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Second Circuit Clarifies Common Legal Interest and Work Product Doctrines for Material Shared Among Transacting Parties

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The U.S. Court of Appeals for the Second Circuit recently ruled that the "common interest" doctrine protects legal and tax liability analysis prepared for a client and subsequently shared with a consortium of banks providing financing for the client. Schaeffler v. United States, No. 14-1965, slip op. (2d Cir. Nov. 10, 2015). The Court also ruled that the accountants' tax liability analysis was protected under the work product doctrine. In so ruling, the Court clarified 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."

Background

Amid the financial crisis of 2008, the Schaeffler Group underwent complex refinancing and restructuring, raising complicated tax liability issues. Anticipating IRS scrutiny over this restructuring, the Schaeffler Group retained Ernst & Young LLP ("EY") for advice on potential tax implications and litigation consequences. As part of this work, EY drafted documents, including a memorandum ("EY Tax Memo") that identified potential U.S. tax consequences of restructuring, analyzed potential IRS challenges to the Group's tax treatment, and provided detailed descriptions of relevant legal and regulatory authority. The Group shared the EY Tax Memo with a consortium of banks ("the Consortium"), which financed the transaction.

The IRS began an audit, but when it requested disclosure of EY documents providing "legal opinions," the District Court rejected the Schaeffler Group's claim to attorney-client privilege and work product protection.

Common Legal Interest

The Second Circuit reversed. It first addressed the lower court's determination that the Schaeffler Group waived privilege by sharing the EY Tax Memo (and similar material) with the Consortium. The Second Circuit stated that the purpose of privileged communications must be solely to obtain or provide legal advice, while "[c]ommunications that are made for purposes of evaluating the commercial wisdom of various options as well as … getting or giving legal advice are not

protected." However, the Court explained that disclosure of privileged communications to a third party is protected, if both parties are engaged in a "common legal enterprise," which may exist regardless of the presence of ongoing litigation.

The Court observed that, although only the Schaeffler Group faced an immediate threat of litigation from the IRS, both the Group and the Consortium risked financial consequences stemming from the same legal problem. Both the Group and the Consortium, therefore, had an incentive to cooperate in the resolution of that problem. To that end, the Schaeffler Group and the Consortium cooperated to secure a certain tax treatment for refinancing and restructuring, knowing this "would likely involve a legal encounter with the IRS," and undertook mutual obligations to advance their common legal strategy.

Rejecting the district court's conclusion that the Consortium's interest was only economic, not legal, the Second Circuit found that both parties had a "strong common interest" in obtaining favorable tax treatment, which was "of sufficient legal character" to prevent a waiver of privilege. This was true despite the fact that the legal issue would have commercial consequences; "[t]he fact that eleven-billion Euros of sunken investment … were at stake does not render those legal issues 'commercial,'" such that privilege would be waived by communicating between parties.

Application of Work Product Doctrine

The Court also rejected the district court's finding that the work product doctrine was inapplicable to documents like the EY Tax Memo, observing that "[d]ocuments prepared in anticipation of litigation are work product, even when they are also intended to assist in business dealings."

More specifically, the Second Circuit disagreed with the lower court's finding that the EY Tax Memo was not work product because appellants would have sought—and EY would have given—substantially similar advice in the absence of anticipated litigation. The Second Circuit explained that the prepared material, which aimed to address an expected audit and resulting litigation, was not prepared in the ordinary course of business (like an annual tax return), but was, given the nature of the document and the environment in which EY created it, "prepared or obtained because of the prospect of litigation." The Court noted that EY was not required—by regulation or otherwise—to provide the kind of in-depth, litigation-focused analysis that it did, and in any case, it was unrealistic to imagine a scenario with a transaction of the same magnitude and tax issues of the same complexity or ambiguity without the threat of litigation.

Key Takeaways

First, the legal endeavor that the Court found to underpin its application of the common legal interest doctrine was, in significant part, based on shared consequences among the parties stemming from anticipated litigation with the IRS. The fact that only the Schaeffler Group was likely to become a party to that anticipated litigation leaves open the question of to what extent, if at all, anticipated litigation must underpin the common legal problem on which the common legal interest rests.

Second, Rule 26 of the Federal Rules of Civil Procedure, along with some case law, states that work product can be prepared not just by (or even at the direction of) lawyers, but by a party, its

representatives and agents. In conferring work product protection on the EY Tax Memo, the Second Circuit does not address this distinction. It focuses, instead, on the “because of” element, finding that EY’s analysis was done on the Schaeffler Group’s behalf “because of anticipated litigation.” The extent of involvement by the Group’s lawyers in the EY analysis, or the weight of that involvement in the Court’s work product determination, is not clear.

Finally, in distinguishing between materials prepared by tax professionals in the ordinary course of regulatory compliance, versus tax analysis tailored towards a specifically anticipated legal challenge, the Court added clarity about when materials created to assist a business or financial decision can nevertheless fall under the work product doctrine’s protection.

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