# MANAGING TAX ACCRUAL WORKPAPERS AFTER *TEXTRON*[1]

*by Stuart J. Bassin*[2]

Tax accrual workpapers are some of the most private and sensitive documents created by corporations. Until recent years, issues regarding a corporation's ability to protect the workpapers did not frequently arise because the Internal Revenue Service ("IRS") rarely sought to compel disclosure of tax accrual workpapers. Following a revision of the IRS's so-called "policy of restraint" several years ago, the IRS now is seeking disclosure of corporate tax accrual workpapers more often and corporations have been forced to engage in high-stakes litigation to prevent disclosure. The law is in a state of flux and considerable uncertainty remains regarding the circumstances under which the IRS may compel disclosure of tax accrual workpapers.

The recent decision of the First Circuit in *United States v. Textron, Inc.*,[3] represents an important milestone in this litigation. In *Textron*, a divided panel ruled that tax accrual workpapers may, in many instances, be protected from disclosure under the work product doctrine. The decision establishes a split in the circuits on the issue; the Fifth Circuit in *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *cert. denied* 466 U.S. 944 (1984), applied a different analysis and concluded that work product protection was not available to prevent

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2 Mr. Bassin is a tax partner in the Washington, D.C. office of Baker & Hostetler LLP. Prior to joining the firm, he served as a Senior Litigation Counsel in the U.S. Department of Justice, Tax Division. The views expressed in this article are solely those of the author. The author thanks his colleagues Jeffrey H. Paravano and Jeffry J. Erney for reviewing a draft of this article and offering comments.

3 553 F.3d 87 (1st Cir. 2009), aff'g in part, and vacating in part, 507 F. Supp. 2d 138 (D.R.I. 2007).

disclosure of tax accrual workpapers. The stage is now set for the United States Supreme Court to resolve this conflict.

This article provides a primer on the IRS's ability to compel disclosure of corporate tax accrual workpapers and the issues taxpayers should consider in connection with their tax accrual workpapers. Part I describes tax accrual workpapers and their relevance to financial accounting and audits conducted by the IRS. Part II explains the law applicable to the IRS's ability to obtain tax accrual workpapers through the administrative summons process, as well as the IRS's current policy of restraint as it relates to requesting tax accrual workpapers. Part III summarizes the *Textron* litigation, including the motions for reconsideration recently filed for both parties. Part IV discusses the procedural rules governing the motions for reconsideration and the options available to the IRS if its motion is denied, including a potential petition for certiorari to the Supreme Court. Part V provides the author's perspectives on the legal debate and, finally, Part VI describes the options available to taxpayers given the uncertain state of the law.

## I. INTRODUCTION TO TAX ACCRUAL WORKPAPERS

Tax accrual workpapers exist because of the intersection of the needs of a corporation to evaluate its litigation hazards, accurately disclose its financial condition as part of the financial reporting process, and accurately file tax returns which are subject to challenge by the IRS. Particularly in the context of a corporation with a complex tax return, certain proposed adjustments by the IRS are common, especially in areas where the tax law is unclear. Given that reality, corporations seeking to fully present their financial condition must examine, often with the assistance of in-house or outside counsel, to what extent the tax liability reported on their returns may change as a result of any challenge by the IRS. The conclusions reached as a result of such determinations impact financial reporting of tax reserves and are memorialized in the

corporation's tax accrual workpapers. Because of the rules governing auditors, the tax accrual workpapers created through this process often must be shared with financial statement auditors.

The accounting requirements governing to contingent future tax liabilities have evolved over the years. Publicly traded companies must prepare financial statements in accordance with GAAP and those financial statements must be certified by the company's outside auditors. During the period at issue in *Textron*, Financial Accounting Standard (FAS) 5 and FAS 109 governed and required corporations to accrue an estimated loss for future contingent tax liabilities and to reflect that accrual as a reserve on their financial statements. With the well-publicized accounting scandals of the past decade, and the enactment of the Sarbanes-Oxley Act of 2002, FAS 5 and FAS 109 were supplemented with FASB Interpretation No. 48 (issued in June 2006) ("FIN 48"), which generally strengthens and expands the reporting requirements. Under FIN 48, corporations generally may recognize tax benefits in their financial statements only with respect to positions deemed "more likely than not" to be sustained upon audit and must discount any tax benefits recognized under this standard to reflect the percentage likelihood that the reported benefits will not survive the audit process. Auditors may not certify the financial statements without first independently evaluating whether the tax reserves reported in the financial statements comply with FIN 48 standards.[4]

Tax accrual workpapers are collected and sometimes prepared to satisfy these financial accounting requirements. The precise contents of tax accrual workpapers vary from corporation to corporation, and some confusion arises out of using the nomenclature "tax accrual workpapers" to describe this diverse assortment of documents. A typical set of tax accrual workpapers would include (1) a master spreadsheet used to compute the amount of the reserve

[4] Statement of Auditing Standards, AU §110.

by multiplying (a) the amount at stake with respect to each return position potentially subject to challenge by the IRS, by (b) the likelihood that the taxpayer's return position will prevail; (2) memoranda prepared after filing the return (often by attorneys) providing a reasoned explanation for the conclusions reflected in the master spreadsheet regarding the likelihood that each return position would prevail. Tax accrual workpapers might also include similar documents created by the firm's auditors, memoranda prepared during the corporation's process of entering into a particular transaction and taking a particular return position, along with transactional documents and bookkeeping records establishing the underlying facts.

A corporation's auditors will require access to the corporation's tax accrual workpapers before the auditors certify the corporation's financial statements. The auditors may retain copies of some of the workpapers in their files. In addition, the auditors may create workpapers during their review of a corporation's financial statements reflecting the auditor's own analysis of various return positions

Because of the nature and content of tax accrual workpapers, access to the workpapers may provide the IRS with substantial advantages in auditing a corporation's tax returns. The master spreadsheet used to compute the reserve may provide the IRS with a roadmap for conducting its audit because it identifies the issues the taxpayer and its auditors deemed most vulnerable to scrutiny; with the spreadsheet in its possession, the IRS is unlikely to "miss" issues. In addition, workpapers summarizing the corporation's analysis of its likelihood of success in defending various return positions may provide the IRS with the taxpayer's internal analysis of the strength of its position—useful information in any compromise negotiations. Inclusion of other documents created at the time of the transaction (*e.g.*, a tax opinion letter) in the workpapers also may result in waiver of an otherwise meritorious attorney-client privilege

claim. Finally, the workpapers may provide the auditors with a convenient collection of relevant documentation related to specific issues under audit.

Not surprisingly, taxpayers have resisted production of their workpaper. At the most basic level, taxpayers have complained that it is unfair for the IRS to benefit from the taxpayer's effort in preparing and collecting tax accrual workpapers. On a more principled level, taxpayers have argued that the knowledge that tax accrual workpapers are subject to disclosure will compromise the quality of the tax reserve computation, ultimately resulting in dissemination of less reliable information to the consumers of financial statements. Finally, corporations note that the potential for disclosure of tax accrual workpapers produces perverse incentives; unethical taxpayers who do not take their obligations under FIN 48 seriously and who do not prepare thorough workpapers will be able to maintain more secrets from the IRS (and possibly pay less tax) than honest taxpayers who prepare more thorough workpapers.

Responding to such concerns, the IRS long ago adopted a policy of restraint in determining whether to seek production of tax accrual workpapers. Announcement 84-46, 1984-18 I.R.B.18. Under the IRS's former guidelines, auditors could only issue a summons for tax accrual workpapers under "unusual circumstances" and only with the prior approval of senior-level IRS personnel. In more recent years, the IRS has relaxed this policy for returns filed after July 1, 2002, allowing revenue agents to summons tax accrual workpapers related to reporting of transactions deemed by the IRS to be abusive or tax shelters (generally referenced as "Listed Transactions") and all workpapers related to any return which discloses multiple Listed Transactions or fails to disclose a Listed Transaction. *See* Announcement 2002-63, 2002-2 C.B. 72. *See also* Remarks of Donald Korb to TEI/IRS Financial Services Seminar (Sept. 27, 2004) *reprinted at* 2004 WL 2287746. With this change in policy, the number of IRS requests for tax

accrual workpapers greatly increased. Appendix A summarizes the development of the IRS's policy of restraint and its current status after *Textron*.

## II. THE LEGAL FRAMEWORK

A. The IRS has broad authority to issue administrative summonses requiring production of documents to assist it in determining the correctness of any return. Section 7602(a) authorizes the IRS to summons and examine any document "which may be relevant or material" to such an inquiry and Section 7604 authorizes the IRS to enforce such summonses in federal district courts. The Supreme Court has recognized the breadth of this authority in cases such as *United States v. Powell*, 379 U.S. 48 (1964) and imposes a "heavy" burden upon any person opposing enforcement of a summons. *United States v. LaSalle National Bank*, 437 U.S. 298, 316 (1978). The required relevance is established by a showing that the requested documents "might have thrown light upon the correctness of the return" which has been defined as requiring little more than an "idle hope" that something will turn up in the requested documents. *United States v. Arthur Young & Co.*, 465 U.S. 805, 813, 814 n.11 (1984)(citations omitted). As a practical matter, the IRS is usually able to easily satisfy this relevance standard absent evidence that the IRS acted with bad faith or an improper purpose.

B. Disputes relating to the IRS's ability to obtain tax accrual workpapers have generally been litigated in the context of taxpayer claims that the workpapers are protected from disclosure under the work product doctrine. That doctrine has its origins in the Supreme Court's ruling in *Hickman v. Taylor*, 329 U.S. 495 (1947). In that case, the Supreme Court addressed witness statements taken promptly after a marine accident by the boat-owner's lawyer. When the victims asked the courts to mandate disclosure of the witness statements, the Supreme Court refused, holding that the statements were immune from discovery. In the Court's view,

> In performing his various duties, . . . it is essential that a lawyer work with a certain degree of privacy, free from unnecessary intrusion by opposing parties and their counsel. Proper preparation of a client's case demands that he . . . prepare his legal theories and plan his strategy without undue burden and needless interference.

*Id.* at 510- 511. A lawyer's case preparation was protected by a zone of privacy and parties were not entitled to prepare their cases based upon "wits borrowed from the adversary." *Id.* at 516 (Jackson, J., concurring).

This common law doctrine was codified in the 1970 amendments to the Federal Rules of Civil Procedure in Rule 26(b)(3)(A), which protects documents "prepared in anticipation of litigation or for trial" from discovery. Writing nearly 25 years later, the Rules Advisory Committee responsible for drafting the original rule stated that it—

> reflects the view that each side's informal evaluation of its case should be protected, that each side should be encouraged to prepare independently, and that one side should not automatically have the benefit of the detailed preparatory work of [an adversary.

Advisory Committee Notes to 1970 Amendments. Attempting to articulate the boundary between preparation for litigation and routine legal advice, the Rules Advisory Committee stated that-

> Materials assembled in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other nonlitigation purposes are not [protected][.

*Id.* The protection for work product is qualified; disclosure can be ordered upon a showing of good cause.

The phrase "prepared in anticipation of litigation" is subject to a range of different interpretations and has been the subject of many disputes. Obviously, the party which obtained the witness statement in *Hickman,* acting after a boat sank with the loss of life, was anticipating imminent litigation over a specific claim involving a specific claimant. However, virtually every

client who retains counsel recognizes that conflict and litigation are an unavoidable reality of modern life; clients retain lawyers to advise them on how best to arrange their affairs so that they are best prepared for litigation should it arise. Legions of motions have been litigated on the question of where routine legal work becomes preparation for litigation.

The courts have focused upon a variety of factors in attempting to distinguish work done by lawyers in anticipation of litigation and work done for other purposes in specific cases. Some courts have focused upon whether, at the time the document was created, a specific claim of a specific claimant had been identified. Other courts have looked at the matter from a temporal perspective, focusing upon the amount of time elapsed between preparation of the document and the beginning of the litigation. Others have evaluated the contingencies which needed to be satisfied before litigation can ensue in an effort to determine the likelihood of litigation at the time the document is created. *See generally* Wright & Miller, Federal Practice & Procedure: Civil §2024.

One critical issue frequently addressed by the courts has been the treatment of documents prepared for multiple purposes—*e.g.*, to inform a business decision and to assist the corporation in the event of litigation. The courts have articulated at least two approaches in determining whether the work product doctrine protects such dual purpose documents. The First Circuit phrases the test in terms of a "because of" analysis, providing work product protection when "in light of the nature of the document and the factual situation in the particular case, the document can be fairly said to have been prepared or obtained because of the prospect of litigation." *Maine v. United States Department of the Interior*, 298 F.3d 60, 68 (1st Cir. 2002). Other courts ask whether the "primary motivating purpose" behind the creation of the document was to aid in possible litigation. *United States v. Bornstein*, 977 F.2d 112, 117 (4th Cir. 1992); *United States*

*v. Rockwell*, 897 F.2d 1255, 1266 (3d Cir. 1990); and *United States v. El Paso Co*., 682 F.2d 530, 542 (5th Cir. 1982), *cert. denied* 466 U.S. 944 (1984).

C. In the context of tax accrual workpapers, the IRS has, on certain facts, successfully argued in the past that the documents are not protected by the work product doctrine because they were, at least in part, created and assembled to support financial statements and to satisfy securities law requirements. In *United States v. El Paso Co*., 682 F.2d 530 (5th Cir. 1982), *cert. denied* 466 U.S. 944 (1984), the Fifth Circuit rejected an assertion that the tax accrual workpapers in that case (called the "tax pool analysis") were protected work product, stating—

> We believe that the tax pool analysis does not contemplate litigation in the sense required to bring it within the work product doctrine. The tax pool analysis concocts theories about the results of possible litigation; such analyses are not designed to prepare a specific case for trial or negotiation. Their sole function, from all that appears in the record, is to back up a figure on a financial balance sheet. Written ultimately to comply with SEC regulations, the tax pool analysis carries much more the aura of daily business that it does of courtroom combat.

682 F.2d. at 543-44. At the same time that it denied the taxpayer's petition for certiorari in *El Paso*, the Supreme Court, in *Arthur Young*, reversed a Second Circuit decision which had recognized an accountant work product privilege protecting tax accrual workpapers, stating that "We are unable to discern the sort of 'unambiguous directions from Congress' that would justify a judicially created work-product immunity for tax accrual workpapers. . . ." 465 U.S. at 816. The "Court of Appeals' effort to foster candid communication between accountant and client by creating a self-styled work-product privilege was misplaced." *Id*. at 817. While the combined effect of *Arthur Young* and *El Paso* suggested to many that the IRS had legal authority to compel disclosure of tax accrual workpapers, the precedent lay largely dormant because the IRS rarely sought production of workpapers until it revised its policy of "restraint."

## III. THE *TEXTRON* DECISION

*Textron* arose out of a multi-year corporate audit of Textron during which, the IRS discovered, Textron had engaged in several sale-in, lease-out (SILO) transactions covered by listing Notice 2005-13.[5] During the audit, the IRS issued a summons seeking production of all tax accrual workpapers created either by the taxpayer or its independent auditor (Ernst & Young) for Textron's 2001 tax year.[6] The workpapers at issue in *Textron* consisted of three principal categories of documents—(1) a master spreadsheet used to compute the amount of the reserve by multiplying (a) the amount at stake with respect to each return position potentially subject to challenge by the IRS, by (b) the likelihood that the taxpayer's return position will prevail; (2) memoranda prepared after filing the return by Textron's in-house tax attorneys providing a reasoned explanation for the conclusions reflected in the master spreadsheet regarding the likelihood that Textron would prevail on each return position; and (3) comparable documents prepared with respect to the prior year's return. Ernst & Young reviewed those workpapers, but did not retain copies, and independently created its own workpapers evaluating the adequacy of the reserve.[7]

*A. District court proceedings*. Textron refused to comply with the summons and the IRS brought suit to enforce the summons pursuant to Section 7604. The district court reviewed affidavits and conducted an evidentiary hearing at which it heard testimony from Textron employees, the revenue agent who issued the summons, and two experts on tax accrual

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5 2005-1 C.B. 630.

6 While Textron had claimed tax benefits arising out of SILO transactions in earlier years, the summons only sought production of the tax accrual workpapers for 2001 because the IRS's change of policy relating to tax accrual workpapers was applicable only to returns filed after July 2002 and Textron's 2001 return was filed after that date. The opinion does not disclose why the IRS sought production of all Textron's workpapers when the opinion does not identify any non-SILO Listed Transactions reported on the return, although IRS may have treated each individual SILO transaction as a separate Listed Transaction under its policy.

7 507 F. Supp. 2d at 142-43; 553 F.3d at 91-92.

workpapers retained by the IRS. Ultimately, the district court refused to enforce the summons based primarily upon its determinations that the tax accrual workpapers were protected work product and the protection was not waived when Textron allowed Ernst & Young employees to review the documents.

Specifically, the district court held that tax accrual workpapers prepared in anticipation of litigation need not be shown to the IRS. The district court held that Textron's tax accrual workpapers were protected work product because, as a factual matter, they were prepared because of the prospect of litigation. The workpapers may have helped satisfy the SEC and financial accounting rules relating to the tax reserve but, if there were no prospect of litigation, no tax accrual workpapers would have been prepared. Further, while the attorney-client privilege and the Section 7525 practitioner privilege were waived by disclosure of the workpapers to Textron's auditor, that disclosure does not waive work product protection unless the disclosure substantially increased the likelihood that the company's adversary—the IRS in this case—would obtain access to the information. In sum, the district court's decision represented a major defeat for the IRS's policy of seeking tax accrual workpapers.[8]

*B. Court of Appeals ruling.* The IRS appealed and a divided panel of the First Circuit affirmed most of the trial court's conclusions. Focusing upon the work product analysis, the majority ruled that—

> While not all "dealing with the IRS" during the audit is "litigation," the resolution of disputes through adversary administrative processes, including proceedings before the IRS Appeals Board, meets the definition of litigation.

[8] The district court also ruled that the workpapers were protected by the attorney-client privilege, but that the privilege had been waived when Textron disclosed the workpapers to its auditors. 507 F. Supp. 2d at 146-47 and 151-52. The district court opinion did not address the workpapers created and held by Ernst & Young.

553 F.3d at 94. The availability of work product protection turns upon "'the function the document the document serves,' not its content." Id. at 95 (citation omitted), Applying that legal rule and the concept of "anticipation of ligation," the court concluded that—

> here, the function of the documents was to analyze litigation for the purpose of creating and auditing a reserve fund. It can be fairly said that "the driving force behind the preparation" of the documents was the need to reserve money in anticipation of disputes with the IRS.

*Id.* Perhaps most significantly, the majority read the Advisory Committee Note excluding documents prepared to satisfy other governmental requirements from the definition of protected work product as not dispositive because the Note did not address situations "where a document is prepared because of the possibility of litigation, but also for a business or regulatory purpose." *Id*. at 97. The majority likewise distinguished the Supreme Court's decision in *Arthur Young*, stating—

> We are not now confronted with the question of whether to recognize a new privilege. Here, the doctrinal decision we face is whether to afford protection to documents created because of both business and litigation—a question not presented in *Arthur Young*. Since this question has broader implications, the Supreme Court's policy judgment that a new privilege is not necessary for the accurate preparation of accountant's tax accrual workpapers is not controlling.

553 F.3d at 99. The majority, therefore, affirmed the district court's ruling that the workpape3rs constituted protected work product.

Turning next to the question of whether Textron's disclosure of its tax accrual workpapers to Ernst & Young waived work product protection, the majority focused upon the relationship between Textron and its auditors. The court summarized the applicable legal rule as—

> work product protection is provided against "adversaries," so only disclosing material in a way inconsistent with keeping it from an

> adversary waives work product protection. Specifically, disclosure to an adversary, real or potential, forfeits work product protection.

*Id*. at 102, *citing United States v. Massachusetts Institute of Technology,* 129 F.3d 681, 687 (1st Cir. 1997) (holding that the university waived work product protection when it disclosed financial records to Defense Department auditors because the government and the university were potential adversaries if a dispute arose regarding performance of a government contract). Textron's relationship with Ernst & Young with respect to the tax accrual workpapers was "a cooperative not adversarial relationship." *Id*. at 103. However, the court noted that the Ernst & Young workpapers could be subpoenaed by the Securities and Exchange Commission or by a litigant in a non-tax matter such as a shareholder derivative action.[9] The majority viewed "the question we must ask is whether disclosure of those workpapers [to Ernst & Young] substantially increased the risk that the contents of Textron's workpapers would be disclosed to an adversary." *Id.* at 104. Finding the factual record inadequate to resolve this question, the First Circuit remanded this aspect of the case to the trial court for additional fact-finding, as well as for fact-finding regarding the contents of the workpapers held by Ernst & Young.

The dissent argued that the tax accrual workpapers were not protected by the work product doctrine. Accusing the majority of misreading the case law establishing the "because of" rule, Judge Boudin stated that—

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[9] The courts have recognized that a separate work product issue arises when a document is prepared in anticipation of one type of litigation and is requested in connection with another type of litigation. Most often, the issue arises in areas like mass tort litigation, where multiple plaintiffs separately sue similar claims. In those situations, courts have protected work product despite the differences in the named plaintiff because the protected documents were prepared in anticipation of all of the plaintiffs' similar claims.

The notion that the work product doctrine is designed to protect an attorney's trial preparation for trial from his adversary is more difficult to apply when different adversaries pursue very different claims. For example, in recent months, certain participants in LILO and SILO transactions have been involved in litigation involving each other. In *Hoosier EnergyRural Electric Cooperative, Inc. v. John Hancock Life Insurance Co*., 588 F. Supp. 2d 919 (S.D. Ind. 2008), the parties in a LILO transaction litigated the consequences of technical non-compliance with a contractual provision requiring one party to maintain certain backup loan security type that was unavailable due to the current crisis in the financial markets. The parties in that litigation will have a difficult time arguing that the tax accrual workpapers they created in preparing their tax reserve analyses were prepared in anticipation of litigation with each other.

> it is not the subject matter discussed in the materials that controls but whether documents are prepared "in the ordinary course of business" or were otherwise independently required, which are both the case with tax accrual work papers mandated by accounting requirements.
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> [I]n cases finding documents to be protected, it is because the documents were created in order to be useful in litigation.

*Id.* at 107. He also concluded, contrary to the fact-finding by the district court, that the "sole reason for the creation of Textron's estimates of risk with respect to individual tax positions was to prepare the reserve figures." *Id.* at 108. Ultimately, he argued that the tension between the majority opinion and both *Arthur Young* and *El Paso* decisions should be resolved by the First Circuit in an en banc hearing. *Id.* at 109.

*C. Petitions for Rehearing.* The majority's decision represents a substantial victory for taxpayers and a major defeat for the IRS. Reduced to its essentials, the decision stands for the proposition that tax accrual workpapers prepared by taxpayers with input from counsel for purposes of determining litigation hazards are generally protected from disclosure to the IRS under the work product doctrine. As a result, the IRS's policy of seeking the tax accrual workpapers of corporations involved in Listed Transactions appears to be on life support.

Not surprisingly, the IRS filed for rehearing en banc before the entire First Circuit, challenging the majority's determination that Textron's workpapers. Emphasizing the rule that the function of a document, not its content, controls the analysis, the IRS argued that—

> The majority's assertion that Textron's anticipation of litigation "triggered certain business and accounting obligations" has it exactly backward. It was Textron's business and accounting obligations that triggered its consideration of litigation, not the other way around. Satisfying those regulatory obligations is the workpapers' function; describing hypothetical litigation is the workpapers' content. Therefore, that "Textron was effectively forced . . . to operate under the hypothetical belief that litigation

> would occur" does not mean that the workpapers were generated for litigation purposes, only that their "subject matter" may relate to litigation. Having litigation-related "subject matter" is insufficient for work-product protection.

Petition at 8. Instead, the IRS argued that the applicable test was whether a document a document had an "independently required" business purpose; if so, the document cannot be work product. As the securities laws and financial regulatory standards independently require preparation of a tax reserve, Textron's workpapers could not be protected work product.[10]

Textron also sought rehearing, challenging the court's remand on the question of whether the work product protection had been waived with respect to the workpapers held by Ernst & Young. It argued that the opinion suggests that Ernst & Young could be viewed as a "conduit" through which Textron's adversaries might obtain otherwise protected information. Because of the confidentiality obligations imposed upon auditors, it argued that—

> Textron's tax accrual workpapers, which E&Y was permitted to review but not keep, were cloaked with the expectation of confidentiality. Therefore, E&Y is not a channeling source, or conduit to a Textron adversary, the IRS, and there was no substantial risk that the contents of Textron's workpapers would be voluntarily transmitted by E&Y to the IRS.

Petition at 4. Accordingly, disclosure of the workpapers to E&Y did not "substantially increase" the ability of potential Textron adversaries to obtain otherwise protected information. Ultimately, Textron asked the court to "clarify" the instructions it provided to the trial court regarding the remand. *Id.* at 13-14.

## IV. THE NEXT STEP IN THE *TEXTRON* LITIGATION

The *Textron* litigation is not yet over and taxpayers will need to follow the future development of the case. At least for now, taxpayers that undertake appropriate steps in the

[10] The IRS also argued that work product protection only extents to "existing or expected litigation" and that, for many of the issues addressed in the workpapers, litigation was merely "hypothetical." Petition at 12-13.

creation and evaluation of their workpapers, at least those situated outside the Fifth Circuit (where *El Paso* still controls), may refuse to comply with the IRS's requests for production of their tax accrual workpapers based upon the principles enunciated by the *Textron* court. That conclusion would change, however, were the panel's decision not to survive in its present form. Were the IRS to obtain a reversal upon en banc rehearing, for example, the legal landscape would radically change and the *Textron* litigation could be viewed as vindicating the IRS's policy of seeking tax accrual workpapers.

The IRS's petition for en banc rehearing is governed by Federal Rule of Appellate Procedure 35. Whether to grant a rehearing is within the court's discretion and a party seeking en banc rehearing must not only show that the original panel's decision was incorrect but, before even reaching the merits, must show that the panel decision conflicts with either a Supreme Court decision, conflicts with a prior decision of the First Circuit, conflicts with a decision of another court of appeals, or is of exception importance. The petition is considered by all of the active circuit judges, who vote on whether the case should be reheard by the entire court sitting en banc. En banc petitions are disfavored and are rarely granted, although the likelihood that a petition in *Textron* would be granted is somewhat greater than in most cases because of the importance of the issue, the split in the panel decision, and the conflict between the panel decision and the Fifth Circuit's *El Paso* decision.

Even if the First Circuit denies the petition for en banc rehearing, the IRS would still have options. Those options would include—

**1) Pursue the remand.** The First Circuit remanded several questions to the trial court for additional consideration, mostly relating to Ernst & Young's role in creating or reviewing the workpapers. The IRS has a right to litigate those issues and, depending upon the

trial court's ruling, could still obtain a ruling which gives the IRS access to some of the Textron tax accrual workpapers. Such a ruling would, however, leave intact the First Circuit's principal ruling on the protected status of tax accrual workpapers. Depending upon the contours of the trial court's rulings upon remand, corporations and auditors might well be able to structure the reserve-development process in a manner that would keep most of their tax accrual workpapers beyond the IRS's grasp.

**2) Litigate in other circuits**. *Textron* is the law only in the states within the First Circuit. As a result, the IRS may still summons corporate tax accrual workpapers, and litigate any work product assertions, in the 46 states outside the First Circuit. Those courts could require disclosure of the workpapers, following the reasoning of *El Paso* and rejecting taxpayers' assertions of work product protection. The IRS may take its chances that one of those rulings will produce either a more acceptable statement of the applicable legal standard or a better litigating vehicle for presentation of the issue to the Supreme Court.

**3) File petition for certiorari to the Supreme Court**. Under 28 U.S.C. §§1254 and 2101, any party may file a petition for certiorari within 90 days of the entry of judgment in the court of appeals. The Supreme Court denies the vast majority of certiorari petitions, although petitions filed by the Solicitor General have a much greater likelihood of being granted than those filed by others. The factors discussed above which support rehearing en banc would also favor a grant of certiorari. As with the pending motion for en banc reconsideration, the IRS could turn defeat into victory if it both obtains certiorari and prevails on the merits.

Given the fact that the IRS has already decided, with the concurrence of the Solicitor General, to seek en banc rehearing, it appears that the IRS is not yet ready to rethink its position on tax accrual workpapers. It thus seems likely that, if rehearing en banc is denied, the IRS will

pursue some combination of these options.[11] The IRS could pursue the remand on the Ernst & Young questions in Textron while it attempts to enforce summonses seeking tax accrual workpapers in other circuits and it seeks certiorari in the Supreme Court. It should be noted, however, that several of the most important players who will participate in the IRS's decision have yet to even be nominated for office by the President.

Textron's petition for panel rehearing is governed by Federal Rule of Appellate Procedure 40. Under that rule, litigants can obtain panel rehearing upon a showing that the original decision has "overlooked or misapprehended" some point of law or fact; the decision regarding whether to grant panel rehearing is discretionary and is left to the original panel Here, Textron's best argument is that the appellate court did not sufficiently consider the rules governing auditor confidentiality and that, if it had, it would have more narrowly circumscribed the scope of the waiver issues to be consider by the district court upon remand. Given the limited relief sought by Textron, and the fact that it can present the same arguments to the district court upon remand, it seems unlikely that the appellate court would address Textron's points upon rehearing (although the terms established by the court to define the scope of any grant of the IRS' request for en banc rehearing might be broad enough to allow Textron to present these arguments).[12]

Regardless, the decision regarding whether to grant a petition for rehearing is generally made fairly quickly. One early indicator to watch for is an order asking the opposing party

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[11] Of course, the IRS could concede the issue. It was able to enforce the revenue laws of this country for nearly a century without access to corporate tax accrual workpapers and the Republic will survive regardless of whether the IRS may obtain workpapers in future years. Thus, the IRS could rescind the policy change reflected in Announcement 2002-63 and return to its prior practice of seeking production of workpapers only in the rare and unique cases where the IRS has a special need for the workpapers.

[12] It is unclear whether Textron would have even sought rehearing if it had not anticipated the IRS' petition for en banc rehearing. By filing the petition, Textron put the case in a context where the court would be more likely to reject the IRS's petition based upon the notion that, if both sides to a dispute are unhappy with a judicial ruling, then the ruling may represent an appropriate compromise position.

to respond to the petition; parties are generally prohibited from opposing rehearing petitions, but both Federal Rules of Appellate Procedure 35 and 40 generally contemplate that the court would issue an order seeking a responsive brief if the court finds sufficient merit in the rehearing petition to warrant serious consideration.

## V. ANALYSIS OF THE *TEXTRON* DECISION

The critical issue both planners and litigators must now consider is whether the treatment of tax accrual workpapers as protected work product under *Textron* will ultimately prevail. In the many months which will elapse before that question is ultimately answered, they must further consider how corporations may best manage their tax accrual workpapers to reduce the risk of unwanted disclosure to the IRS.

The *Textron* decision contains three distinct rulings on three distinct issues. Most significantly, a divided panel ruled that tax accrual workpapers held by a corporation are protected work product where they were prepared in anticipation of litigation. In addition, the panel unanimously agreed that tax accrual workpapers held by a corporation's auditors are, at a minimum, less completely protected by the work product doctrine. Finally, and much less prominently, the court recognized that tax accrual workpapers related to issues not yet identified in an audit were just as relevant, at least for purposes of the summons provisions, as workpapers focused upon an issue which had already arisen in the course of the audit.

1. *Application of Work Product Doctrine*. The traditional formulation of the work product rule in terms of documents "prepared in anticipation of litigation" provides little assistance in distinguishing between documents which should (and should not) be protected as work product in the context of tax controversies. Tax practitioners must view virtually all of their work from the perspective of future conflict with the IRS over the specific return positions

they recommend to their clients; whether the recommended return position survives a challenge by the IRS is one of the most important (if not the most important) criteria by which tax advice is measured. In that context, virtually all tax advice and analysis is prepared in anticipation of a specific legal challenge brought by a known adversary over a known subject matter— *i.e.*, an audit challenge by the IRS to a specific position taken on a specific return. Few other areas of legal counseling are as directly tied to a well-defined potential legal controversy as the advice provided by tax practitioners.

As a result, it is far more difficult in the tax arena to distinguish preparation for litigation from normal business activity than in most any other area of law. The First Circuit majority's framing of the issue as a choice between the "because of" and "primary motivating purpose" standards for determining whether "dual purpose" documents qualify for work product protection is not particularly helpful in drawing the distinction. Everyone can agree that the dual purposes are linked; corporations would have no reason to evaluate, consider and compute a tax reserve contingency if there was no risk of an IRS challenge to the corporation's return positions. The difficulty arises in trying to articulate an intermediate position—one which allows counsel and parties to privately prepare for litigation but which does not immunize all tax counseling from disclosure.

The First Circuit majority offered an interesting basis for drawing the boundary, proposing that it would not extend work product protection to documents prepared where there was no "obvious objectively reasonable need to foresee litigation." 553 F.3d at 102. In the context of tax accrual workpapers there is no need to establish a tax reserve, or to prepare tax accrual workpapers, for positions which the corporation does not objectively see at risk of IRS challenge. Thus, under the majority's rule, most tax accrual workpapers would be entitled to

work product protection.

The position advanced by the IRS in its rehearing petition does not represent a workable standard for distinguishing between protected litigation protection and unprotected documents prepared in the ordinary course of business. The IRS argued that a "document may be protected if it has some business purpose; but a document is ineligible for protection if it has an "independently required" business purpose." Petition at 11. Under the IRS proposed rule, the value of the document in preparation for litigation is irrelevant if its preparation is also independently required by other considerations. Such an analysis ignores the policy considerations underlying the work product doctrine of creating a zone of privacy within which an attorney can prepare a case for litigation. Further, it represents a departure from prior precedent; even under the *El Paso* court's "primary motivating purpose" test, a document which was created, in part, to satisfy an independently required business purpose could still qualify for work product protection if the "primary motivating purpose" for its creation was preparation for litigation. The proposed IRS test represents a departure from existing precedent which is not adequately grounded in the policies underlying the work product doctrine.[13]

Neither the majority nor the IRS have advanced an inquiry suggested by the dissent which would focus the inquiry upon the potential "benefit" to the corporation produced by the disputed document. Such an inquiry would consider the extent to which a particular document would assist the corporation in the event that the propriety of a return position is actually litigated. If the document provides information the corporation's lawyers would need and

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[13] One could argue that tax accrual workpapers might be protected even under the IRS" proposed "independently required" business purpose test. In fact, the SEC and financial accounting rules mandate only that a tax reserve be established and the amount of the reserve be based upon a specific type of analysis. Those rules do not, however, require that the analysis be recorded in a detailed set of tax accrual workpapers. Thus, it could be argued that preparation of detailed tax accrual workpapers is not "independently required" by the SEC and financial accounting rules.

rely upon in the event of litigation, then it should be protected by the work product doctrine. Conversely, if the document is not valuable to the litigators, then it ought not be protected by the work product doctrine. Focusing upon the potential benefit of the document in the event of litigation also reflects the policy underlying the work product doctrine—allowing a party to gather evidence in preparation for trial without undue interference from an adversary.

Regardless of how the issue is analyzed, it is important to recognize that the financial markets and the economy in general are dependent upon the accuracy of the information contained in financial statements, including information about a corporation's contingent tax liabilities. Protecting the integrity of that process is an important societal value and should be encouraged. In the context of tax accrual workpapers, therefore, a rule allowing for disclosure would inevitably erode the quality of the financial reporting process would impose costs throughout the economy. In contrast, the countervailing interest in favor of disclosure of tax accrual workpapers, allowing the IRS to conduct its audits more easily, pales by comparison, particularly in view of all of the other tools available to the IRS. In sum, issues of legal doctrine aside, tax accrual workpapers should generally be protected from disclosure to the IRS during the audit process.

2. *Work product protection for workpapers created by outside auditors.* Unlike attorney-client privilege, which is waived upon disclosure to someone outside the privileged relationship, the rules regarding waiver of work product protection are more flexible. The focus of work product privilege is protection of information from disclosure to adversaries, so the rule of law applied by the First Circuit in *Textron* is that "disclosing material in a way inconsistent with keeping it from an adversary waives work product protection." 553 F.3d at 102. Noting that Ernst & Young might be required to disclose its own workpapers in response to subpoenas

served by the SEC or corporate shareholders, the First Circuit remanded the waiver question for further fact-finding and asked the trial court to evaluate whether Ernst & Young's possession of its own workpapers "substantially increased the risk that the contents of Textron's workpapers would be disclosed." *Id* at 104.

Disclosure of the Ernst & Young workpapers will probably not be required if the IRS chooses to pursue the waiver argument upon remand. As a factual matter, an SEC investigation of Textron and the work of its auditors is statistically unlikely and it is even more unlikely that such an investigation would address Textron's tax reserves. Similarly, a suit by shareholders is also statistically unlikely and it is particularly unlikely that such a suit would address Textron's tax reserves. Many of the points made by Textron in its rehearing petition would reinforce this position. It thus seems unlikely that the IRS would satisfy its burden of showing that a substantial risk exits that Ernst & Young would be called upon to produce the workpapers.

The existence of even that limited risk of waiver would be eliminated by slightly rethinking the legal analysis. As a theoretical matter, disclosure waives either attorney-client privilege or work product protection because disclosure demonstrates that the person possessing the privilege or protection does not truly consider the information confidential. In contrast, a corporation cannot, as a practical matter, prevent its auditors from preparing tax accrual workpapers; the corporation cannot otherwise obtain the auditor's certification of its financial statements and cannot function without those certified financials. This is hardly the type of disclosure which justifies a finding of waiver. Absent a truly "voluntary" disclosure of protected information by the corporation, no waiver should be found.

3. *Relevance of tax accrual workpapers*. The relevance standard imposed upon the IRS when it seeks documents through an administrative summons is rather low. Nonetheless, a

standard still exists; the IRS must make a showing of relevance greater than an empty hope that the requested workpapers will produce useful information. That standard is easily satisfied in the case of tax accrual workpapers related to a return position which the IRS has already identified and is proceeding to audit. Factual information contained in the workpapers relating to that specific issue may well assist in developing the facts for presentation to the court.

The IRS's policy of seeking production of all workpapers when a taxpayer has engaged in multiple Listed Transactions or the IRS discovers a previously-undisclosed Listed Transaction, however, pushes the relevance standard considerably further. The *Arthur Young* court rejected the taxpayer's privilege claim, at least in part, because of its view that the IRS's policy of restraint with respect to tax accrual workpapers showed "administrative sensitivity to the concerns expressed by the accounting profession by tightening its internal requirements" for requesting tax accrual workpapers. 465 U.S. at 820. In revising its policy, the IRS is not showing the "administrative sensitivity" which allowed the *Arthur Young* court to discount industry fears and to enforce a summons for tax accrual workpapers.

The IRS may believe that participation in multiple Listed Transactions or identification of a previously undisclosed Listed Transaction suggests that the taxpayer is willing to take aggressive positions on its return and that the taxpayer may be more likely than most to have taken other debatable return positions. However, the IRS's policy of requesting all tax accrual workpapers under those limited circumstances can be viewed as punitive and may raise questions regarding whether the IRS's action meets the legitimate purpose requirement imposed upon the IRS as a prerequisite to summons enforcement. The *Textron* trial court gave short shrift to such an argument, 507 F. Supp. 2d at 145, and the First Circuit did not even address relevance. Future courts may want to revisit the issue.

## VI. MANAGING TAX ACCRUAL WORKPAPERS IN THE CURRENT UNCERTAIN ENVIRONMENT.

The preceding discussion demonstrates that the panel decision in *Textron* is unlikely to be the final word on whether the IRS can obtain corporate tax accrual workpapers. While the litigation proceeds, however, there are lessons that well-advised corporations can learn from the *Textron* litigation.

1. *Recognize that the battle is not over*. The IRS has plenty of litigating options available and it is unlikely to revise its policy of seeking tax accrual workpapers based upon a single appellate defeat—a divided one at that. Nothing prevents the IRS from issuing new administrative summonses seeking tax accrual workpapers and no one should be surprised if it does so. Moreover, there is no assurance that subsequent decisions may not ultimately decide the issue in favor of the IRS. Therefore, no one should assume that the IRS cannot obtain corporate tax accrual workpapers.

2. *Recognize that disclosure is a possibility*. Well-advised corporations and their auditors will need to continue operating under the assumption that the IRS may obtain access to their tax accrual workpapers. Managers should ensure that their staff fully understand that what they write is potentially subject to disclosure and that they should choose their words carefully; that clever turn of phrase in a workpaper may make its author a pivotal player in subsequent litigation. References to other taxpayers or other return positions in a workpaper can ultimately prove embarrassing or worse when publicly disclosed. That is not to say that the conclusions in the workpapers should be modified, but drafters of workpapers should be made aware that their work may be disclosed to the IRS.

3. *Make greater use of inside or outside counsel.* The extent of work product protection can vary amongst various categories of documents. Documents reflecting the opinions of lawyers, particularly trial counsel, receive the greatest degree of protection. Corporations seeking to provide greater protection for their tax accrual workpapers, therefore, should include counsel in the process and make sure to memorialize the participation of counsel in the preparation of individual workpapers.

4. *Segregate information into multiple workpapers*. Similarly, workpapers containing subjective judgments are more likely to be protected than workpapers containing objective factual information. Well-advised corporations and their auditors, therefore, should consider segregating the factual material and the subjective judgments into separate workpapers—*e.g.,* one workpaper discussing facts, a second workpaper discussing available legal arguments, and a third containing conclusions regarding the likelihood of success. By doing so, it becomes possible for the corporation to disclose factual information and analysis while protecting the most sensitive information regarding its legal analysis and appraisal of its likelihood of success.

5. *Define ownership of the tax accrual workpapers*. The *Textron* decision provides less protection to an auditor's workpapers than those of a corporation. The tax professionals in that case acted wisely, therefore, in ensuring that Ernst & Young was not allowed to copy or retain any of Textron's workpapers, thereby weakening a potential waiver argument the IRS might have advanced. They did not, however, establish ownership of the workpapers created by Ernst & Young, and the First Circuit concluded that Textron could obtain those workpapers upon request from Ernst & Young. 553 F.3d at 105. Thus, the court treated the summons issued to Textron as reaching the Ernst & Young workpapers. A different ruling might have been issued

if the retainer agreement between Textron and its auditors had established that Textron could not obtain the Ernst & Young workpapers. Corporate tax managers and their auditors might consider addressing the issue in retainer agreements.

## CONCLUSION

*Textron* represents a significant victory for taxpayers seeking to protect their tax accrual workpapers from the IRS. The decision, however, is unlikely to be the last word on the subject and substantial changes in the law remain a real possibility. Given the existing uncertainty, and the sensitivity of the information contained in corporate tax accrual workpapers, well-advised taxpayers should continue to exercise care in managing creation and retention of their tax accrual workpapers.

## Appendix A

## IRS Policy of Restraint Regarding Tax Accrual Workpapers After *Textron*

1. *Announcement 2002-63*. In June of 2002, the IRS announced that it was revising its policy concerning when it will request tax accrual and other financial audit workpapers relating to the tax reserve for deferred tax liabilities.[14] In Announcement 2002-63, the IRS stated that, for tax returns filed after July 1, 2002, if all Listed Transactions are properly disclosed, the IRS may routinely request only those tax accrual workpapers associated with such transactions. If the IRS discovers Listed Transactions that were not properly disclosed, however, it may routinely request all tax accrual workpapers.

Announcement 2002-63 caused many taxpayers to file "protective" disclosures for Listed Transactions in order to avoid automatically triggering tests that may give rise to an IRS request for all tax accrual workpapers.[15] The IRS has said that checking the "Listed Transaction" box on IRS Form 8886 and completing the form its entirety by providing all other relevant data is required for protective disclosure of a Listed Transaction to constitute disclosure.

Announcement 2002-63 also notes that the IRS may, as a discretionary matter, request all tax accrual workpapers if it determines that tax benefits from multiple investments in Listed Transactions are claimed on a return (regardless of whether such transactions were disclosed) or if there are reported financial accounting irregularities (such as those requiring a restatement of earnings).

2. *July 2004 Internal Revenue Manual Update*. In July of 2004, the IRS issued a memorandum to its Large and Midsize Business Division ("LMSB") clarifying its policy on when audit, tax accrual, and tax reconciliation workpapers should be requested in the course of an examination.[16] Deborah M. Nolan, Commissioner of LMSB, stated, "I want to emphasize that the new IRM follows Announcement 2002-63 in making clear that a request for tax accrual workpapers is mandatory when a taxpayer claims the benefit of a Listed Transaction for a return filed on or after July 1, 2002, and for some returns filed before that date." (Emphasis added.) It is interesting to note that Announcement 2002-63 states that the IRS "may" request workpapers, although it does subsequently warn that the IRS "will routinely request" workpapers.

The July 2004 memorandum provides that if an examiner finds an undisclosed Listed Transaction on a return filed before July 1, 2002, he or she needs approval not to request tax accrual workpapers pertaining to the Listed Transaction. Similarly, while the July 2004 memorandum clarifies the term "as a discretionary matter" (as used in reference to requests involving multiple investments in Listed Transactions or financial accounting irregularities) and denotes the exercise of prudence in executing policies, it nevertheless provides that "the presumption is that the Service will request all tax accrual workpapers," and an examiner must obtain approval not to request all of the workpapers in those instances.

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[14] *See* Announcement 2002-63, 2002-27 I.R.B. 72. *See also* Chief Counsel Notice 2003-012, CC-2003-012 (April 9, 2003).

[15] *See* Regs. § 1.6011-4(f)(2) (filing protective disclosure statements).

[16] *See* IRM § 4.10.20.

Finally, the July 2004 memorandum provides that IDRs for workpapers involving Listed Transactions must be approved by the Team Manager in LMSB cases or the Group Manager in SB/SE cases (other "unusual circumstances" requests require approval by the Director of Field Operations of LMSB or Area Compliance Director and Director of Compliance Policy for SB/SE).

The following chart summarizes current IRS policy on requests for tax accrual workpapers:

| **Current IRS Policy On Tax Accrual Workpapers** | | | |
|---|---|---|---|
| **Circumstances** | **Standard** | **Scope** | **Approval** |
| • Single Listed Transaction not timely and properly disclosed (returns filed after 2/28/00 but before 7/1/02) | • "Appropriate circumstances"; circumstances when a request would not be appropriate are rare | • Workpapers that pertain to the Listed Transaction for the year under examination<br>• But not limited to years under examination if others "directly relevant" | • Examiner prepares; Team Manager (LMSB) or Group Manager (SB/SE) must review<br>• Approval not to request workpapers required |
| • Single Listed Transaction timely and properly disclosed (returns filed after 7/1/02) | • Will routinely request (mandatory) | • Workpapers that pertain to the Listed Transaction for the year under examination<br>• But not limited to years under examination if others "directly relevant" | • Examiner prepares; Team Manager (LMSB) or Group Manager (SB/SE) must review |
| • Single Listed Transaction not timely and properly disclosed (returns filed after 7/1/02) | • Will routinely request (mandatory) | • All tax accrual workpapers for the year under examination<br>• But not limited to years under examination if others "directly relevant" | • Examiner prepares; Team Manager (LMSB) or Group Manager (SB/SE) must review |
| • Multiple Listed Transactions timely and properly disclosed (returns filed after 7/1/02) | • As a "discretionary matter"; presumption is that IRS will request all tax accrual workpapers | • All tax accrual workpapers for the year under examination<br>• But not limited to years under examination if others "directly relevant" | • Examiner prepares; Team Manager (LMSB) or Group Manager (SB/SE) must review<br>• Approval not to request all workpapers required |
| • Single Listed Transaction timely and properly disclosed and reported financial irregularities (returns filed after 7/01/02) | • As a "discretionary matter"; presumption is that IRS will request all tax accrual workpapers | • All tax accrual workpapers for the year under examination<br>• But not limited to years under examination if others "directly relevant" | • Examiner prepares; Team Manager (LMSB) or Group Manager (SB/SE) must review<br>• Approval not to request all workpapers required |

3. *FIN 48 Compliance*. On March 22, 2007, the IRS concluded in generic legal advice that documents produced in accordance with FIN 48 to substantiate a taxpayer's uncertain tax positions will be treated by the IRS as tax accrual workpapers.

4. *Impact of Textron Victory*. In *Textron*,[17] as noted in the main text of this article, the district court held tax accrual workpapers prepared in anticipation of litigation need not be shown to the IRS. The court held as a factual matter that Textron's tax accrual workpapers were prepared because of the prospect of litigation. The court further held that SEC disclosure rules of litigation hazards does not mean the tax accrual workpapers were not prepared in anticipation of litigation because, if there is no prospect of litigation, no tax accrual workpapers would be prepared. And although the attorney-client privilege and the Section 7525 practitioner privilege are waived by disclosure to a third party, including a company's independent auditor, the work product privilege is not waived except by disclosures that substantially increase the likelihood the company's adversary—the IRS in this case—would obtain access to the information. As a result, the court held that tax accrual workpapers prepared in anticipation of litigation need not be shared with the IRS even where the workpapers are shared with non-adversaries like the company's independent auditors. The decision in *Textron* makes the IRS's policy of restraint moot with respect to tax accrual workpapers prepared in anticipation of litigation.

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[17] *United States v. Textron, Inc. and Subsidiaries,* 507 F. Supp. 2d 138 (D. Rhode Island, August 28, 2007), aff'd, in part, and vacated in part, remanded, 553 F.3d 87 (1st Cir. 2009).