



## Corporate Internal Investigations

### *Do Privileged Investigations Stay Privileged?*

By William E. White and Megan L. Greer

According to the American College of Trial Lawyers, more than 2500 companies conducted internal investigations with the assistance of outside counsel between 2001 and 2008. The recent options backdating scandal alone accounted for 143 internal investigations at public companies. In the wake of the current economic crisis, there will likely be an even greater surge in the number of these investigations.

While companies conduct internal investigations for many reasons, the results of these investigations are often shared with the government. Under guidance from both the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), such cooperation can lead to reduced charges or fines. But the disclosure required by that cooperation with the government leaves open the real possibility that the attorney-client privilege and the work product doctrine may be waived.

As we discuss below, recent court decisions have been finding that these investigations are either not covered by the attorney-client privilege and the work product doctrine or that those privileges have been

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## Attorney Work Product at Risk

### *Textron and the Near Certainty of Supreme Court Review*

By Anthony M. Sabino

A new federal appeals court decision promises to give significant pause to corporate counsel, particularly in-house tax attorneys. To their dismay, the First Circuit has ruled that no amount of anticipation of litigation, nor the intimate involvement of legal counsel, can ever immunize so-called “tax accrual workpapers” from discovery by the IRS. Because of the widespread implications to the conduct of all litigation and the dispensing of legal advice in the business context, and the near certainty of Supreme Court review, we set out the controversy.

*United States v. Textron Inc.*, \_\_\_ F.3d \_\_\_ (1st Cir. Aug. 13, 2009) (available on the First Circuit’s Web site), involves Textron, a well-known aerospace and defense conglomerate. The corporation calculates its tax liability for the dual purposes of preparing audited financial statements, and its tax return. This gives rise to the commonplace necessity for “tax accrual workpapers.”

Tax accrual workpapers are typically spreadsheets that support a corporation’s calculation of tax liabilities, and routinely include an assessment of whether a particular tax deduction will pass muster if challenged by the IRS. Such frank appraisals by in-house and outside tax counsel represent the soft underbelly of corporate accounting, because they give the tax collector a well-marked road to potential tax underpayments.

### **SOME HISTORY**

An audit of Textron’s 1998-2001 tax years revealed that Textron had engaged in several sale-in, lease-out deals, called “SILOs,” deals that have long been flagged by the Service as potentially abusive tax shelters. When the IRS demanded a look at the tax accrual workpapers relating to those transactions, Textron refused, asserting attorney work product privilege. This is a centuries-old concept that focuses on maintaining the confidentiality of material that counsel prepares in preparation for trial or for the possibility of litigation. Textron’s dozen witnesses, nearly all of them in-house lawyers, emphasized that their work was done in preparing for

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what Textron viewed as inevitable litigation. The lower courts agreed that the spreadsheets were attorney work product privileged, and on appeal the matter was placed before the First Circuit for a hearing en banc.

### FIRST-CIRCUIT RATIONALE

A sharply divided court ruled to deny confidentiality to the workpapers. The court emphasized that tax accrual workpapers are indispensable in assessing a company's financial position. The tribunal concluded that provisions of the federal securities law, in conjunction with prevailing accounting and auditing standards, made the creation of the tax accrual workpapers inevitable.

The First Circuit asked if the spreadsheets were they indeed the kind of documents attorneys typically prepared when the prospect or the reality of litigation arose? No, said the court. Judge Boudin bluntly opined that "[a]ny experienced litigator would describe the tax accrual work papers as tax documents and not as case preparation materials." The mere fact that each of the corporation's in-house lawyers "us[ed] the word 'litigation' as often as possible in their testimony" did not persuade the majority. "No one with experience of law suits would talk about tax accrual work papers in those terms."

The First Circuit declared that such an important question could be resolved only by resort to the legal doctrine of work product protection. The tribunal called upon the Supreme Court landmark of *Hickman v. Taylor*, 329 U.S. 495 (1947), which memorialized the long-established concept that material prepared for litigation, whether actually pending

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or merely anticipated, was not subject to disclosure. Significantly, in the intervening years the work product doctrine was codified in Federal Rule of Civil Procedure 26, which set out a stout umbrella of nondisclosure for material "prepared in anticipation of litigation or for trial." Fed. R. Civ. P. 26(b)(3)(A).

In contradistinction, continued Judge Boudin, it is insufficient that "the *subject matter* of a document relates to a subject that might be conceivably litigated ... [n]or is it enough that the materials were prepared by lawyers or represent legal thinking." (emphasis in the original). The court took notice of the vast ocean of documents that modern corporations prepare in the ordinary course of business, many of which bear the imprint of attorneys. In light of present Supreme Court doctrine on attorney work product privilege, the First Circuit concluded the work papers here were not immunized from routine discovery.

Judge Boudin next wrote that the First Circuit was one of the only two federal appeals courts to rule on this specific matter. In *Maine v. U.S. Dep't of Interior*, 298 F.3d 60 (1st Cir. 2002), it had declared that work product protection does not apply to documents prepared in the ordinary course of business or which would have been created in essentially similar form irrespective of the prospect of litigation. Without difficulty, the present day court applied its recent precedent to the case at bar, and concluded Textron's tax accrual workpapers were that very same breed of ordinary business document that would have come into existence, even without the potential of litigation with the government.

The *Textron* court recognized that the Fifth Circuit in *U.S. v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), cert. denied, 466 U.S. 944 (1984), had ruled likewise that workpapers stood unprotected because their existence was grounded in the need to conform to financial reporting requirements, and not due to the prospect of litigation. Notably, the Fifth Circuit espoused

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a “primary motivating purpose” test, which first asks what was the primary motivation for preparing a document, and then granting immunity only if the paramount motive was trial preparation or the anticipation of a controversy. A further assessment of related work product jurisprudence led the First Circuit to conclude that its brethren would only include documents “unquestionably prepared for potential use in litigation” within the scope of nondisclosure.

Finally, the First Circuit turned to the policy considerations underlying its holding, and here it saved some of its harshest words for the very last. At first, it calmly reiterated the notion that the work product privilege protects the litigation process only, not the more general corporate tasks that even attorneys may be involved in. Tax accrual workpapers exist because of the financial reporting requirements of public companies, not because litigation over tax liability might ensue with the IRS. Well said, but the tribunal went much further.

Judge Boudin flatly rejected *Textron*’s claim of the unfairness of compelled disclosure, declaring that “tax collection is not a game.” Decrying the “likely endemic” underreporting of corporate taxes and the “serious” problems of the IRS in unmasking same, the court contrasted the over 4,000 pages comprising *Textron*’s tax return with the Service’s demand for the accrual workpapers only after it discovered transactions of the type already flagged as susceptible to abuse. “[T]he collection of revenues is essential to government,” and disclosure during an IRS audit (which, the court asserted, is not litigation) should not be hindered by privileges intended to regulate discovery only in actual court cases.

At the end of the day, Judge Boudin concluded for the First Circuit that the work product privilege “protect[s] work done for litigation, not in preparing financial statements.” Not extending confidentiality to tax accrual workpapers does no harm to the effi-

cacy of those documents for auditing purposes, and serves “the legitimate, and important, function” of aiding the IRS in uncovering the underreporting of taxes due. No privilege of confidentiality was extended to the tax accrual workpapers here, and clearly no such privilege would be extended to similar documents in future cases within the First Circuit’s domain.

### THE DISSENT

But our story does not end here. As aforementioned, *Textron* was decided *en banc* by the First Circuit, which is compromised of only five circuit judges. The full court was divided three to two, as close a division as one can get. Above mere numbers is the fact that Judge Torruella submitted a dissent essentially equal to the majority opinion in both vigor and length. In it, the veteran jurist not only took great exception to the majority holding, but both gave the reasons for and indeed invited review by the U.S. Supreme Court.

The dissent does not mince words. First, Judge Torruella accuses the *Textron* majority of abandoning its own precedent established in *Maine*, which had repudiated *El Paso Co.*, where the Fifth Circuit first asks what was the “primary motivating factor” for the creation of a document before affording it attorney work product confidentiality.

In *Maine*, the First Circuit had embraced *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998), where, in sharp contradistinction to *El Paso*, the Second Circuit espoused a “because of” test, which bestows confidentiality upon a document prepared for both anticipated litigation and an ordinary business purpose. Pointing out that the First Circuit in *Maine* not only agreed with *Adlman*, but quoted its language extensively, Judge Torruella found it “simply stunning” that his court would turn its back on its own precedent.

### ‘A Bad Rule’

Judge Torruella also faulted *Textron* for pronouncing “a [b]ad [r]ule.” For one, the scope of Federal Rule 26 is not so constrictive as to keep confidential only material prepared for an actual trial. Next, *Textron*’s denial of attorney work product pro-

tection is antithetical to *Hickman v. Taylor*. The “fundamental concern” of that Supreme Court landmark was to shield an attorney’s thought process from the prying eyes of adversaries. The fact that counsel’s impressions might be recorded both in anticipation of litigation and for a legitimate business purpose is not a reason to deny it confidential treatment, as *Adlman* and *Maine* ruled. Yet today, *Textron* tosses that aside, and denies the cover of the privilege if a paper is prepared for any non-litigation purpose at all.

Judge Torruella condemned the majority on policy grounds, as well. The ruminations of *Textron*’s tax lawyers are precisely the sort of mental impressions the Supreme Court sought to protect from disclosure in *Hickman* and its progeny. *Textron* will discourage attorneys from memorializing their analysis out of fear of discovery, and thereby endanger the quality of legal representation.

“But more important,” the dissent declares, “are the ramifications beyond this case and *beyond even the case of tax accrual workpapers.*” (emphasis supplied). Taken to its logical conclusion, *Textron* will permit any party in any controversy to discover an opponent’s analysis of the business risk of a lawsuit, “including the amount of money set aside in a litigation reserve fund.” Judge Torruella forthrightly declared that “[n]early every major business decision by a public company has a legal dimension that will require such analysis.” The dissent warns attorneys and corporations within the First Circuit’s ambit that now such work product risks exposure in court.

### REAFFIRMING MAINE AND ADLMAN

To be sure, Judge Torruella did not simply criticize *Textron*; he strongly reaffirmed the proven holdings of *Maine* and *Adlman*. Applying their “because of” inquiry, he first submitted that the evidentiary findings of the lower court had shown beyond doubt that *Textron*’s tax accrual workpapers included and reflected attorney work product. Similarly, the court below made a fact finding that

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Textron had both a litigation and a business purpose in creating these spreadsheets and related documents.

Judge Torruella took great umbrage that the majority simply ignored that, and blithely recharacterized the work papers as something any trial attorney would classify as tax papers and not litigation materials. Ignoring the district court's factfinding in this manner worked a "corruption of the proper role of an appellate court." Furthermore to this specific case, tax accrual workpapers are not uniform from corporation to corporation, and therefore content obviously varies. Yet by its across-the-board denial of protection to any document so labeled, *Textron* errs again.

When viewed properly under the "because of" test, according to Judge Torruella, Textron's tax accrual workpapers were clearly prepared in anticipation of Textron and the IRS being adversaries. "Without the anticipation of litigation, there would be no need to estimate a reserve to fund payment of tax disputes." As point in fact, Textron's other financial reporting obligations were rooted in its expectation of controversy with the Service. With such duality intertwined, the dissent argues that attorney work product protection should have been applied.

Addressing a final point of importance, the dissent turned its attention to the obvious fact that Textron had straightforward business reasons, exclusive of the litigation threat, to have its tax attorneys prepare these workpapers. Yet the "because of" inquiry does not diminish the confidentiality afforded documents prepared for dual purposes. Put another way, a paper that also serves a simple business purpose does not forego protection as attorney work product, if it was nonetheless prepared with a view towards a potential controversy.

Nearing its conclusion, the dissent asserted that its reasoning does not conflict with the Supreme Court's 1984 holding in *United States v. Arthur Young & Co.*, 465 U.S. 805 (1983), as the discrete ruling there

only denied the existence of an "accountant work product" privilege. That is inapposite, Judge Torruella noted, since the question before this court was the scope of the current attorney work product doctrine.

On the other hand, *El Paso* from the Fifth Circuit factually landed on all fours with *Textron*; it was the majority's sharp departure from the prior reasoning of *Maine* and its apparent switch to the Fifth Circuit's "primary motivating purpose" rubric which so agitated the dissent. Judge Torruella posited that, had the majority adhered to its earlier teachings and extended the privilege to the work papers at issue here, it would not create a new circuit split, "but be merely an application of a widely acknowledged existing difference" between *El Paso* and the circuits already aligned with *Maine* and *Adlman*. This was an explicit acknowledgment of the ongoing internecine conflict among the circuits, and an allegation that Textron merely exacerbates a schism that only the High Court can bridge.

### A 'DANGEROUS ABERRATION'

The dissent concluded with no less power or vigor than that with which it opened. "[T]his decision will be viewed as a dangerous aberration in the law of a well-established and important evidentiary doctrine" throwing the principles of attorney work product privilege into "disarray." Already the circuits are divided between the irreconcilable tests of *El Paso* and *Maine*; *Textron* only fans the flames of discord. No one could misunderstand the dissent's closing admonition. "The time is ripe for the Supreme Court to intervene and set the circuits straight on this issue which is essential to the daily practice of litigators across the country."

### ANALYSIS

For our analysis, let us first state our ultimate conclusion; the U.S. Supreme Court will grant *certiorari* and rule on this vital issue. The reality of the internecine circuit conflict is undeniable. While *El Paso* appears to stand alone, *Maine's* alliance with *Adlman* is in accord with the Sixth Circuit in *U.S. v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006), the Ninth in *In re Grand Jury Subpoena*, 357 F.3d 900

(9th Cir. 2004), and the D.C. Circuit in *Senate of Puerto Rico v. Dep't of Justice*, 823 F.2d 574 (D.C. Cir. 1987).

Next, we concur with the dissent that the better reasoned approach is found in the *Maine/Adlman* line of cases. *El Paso* takes too narrow a view; in sharp counterpoise, the *Textron* dissent and its antecedents shield vital attorney work product from disclosure to adversaries, an imperative is to assure the maximum benefit of legal representation, by immunizing counsel's thinking from discovery.

Out of fear of disclosure, counsel will refrain from memorializing its thinking, and legal representation will suffer exponentially. Delimiting the doctrine will not simply be chilling; far worse, it will have a glacial effect on attorney/client candor. Because *Textron* erodes this vital evidentiary privilege, and since erosion ultimately leads to destruction, the High Court must step in.

We think it a near certainty that the Supreme Court will grant review, and end this schism among the circuits on this important issue. Indeed, it might well bring together what are commonly perceived as the opposing ideologies of the high Court. We envision Justice Scalia and Chief Justice Roberts, among others, reinforcing the attorney work product doctrine as imperative to preserving the sanctity of the adversarial process. And while new Justice Sotomayor is most identified with a liberal point of view, we think the need to maintain the confidentiality of attorney work product will appeal to her experience as a litigator.

### CONCLUSION

All told, both conservative and liberal wings of the Supreme Court could well unite in favor of safeguarding protection for tax accrual workpapers on the grounds of attorney work product privilege. Such a proclamation from the Supreme Court will stand in the forefront of safeguards for the proper conduct of litigation in American courts, and reaffirm the confidentiality of legal advice given in the corridors of American business.

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