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Attorney/Client Privilege and Work Product Doctrines

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Although relatively infrequently discussed by tax lawyers or tax accountants, it is important to remember the attorney/client privilege and work product doctrines that apply when there is an IRS inquiry into a matter. Very frequently, documents or correspondence may be prepared in the course of tax planning that are protected under either the attorney/client or the work product doctrine. Although taxpayers and

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their advisors may be inclined to simply open their files, this is certainly inappropriate in situations where these legal protections are available.

After all, given the tax planning and tax structuring that often precedes a transaction, it may be important to the outcome of an audit, appeal or tax litigation whether certain draft documents or correspondence about tax treatment are disclosed or not. That is why some understanding of the fundamentals of attorney/client privilege and the work product doctrine are important. Remember, too, that there is no accountant/client privilege, at least not yet.

The attorney/client privilege is easier to define, in that it protects all communications occurring in the context of the attorney/client relationship. As one would suspect, there is a considerable volume of authority dealing with particular situations, such as whether the presence of third parties will waive the attorney/client privilege, the extent to which the privilege applies in the context of corporate counsel (who actually work full-time for their "client"), etc.

The work product doctrine is even more susceptible to various rules, because it is a narrower protection. In particular, many courts have sought to determine whether documents are prepared primarily or exclusively to assist in litigation. If so, they may not be covered under the work product protection.

A recent Second Circuit Court of Appeals case throws additional light on work product protection, specifically in the tax area, and specifically relating to a merger/acquisition transaction. The case, *U.S. v. Adlman*, No. 96-6095 (2d Cir., Feb. 13, 1998), involved Sequa Corp., an aerospace manufacturer with annual revenues of nearly $2 billion. Monroe Adlman was an attorney and vice president for taxes at that company. In early 1989, Sequa considered merging several wholly-owned subsidiaries to create an enormous loss. Adlman expected that the resulting

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claim for a tax refund would be challenged by the IRS. Adlman requested an attorney at Arthur Andersen & Co. to evaluate the tax implications of the proposed merger.

A 58 page memorandum was prepared by Arthur Andersen dealing with the likely IRS challenges to the merger and the tax refund claim. This extensive memo also treated possible legal theories and strategies for the company to adopt. It even recommended preferred methods for structuring a transaction. Lastly, it made predictions about the likely outcome of the litigation, if litigation did ensue.

Armed with the thorough memorandum, Sequa went ahead with the merger, completing it in December 1989. The merger generated a refund claim of $35 million. The IRS did audit the transaction, and document requests began coming in.

"Give It Up"

The IRS asked for a number of documents concerning the transaction. Sequa acknowledged the existence of the Arthur Andersen memorandum, but cited work product privilege as grounds for declining to give the memorandum to the IRS. The IRS then served a summons on Mr. Adlman for production of the memorandum. When Adlman refused to comply with the summons, the IRS sued him. Initially, Adlman claimed in District Court that the memorandum was protected by both the attorney/client privilege and work product doctrine. The District Court denied his motions and ordered that he produce the memo.

In the Second Circuit Court of Appeals, the Second Circuit affirmed the denial of Adlman's claim of attorney/client privilege but remanded the case for consideration of the work product doctrine. The Second Circuit vacated the District Court's production order because it found an erroneous standard to have been used regarding the work product privilege.

In the District Court on remand, this time Adlman argued that the memorandum was protected by Rule 26(b)(3) of the Federal Rules of Civil Procedure because it included legal opinions prepared in reasonable anticipation of litigation. The District Court again rejected this claim of work product privilege (based on the applicable Federal Rules). The District Court concluded that as a factual matter, this memorandum was not prepared in anticipation of litigation. Thus, the District Court again ordered Adlman to comply with the IRS summons. Adlman appealed once more to the Second Circuit.

Second Time Around

The Second Circuit a second time vacated the District Court order enforcing the IRS summons. Once more, the Second Circuit remanded the case to the District Court for further findings. In doing so, the Second Circuit gave some guidance about how such a matter should be resolved. The court noted that some courts have applied a formula to determine whether documents are protected by the work product privilege based on whether they are prepared primarily or exclusively to assist in litigation.

That would potentially exclude documents that have an analysis of expected litigation if the main purpose would be to assist in making a business decision. Other courts, however, have formulated the question to ask if the documents were prepared "because of" existing or expected litigation. This would include such documents despite the fact that their purpose is not to "assist in" litigation.

The Second Circuit noted that protection of documents of this latter sort was more consistent with the literal terms of Federal Rules of Civil Procedure Rule 26(b)(3). The court therefore adopted the latter formulation of the bounds of the work product protection. As to the particular Arthur Andersen memorandum in question, the court concluded that it fell within most of the protected categories of work product, which shows the mental impressions, conclusions, opinions or legal theories of an attorney or other representative.

Watch Out

Ultimately, few tax lawyers (or tax professionals of any variety) are likely to become experts on the attorney/client privilege and work product doctrine. Still, practitioners should be cautious about any potential waiver of documents that might be

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protected by either privilege. For example, it is often a good idea to get into the habit of putting "personal and confidential, attorney/client privilege" on virtually any significant transmittal that occurs in this context.

At least that will allow one additional argument that there was no waiver of the privilege by too wide a dissemination. It will also serve as an additional flag to personnel (who might need a reminder) that documents appropriately so labeled need not be provided to the IRS (at least without careful analysis). If the attorney/client or work product protection is ultimately considered to apply, you may be glad that such a warning label was placed on what might some years down the road be viewed as a critical letter or memo.

Evidentiary Matters Regarding Settlement Agreements

Another example of this area relates to the tax treatment of settlement payments. In recent years (particularly since the Small Business Job Protection Act of 1996), the employment tax consequences of dispute resolution have become almost as significant as the income tax consequences. With the 1996 Act's amendments to Section 104, many people are more concerned today about employment tax consequences, even though there were good reasons to be concerned about these consequences prior to the 1996 law change.

A recent case shows that evidence of the tax discussions surrounding a settlement payment may be important. That seems an obvious proposition. What is not so obvious is that the attorney/client privilege and work-product doctrine protection covering such evidence may be waived.

FICA and FUTA

In *Cleveland Indians Baseball Co. v. United States*, No. 96-CV-2240 (N. Dist. Ohio, Jan. 28, 1998), Tax Analysts Doc. No. 98-6335 (19 pp.), the U.S. District Court for the Northern District of Ohio granted most of the government's motion to compel compliance with requests for admission. The action was brought by the Cleveland Indians baseball club for a refund of FICA and FUTA taxes paid on settlement payments the club made to players. The original dispute arose out of claims by the Major League Baseball Players' Association against the professional clubs (including the Cleveland Indians). The players' allegations were that the clubs had violated the collective bargaining rights of the free agent players.

A panel of arbitrators agreed with these allegations, and the clubs and the Association settled the matter in 1990 for approximately $280 million. The 26 baseball clubs were to pay the amount in equal portions. The settlement agreement did not specify what amount was to be paid to the players, that amount being determined in a separate proceeding.

Before making any payments, however, the baseball clubs requested a letter ruling from the IRS regarding the tax treatment of the payments to the individual players. In 1995, the IRS ruled that the non-interest portion of the payments would be treated as wages subject to FICA and FUTA taxes. The interest portion, however, would not be treated as wages. The ruling also concluded that the settlement payments were taxable in the year paid (1994), rather than in the years to which the payments related (1986 and 1987).

In October 1996, the Cleveland Indians baseball club filed a refund action, seeking a refund of the FICA and FUTA taxes it paid on the settlement payments. The court set a December 1997 deadline for non-expect discovery. Later, however, the government notified the court that the club had not responded to requests for admissions, interrogatories, and requests for documents. The club asserted objections to the document requests, but the court ordered the club to comply. The government then filed a motion to compel.

The district court granted the government's motion in part. The court concluded that the club's claims of attorney/client privilege or work product doctrine protection were meritless, as the club had placed in issue the character of the settled claims. Thereafter the court ordered the club to provide (1) copies of all documents discussing the nature of the claims and damages asserted by the players and the Association; (2) the club's reasons for settling; and (3) the

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settlement itself.

Note: A refund action such as this would put in question matters relating to the character of the settlement payments. Perhaps that is as it should be. However, the fact that the court in this refund action found the attorney/client privilege and work-product protections not to apply should cause lawyers (and clients) in settlement discussions to be aware of what they are saying and to whom. ■