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Regions Financial Corp. Persuades District Court that Tax Opinions Provided to Outside Auditors Are Protected Work Product

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Replaying the victory of Textron[1] in 2007, Regions Financial Corporation ("RFC") prevailed last week (May 8) in its opposition to an IRS summons seeking certain tax accrual workpapers from RFC's outside auditor. While the IRS has been successful litigating the merits of what it considers to be abusive shelters, it has largely met with failure in attempting to override evidentiary protections such as the work product doctrine. (Click here to view the decision.)

Background

In connection with the tax audit of RFC for the 2001 through 2003 tax years, in April 2006 the IRS issued a summons to RFC's outside auditor, Ernst & Young ("E&Y"), requesting all tax accrual workpapers that E&Y had created or assembled in connection with its audit of RFC. During the course of the audit, the IRS had determined that RFC had participated in two listed transactions during the audited tax years, and, pursuant to its tax accrual workpaper policy, the IRS sought all the tax accrual workpapers relating to the 2002 and 2003 tax years, although for the 2001 tax year the IRS sought only the workpapers relating to the listed transactions.

RFC moved to quash the summons on grounds of work product. Work product protects from disclosure documents and tangible things that are created in anticipation of litigation. *See* Fed. R. Civ. Pr. 26(b)(3). Eventually the dispute narrowed to four tax opinions from RFC's tax advisors that were in E&Y's files. RFC instructed E&Y to decline to produce four tax opinions: three authored by its outside tax counsel, Alston & Bird; and one authored by tax professionals at E&Y who were separate from the audit team. RFC claimed that these opinions were protected by work product. RFC also claimed that certain portions of several other documents that referenced the tax opinions were also protected under work product. The tax opinions discussed a transaction in which an existing REIT subsidiary of RFC issued new preferred stock that was subsequently acquired by the European Reconstruction and Development Bank (the "ERDB Transaction").[2]

The district court ruled that the documents at issue were protected work product and, like the judge in *Textron*, suggested that the preparation of analyses with respect to contingent tax liabilities is fundamentally an action carried out in anticipation of litigation.[3] The court did not resolve the uncertainty as to the standard for application of work product in the 11th Circuit (to which the case would be appealed). Instead the court said that under either the more restrictive "primary purpose" test or the less restrictive "because of litigation" test the documents met the requirements for work product protection.

Supporting Affidavits Were Critical to Work Product Claim

There was no dispute between the parties that the opinions at issue contained RFC's advisors' analyses regarding the merits of the consent dividend treatment of the ERBD Transaction. Thus, the *content* of the documents was consistent with RFC's claim of work product protection. Indeed, the IRS did not attempt to argue that its need for the information and facts contained in the opinions should overcome RFC's claim of work product (as it was entitled to do under Fed. R. Civ. Pr. 26(b)

(3)). This showed that the IRS was not interested in obtaining facts regarding the transaction – it wanted to see the taxpayer's legal analysis. RFC conceded that the IRS was entitled to the facts. Based on its *in camera* review in which the court found that the documents contained "the mental impressions and opinions of RFC's lawyers" the court noted that: "the contested documents contain precisely the kind of legal analysis that the work product doctrine exists to protect." Slip Op. at 13. The court cited *United States v. Roxworthy,* 457 F.3d 590, 598 (6th Cir. 2006), for the statement that this factor weighs in favor of recognizing the documents as protected.

Because of the parties' positions, the arguments before the court focused on whether the work product doctrine applied, not on whether the IRS had made a showing sufficient to override those protections because of need to obtain the facts. Work product depends on the purpose for the creation of the document sought to be protected from disclosure – was it created in anticipation of litigation? This is rarely an open question for documents prepared in connection with actual or imminent litigation. However, if the document is created before even a threat of litigation, as here and in *Textron*, the question is potentially debatable. Moreover, because RFC's opinions were used in the course of the E&Y audit to support RFC's tax reserves in the financial statements, this case raised the issue argued by the IRS that the documents were created not because of possible litigation but because of financial reporting requirements.

Once again though, as in *Textron*, careful presentation of key testimony was critical to RFC's victory. The affidavits submitted by RFC established that: (1) RFC's general counsel solicited the tax opinions, (2) the General Counsel was concerned with the prospect of litigation regarding the ERBD Transaction, (3) RFC solicited the tax opinions from outside tax advisors because of the anticipated conflict with the IRS, and (4) RFC, outside counsel, and E&Y would maintain the confidentiality of the documents.

The Court Endorses the "Because Of" Test

The central argument in the case concerned the appropriate work product test. The minority view, advocated by the IRS, is that the primary motivating purpose for the creation of the document must be to assist in pending or impending litigation.[4] The majority view is that the document must be created "because of" the prospect of litigation.[5] The majority view thus extends the protection of work product to documents that have been created earlier in time than actual commencement or threat of litigation and to documents that may have a dual purpose in their creation. In *Roxworthy,* for example, the Sixth Circuit recognized work product protection for a tax opinion from an outside accounting firm even though the document may have served both a litigation preparation and penalty protection purpose.

The district court, after a lengthy consideration of competing case law in the Fifth and Eleventh Circuits, did not definitely resolve which test the Eleventh Circuit would follow. However, it stated that "[i]f it were forced to decide the question, the court concludes that the 11th Circuit would align itself with the majority of the other courts of appeal and adopt the 'because of litigation' test" rather than the "primary motivating purpose test." Slip. Op. at 10. The court avoided a definitive ruling on which test would be adopted by finding that RFC prevailed under both tests. Here the evidence supplied by RFC carried the day, for even under the more restrictive primary motive test, the court summarized its view regarding the purpose for which the documents were created:

> It was clear in this case that Regions was primarily motivated by litigation when it solicited opinions about the potential outcomes of *litigation* from Alston & Bird and E&Y. The fact that Regions undertook the time and expense of consulting outside firms to assess its potential liabilities shows that it believed litigation to be likely, and this court cannot say that RFC's subjective belief was objectively unreasonable.

Slip Op. at 12 (emphasis in original). Showing that it preferred the more inclusive "because of litigation" test, the court vigorously shredded the IRS's argument that RFC had to prove that the opinions were not used for financial reporting purposes in order to establish the necessary anticipation of litigation purpose. The court wrote:

> It appears that the Service's argument is that Regions cannot claim work product production **[sic ("protection" intended)]** if the contested documents had *any use other* than litigation preparation. The IRS has not cited, nor has the court found, any authority that articulates such a test. Indeed the court has found no support for the conclusion that a party must show that it was motivated by preparation for litigation *and nothing else* in order to claim that a document is protected work product.

Slip. Op. at 13 (emphasis in original).

The court rounded out its analysis by taking up the IRS's argument that the tax opinions were created for financial reporting purposes, i.e., to support RFC's calculation of tax reserves when those reserves came under scrutiny by its outside auditors. The court accepted RFC's response and turned this argument against the IRS. The court said that it was because of the possibility that the IRS would litigate the tax consequences of the transaction that RFC was required to establish a reserve for a contingent liability in its financial statements audited by E&Y. *See* Slip Op. at 11. Thus, anticipation of litigation necessarily precedes creation of reserves for contingent tax liabilities.

***Arthur Young* and Accountant-Created Work Product**

In briefing, the IRS argued that the 1984 Supreme Court decision, *United States v. Arthur Young & Co.*, 465 U.S. 805, supported the proposition that there was no protection available to tax accrual workpaper files maintained by an outside auditor. *Arthur Young* specifically rejected the creation of an accountant-client privilege applicable to tax accrual workpapers or other communications. The underlying question posed by the IRS with the RFC summons was whether documents created by the audited company or its advisors, which subsequently become part of the outside auditor files, fall into the *Arthur Young* rule of non-protection for auditor workpapers. The IRS's contention was that *Arthur Young* removed all protections from outside auditor workpaper files. This was a stretch (and ultimately an overreach) of the principle of *Arthur Young.* An auditor's workpapers are generally understood to be the documents that *the auditor* creates to support its audit conclusions. The auditor may have other documents, such as the audited company's tax opinion, which are associated with the workpaper files but are not, in the usual sense, the auditor's workpapers.

The district court did not discuss the Supreme Court decision in *Arthur Young.* It analyzed an 11th Circuit opinion, *United States v. Newton*, 718 F.2d 1015 (1983). *Newton*, anticipating the Supreme Court's views, rejected the Second Circuit decision in *Arthur Young*, which had recognized a new accountant-client privilege. Based upon its analysis of *Newton* the district judge noted that *Arthur Young* really involved a claimed new accountant client privilege and not work product protection for materials prepared by attorneys or accountants: "*Newton* cannot be read to prevent the protection of trial preparation materials simply because they were created by an accountant. *See* Fed. R. Civ. Pr. 26(b)(3)(A) (extending work product to materials created by a 'party or its representative')." Slip Op. at 7.

Thus, because the Supreme Court in *Arthur Young* rejected the Second Circuit's creation of a new accountant-client privilege (erroneously described by the Second Circuit at times as accountant work product as noted by the court in *Newton*) and did not address the application of work product doctrine to third-party documents (including documents prepared by the audit firm in an advisory capacity in connection with anticipated litigation) in the auditor's workpapers, the court reasoned that the protection afforded by that rule could still apply to such documents.[6] In other words, the tax opinions created by RFC's outside tax advisors retained work product protection even though they were provided to the outside auditor in connection with the auditor's preparation of its workpapers. The proper analytical question (discussed below) was whether such provision constituted a waiver of work product. Also, with regard to the E&Y opinion, the judge clearly recognized that work product protection can apply to a document produced by an accountant acting in the capacity of a tax advisor.

Waiver?

The court found that RFC had not waived work product by providing its outside auditor with the contested documents during the course of the audit. Here the district court judge followed the trend of cases and held that outside auditors are not adversaries or conduits to adversaries. Accordingly, supplying the documents to the accountants did not substantially increase the risk that an adversary would obtain the documents, and thus there was no waiver of work product privilege. Moreover, because E&Y maintained the confidentiality of its audit files, and because RFC and its tax advisors agreed to confidentiality regarding the opinions, there was no opportunity for the documents to be distributed outside the zone of work product protection.

Footnotes:

[1] The Textron case is now fully briefed on appeal to the First Circuit. In *Textron* (507 F. Supp. 2d 138 (D.R.I. 2007)), the IRS sought tax accrual workpapers from the files of the taxpayer, whereas in this case the IRS issued the summons to the outside auditor for documents in its files.

[2] As described in briefing before the court, the transaction was intended to raise Tier 1 and Tier 2 regulatory capital for RFC. RFC understood that significant tax benefits could result from the transaction (almost $400 million of sheltered income) based on a favorable treatment of the dividends to the ERDB.

[3] In *Textron*, the documents at issue were the spreadsheet and backup analysis prepared in-house that supported the tax reserves. The district judge in *Textron* reasoned that there would have been no need to establish reserves and prepare such analysis were it not for the potential for litigation with the IRS.

[4] The district judge chastised the IRS for its erroneous formulation of this test. Citing a leading minority view case, *El Paso v. United States*, 682 F.2d 530 (5th Cir.), the IRS stated that the primary motivation test required that the document be created "primarily or exclusively to assist in future litigation." Slip. Op. at 6, n. 4. The judge pointed out that the circuit court never used the words "exclusively." That a work-product-protected document might have other uses and purposes in addition to preparing for litigation is consistent with the district court's analysis throughout the opinion.

[5] The leading majority case is *United States v. Adlman*, 134 F.3d 1194 (1998).

[6] The court, relying on the Supreme Court's ruling in *Upjohn v. United States*, 449 U.S. 383 (1981) that the work product privilege limits the IRS's summons power, essentially held that the work product protection does not evaporate simply because the document is provided to an outside auditor.