Id.* at 138 (emphasis added). Because the district court had not reviewed the Deloitte memorandum *in camera* to determine whether any of it was prepared because of the prospect of litigation, the D.C. Circuit remanded to the district court to make this determination.

The court then turned to the IRS's argument that Dow had waived any claim to work-product protection over the remaining two documents—which the IRS conceded were protected in the first instance—when it disclosed them to Deloitte. Whether disclosure to an outside auditor constitutes waiver of the work-product doctrine was an issue of first impression at the federal appellate level.

The IRS argued that Deloitte was a potential adversary or conduit to other adversaries and, therefore, disclosure to Deloitte was inconsistent with the maintenance of secrecy from Dow's adversaries. The court disagreed. In considering whether Deloitte was a potential adversary, the court focused not on whether Deloitte could be Dow's adversary *in any conceivable future litigation*, but on whether Deloitte could be Dow's adversary *in the sort of litigation the Dow documents addressed*. Because the Dow documents were prepared in anticipation of a dispute with the IRS—not with Deloitte—Deloitte could not be considered a potential adversary. Nor was Deloitte a conduit to other adversaries because, as an independent auditor, it was obliged not to disclose Dow's confidential information. The D.C. Circuit therefore found that Dow had a reasonable expectation of privacy in the documents, and their disclosure to Deloitte did not waive work-product protection.

Deloitte's Implications

In light of the split between the First and Fifth Circuits on the one hand, and the D.C. Circuit on the other, *Deloitte* is unlikely to be the last word on the application of the work-product doctrine to tax workpapers. Many commentators have suggested that the *Deloitte* decision increases the likelihood that the Supreme Court will take up this issue. For now, however, *Deloitte*

represents a formidable weapon against attempts by the IRS and private litigants to compel production of tax documents that reflect or incorporate the thoughts or impressions of a party's attorney. Further, because the U.S. Tax Court is bound to follow the decisions of the D.C. Circuit on evidentiary issues (*see* Tax Court Rule 143(a)), ***Deloitte's*** impact is likely to be widely felt. But until the Supreme Court weighs in, taxpayers must still remain cautious about disclosure of legal analysis to their outside auditors and should not assume that such documents will necessarily be protected from discovery.