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The Second Circuit Reaffirms the work-product Doctrine's Scope

By Kenan Mullis

When tax controversy or litigation is anticipated, retaining confidentiality of documents is of the utmost importance. Fortunately, a recent decision brings good news for taxpayers. In *Schaeffler v. United States*,[1] the United States Court of Appeals for the Second Circuit issued a taxpayer-friendly decision on the scope of the attorney-client privilege and the work-product doctrine, holding that (1) the taxpayer did not waive attorney-client privilege[2] when it shared a document created by an accounting firm with a consortium of banks because the taxpayer and banks shared a common legal interest; and (2) the work-product doctrine also protected the documents. Significantly, the court's work-product doctrine holding departs from the analysis used by the First Circuit Court of Appeals in *United States v. Textron*[3] to hold that the work-product doctrine did not protect tax accrual workpapers. Further, the *Schaeffler* decision should prove useful for taxpayers pursuing issues on a mutual basis with other parties who have a common interest.

Georg Schaeffler was the 80 percent owner of the Schaeffler Group (collectively, "Schaeffler"), an automotive and industrial parts supplier incorporated in Germany. In 2008, Schaeffler sought to acquire a minority interest in the German company Continental AG by means of a tender offer financed with an €11 billion loan from a consortium of banks. German law prohibits a tender offer seeking less than all of a company's shares, so Schaeffler made the offer at a price that was estimated to result in the acquisition of the desired number of shares. During the offer period, the financial crisis of 2008 significantly worsened, the price of Continental AG shares fell sharply, and because German law prohibited the offer's withdrawal, far more shareholders than anticipated accepted the offer. Schaeffler emerged as the 90 percent owner of Continental AG, a result that threatened Schaeffler's solvency and ability to repay the bank consortium's loan.

Schaeffler and the consortium sought to refinance the debt and restructure the group. Due to the complexity of the refinancing and restructuring, and anticipating IRS scrutiny of the U.S. tax consequences, Schaeffler retained Ernst & Young (EY) and Dentons US LLP, and it executed an agreement with the consortium to share legal analyses. When the IRS did, indeed, commence an audit, Schaeffler sought to quash the IRS's demand for tax opinions, arguing both that they were privileged and entitled to protection as attorney work-product. A district court denied the petition to quash, holding that Schaeffler had waived attorney-client privilege by sharing the documents with the bank consortium and also rejecting the work-product claim. On appeal, the Second Circuit vacated and remanded the district court's decision.

Attorney-client privilege protects communications between a lawyer and his or her client that are intended to be (and in fact are) kept confidential for the purpose of obtaining or providing legal advice. It is intended to encourage clients to communicate freely and openly with their lawyer. Generally, the privilege is deemed waived if the client voluntarily discloses otherwise-privileged information to a third party. However, privilege is not destroyed where the client has a common legal interest with that third party, and the communication is in furtherance of that ongoing common enterprise.[4]

Against this background, the Second Circuit examined whether the bank consortium's common interest with Schaeffler was "of a sufficient legal character" to avoid waiver of the privilege upon the sharing of documents prepared by EY with the banks. In holding that it was, the court noted several facts. According to the court, both parties stood to avoid a "mutual financial disaster" (that is, Schaeffler's insolvency and resulting default on the consortium's loan) by securing a particular tax treatment for the refinancing and restructuring. Securing this treatment, they expected, would involve a legal encounter with the IRS, and thus, both Schaeffler and the banks had a common interest in that legal encounter's outcome. The court further explained that the EY documents at issue were "directed to the tax issues, a legal problem albeit with commercial consequences," and that "[a] financial interest of a party, no matter how large, does not preclude a court from finding a legal interest shared with another party where the legal aspects materially affect the financial interests."[5]

As *Schaeffler* shows, before sharing otherwise-privileged documents, taxpayers and tax professionals should take care to distinguish between a shared interest that is purely commercial and a shared interest in a legal outcome that affects a commercial interest. Further, attorney-client privilege requires that the purpose of a communication be to obtain or provide legal advice, and therefore a document shared under the theory of a common legal interest also must be for the acquisition or provision of legal advice. A document drafted to assess the commercial wisdom or commercial consequences of various decisions, even if legal advice is contained therein, will not be protected. Thus, the author of a document that will be shared should clearly identify the parties' common legal interest or common legal strategy to obtain a particular legal outcome. Once

shared, to protect against waiver of the privilege, each party should assure that the shared document is not disseminated.

The IRS has always, to a certain extent, coordinated its efforts to pursue issues that cut across the insurance industry. It is likely this coordination will only increase as a result of the Large Business & International Division's recent restructuring, which will move examinations toward an issue-based, or "campaign," approach.[6] This could give rise to an even greater need for companies to coordinate their efforts on common issues, and the *Schaeffler* decision will be an important and beneficial tool as these efforts go forward.

The second important holding in *Schaeffler* involved the work-product doctrine. That doctrine protects certain documents prepared in anticipation of litigation from discovery, and it is intended to permit lawyers to prepare and develop strategies without unnecessary intrusion by adversaries.[7] Though it most frequently involves an attorney's work, protection also may extend to items prepared by non-attorneys.[8] A document prepared in anticipation of litigation remains work-product even where it is a "dual-purpose document" that will also assist in business dealings.[9]

In holding that the work-product doctrine did apply to the EY documents, the Second Circuit reaffirmed that its governing precedent (*United States v. Adlman*) required the application of a "because of" test; that is, whether a document was prepared or obtained *because of* the prospect of litigation. As the court explained, the tax advice in the EY documents was geared to an anticipated audit and the litigation that likely would follow. Indeed, considering the transaction's size and the complexity and ambiguity of the tax issues, the court stated that any hypothetical scenario where parties to this transaction did not have an eye towards litigation (as the district court had imagined in its analysis) would be "at odds with reality."[10]

The Second Circuit's work-product analysis, which relies heavily on *Adlman* and its "because of" standard, should provide some comfort to taxpayers and tax professionals after the First Circuit's 2009 decision in *United States v. Textron* that tax accrual workpapers were not protected because they were not "prepared for use in" potential litigation. The *Schaeffler* decision confirms that the "because of" standard remains the prevailing test for work-product protection in the Second Circuit and most of the rest of the country,[11] and *Textron's* more restrictive "prepared for use in" standard governs only in the First Circuit. Thus, in most circuits, a memorandum drafted by a tax professional for a client should be protected if it is prepared because of anticipated litigation, even if it will assist in business dealings. Nevertheless, some practical steps could help to enhance the chances of such a memorandum receiving work-product protection: the author might include in the document language that potential litigation with the IRS is anticipated, and the document is being prepared to assist in that potential litigation; and, to avoid waiver, the author should not share the document beyond those who need to see it.

It is common for actuaries to be called upon to support tax departments when tax issues arise. In addition to the informative look at the bounds of the work-product doctrine, *Schaeffler* provides an opportunity to underscore the importance of remembering those practical measures that can lessen the risk that a document prepared in such a support role will be inadvertently discoverable.

The *Schaeffler* decision should ease worry that *Textron* represented a shift toward a narrower application of the work-product doctrine. Instead, it appears that *Textron*'s analysis will be limited to the First Circuit (which covers Maine, New Hampshire, Massachusetts, Rhode Island, and Puerto Rico). Still, tax professionals and actuaries should navigate carefully when preparing documents they expect will be protected from discovery under the work-product doctrine. ■

Kenan Mullis is an associate with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *kmullis@scribnerhall.com.*

ENDNOTES

1 806 F.3d 34 (2d Cir. Nov. 10, 2015), *vacating and remanding* 22 F. Supp.3d 319 (S.D.N.Y. May 28, 2014).

2 Section 7525(a) of the Internal Revenue Code provides that the common law protections of confidentiality applicable to communications between a taxpayer and an attorney also apply to communications between a taxpayer and a federally authorized tax practitioner with respect to tax advice. This generally is known as the "tax practitioner privilege," and it may only be asserted in noncriminal tax matters before the IRS and in noncriminal proceedings in federal court brought by or against the United States. It is essentially coterminous with the attorney-client privilege in terms of scope and waiver in those proceedings. *See United States v. BDO Seidman*, 337 F.3d 802, 810 (7th Cir. 2003); *Salem Fin., Inc. v. United States,* 102 Fed. Cl. 793, 798 (2012). For simplicity, this article will refer to both as attorney-client privilege.

3 577 F.3d 21 (1st Cir. Aug. 13, 2009).

4 *Schaeffler*, 806 F.3d at 40 (citing *United States v. Schwimmer*, 892 F.2d 237 (2d Cir. 1989)).

5 *Id.* at 41-42.

6 *See* IRS Publication 5125, *Large Business & International Examination Process* (Feb. 2016).

7 Fed. R. Civ. P. 26(b)(3); *Hickman v. Taylor,* 329 U.S. 495 (1947); *Schaeffler* at 43 (citing *United States v. Adlman,* 134 F.3d 1194 (2d Cir. 1998)).

8 Rule 26(b)(3) of the Federal Rules of Civil Procedure states the general rule that "a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent)."

9 *Schaeffler,* 806 F.3d at 43 (citing *Adlman).*

10 *Id.* at 44.

11 *See, e.g., In re Grand Jury Proceedings,* 604 F.2d 798 (3d Cir. 1979); *Nat'l Union Fire Ins. Co. of Pittsburgh v. Murray Sheet Metal Co.,* 967 F.2d 980 (4th Cir. 1992); *United States v. Roxworthy,* 457 F.3d 590 (6th Cir. 2006); *Binks Mfg. Co. v. Nat'l Presto Indus., Inc.,* 709 F.2d 1109 (7th Cir. 1983); *Simon v. G.D. Searle & Co.,* 816 F.2d 397 (8th Cir. 1987); *In re Grand Jury Subpoena (Torf),* 357 F.3d 900 (9th Cir. 2003). *But see United States v. El Paso Co.,* 682 F.2d 530 (5th Cir. 1982) (using a "primary motivating purpose" test).