E-Discovery: Coming Soon to a Transaction Near You

*By Susan E. Seabrook**

Susan E. Seabrook discusses why tax advisors should care about e-discovery.

Throughout human history, we have been dependent on machines to survive. Fate, it seems, is not without a sense of irony.[1]

On March 27, 2009, Chief Judge John O. Colvin announced that the U.S. Tax Court had proposed amendments to its Rules of Practice and Procedure.[2] Some of those proposed amendments would align the Tax Court's Rules more closely to selected procedures from the Federal Rules of Civil Procedure. In particular, the amendments addressed discovery rules applicable to electronically stored information. For those of us interested in tax controversy developments, this news was greeted with great interest and generated immediate and prolonged discussion. Some of us pondered the significance of the explicit linkage to the Federal Rules of Civil Procedure. Others wondered whether this meant the discovery process in the Tax Court would become more like the discovery process in the U.S. District Courts—and not in a good way. All of us began to look more closely at the forms of electronic data we had become accustomed to generating, and to evaluate our approaches to the use and retention of such information.

As tax executives and advisors, the ability to provide confidential tax advice to our clients is the bedrock of our profession. As citizens of the 21st century, the use of increasingly advanced technological tools in connection with the provision of our services is a given. The rules applicable to both the advice that we give, and to the processes through which such advice may become available to third parties, have undergone vast and rapid change. As a result, we are now tasked as professionals with acquiring expertise in areas as esoteric as the implications of providing metadata to a client to complying with the preservation duties imposed by rules of civil procedure and evidence.

The recent amendments to the Federal Rules of Civil Procedure and the Tax Court's Rules of Practice and Procedure provide specific rules applicable to the discovery of electronically stored information, or "ESI." The drafters explain that the term "ESI" is intended to be broad enough to cover all current types of computer-based information, and flexible enough to encompass future changes and technological development.

It is estimated that today, approximately 95 percent of documents originate in electronic form. Tax advisors traditionally make use of a number of types of electronic hardware, software and systems in connection with the provision of services. As a result, the electronic material created in that process may one day be the subject of an Information Document Request (IDR) from the IRS or requested in connection with discovery when a tax matter is litigated. Thus, individuals that provide tax advice may become subject to a duty to preserve relevant ESI. Tax advisors are on notice that if their advice is not subject to privilege or otherwise protected, they may be required to produce responsive ESI. More worrisome, if tax advisors destroy ESI—even inadvertently or unintentionally—in certain cases, the tax advisor as well as the client may be subject to sanctions. The amendments to the U.S. Tax Court's Rules of Practice and Procedure have

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provided us with a wake-up call: Whether we like or not, we will have to become conversant with rules applicable to electronic discovery.

Learning to Speak the Language of E-Discovery

> *That gibberish he talked was city speak, gutter talk. A mishmash of Japanese, Spanish, German, what have you. I didn't really need a translator, I knew the lingo, every good cop did. But I wasn't going to make it easier for him.*[3]

There are a number of excellent resources for would-be students of e-discovery. The Sedona Conference and the Federal Judicial Center have a rich array of informational materials available that are easily accessible on the internet free of charge.

> The Sedona Conference is a nonprofit, 501(c)(3) research and educational institute dedicated to the advanced study of law and policy in the areas of antitrust law, complex litigation, and intellectual property rights. Through a combination of Conferences, Working Groups, and the "magic" of dialogue, The Sedona Conference® seeks to move the law forward in a reasoned and just way.[4]

> The Federal Judicial Center is the education and research agency for the federal courts. Congress created the FJC in 1967 to promote improvements in judicial administration in the courts of the United States. This site contains the results of Center research on federal court operations and procedures and court history, as well as selected educational materials produced for judges and court employees.[5]

The development of issues relating to e-discovery through both litigation and rulemaking suggests an increased emphasis on the "meet and confer" concept in connection with promoting the idea of discovery as a cooperative and reciprocal process. As such, we need to be better educated about our own internal e-practices as well as our clients' processes. The parties to a controversy are expected to understand IT platforms and be familiar with company practice. The duty to preserve ESI arises when litigation is "reasonably foreseeable." All ESI must be preserved, and destruction of ESI must be suspended. This generally involves the issuance of a "litigation hold," which notifies the appropriate individuals of their duty of preservation. The duty of ensuring that this process occurs and is maintained falls on counsel, who is charged with notifying the appropriate individuals of the scope and nature of the preservation duty. The litigation hold notice must be clearly stated and periodically reissued, and all possible sources of discoverable evidence should be included. Normal retention/destruction practices are to be suspended, and the destruction of potentially responsive ESI can result in sanctions for spoliation.

Sources of ESI include data stored on active storage devices, such as computers, BlackBerries and voice mail. Data may be stored on removable active storage devices including CD ROMs, flash or "thumb" drives and floppy disks. Employee-owned devices, such as personal computers or cell phones, are potential sources for ESI.

ESI is also stored on archive storage systems, such as backup tapes. Archived material is required to be preserved, but may not be required to be produced if it is not reasonably accessible. Thus, while accessible data must be produced, inaccessible data is not required to be produced absent "good cause." The requirement to produce inaccessible data raises cost shifting issues.

The first step to mastering our professional responsibilities is to gain some basic understanding of the above concepts. That understanding is going to be crucial to our ability to maintain the confidential and privileged nature of certain of the advice we provide to our clients.

Preserving Protections and Preparing for the Challenge

> *The Almighty says this must be a fashionable fight. It's drawn the finest people.*[6]

Tax executives and advisors are well aware that the privileges and protections applicable to tax advice are currently under fire. IRS Chief Counsel William J. Wilkins "warned a large group of corporate tax executives that the IRS is developing a new approach to obtaining companies' information on uncertain tax positions."[7] Without explicitly stating that the IRS's former "policy of restraint" would soon be a thing of the past, statements by government officials,

and the recent release of Announcement 2010-9, confirm that some degree of increased disclosure is inevitable.

There is every indication that the IRS Office of Chief Counsel intends to pursue IRS-favorable development of the legal precedent applicable to the privileges and protections that potentially attach to tax advice. The issue has been framed in the context of seeking the documentation companies develop to analyze and support uncertain tax positions, yet the converse seems equally true—Chief Counsel's strategic litigation program will also focus on defending more aggressive positions taken by the IRS for purposes of limiting the scope of responses provided in connection with taxpayer discovery requests.[8]

Chief Counsel leadership maintains that the selection of cases as litigation vehicles is being performed more carefully, and cases are being selected earlier in the process. Promising cases are identified and may be designated for litigation while still in the examination stage. Moreover, IRS lawyers are involved at every stage, including audits, and there is a Chief Counsel attorney on every issue management team.[9]

Privilege and Protection Overview

Insuring that applicable privileges and protections are maintained and not waived during an IRS examination and during the discovery process is an integral part of competent legal representation. Other than tax return preparation, the difference between accounting services and tax advice is not always a bright line. The three types of potential protection for federal tax advice are the attorney-client privilege, the work product doctrine, and the tax advisor privilege under Code Sec. 7525.

These protections can apply to communications and analysis undertaken in connection with the provision of federal tax advice. Advice may take the form of oral communication, or be memorialized in tangible material such as e-mails, voice mail, memoranda, opinions or notes, and it may be provided for more than one reason:

- Prior to implementation of a transaction, activity or payment in order to determine the most tax efficient structure
- For financial or federal income tax return reporting
- For FIN 48 evaluation
- In connection with a potential challenge by the IRS at the Exam level
- In connection with a Protest to IRS Appeals
- In connection with anticipated or pending litigation

A wide range of material may be protected, and some advice may be covered by more than one type of protection. To the extent that a company may wish to protect the confidentiality of the tax advice it has received, appropriate protocols should be put in place to maximize protection and prevent waiver.

The Attorney-Client Privilege

Protected material includes oral communications as well as documents or other tangible things, including ESI. For the attorney-client privilege to apply, the material must consist of legal advice and must be from a legal advisor acting in that capacity. Non-privileged material includes tax return information, legal fee invoices, third-party material and accounting, financial and business advice.

The communication must be confidential. The attorney-client privilege can only be asserted by the client, and the material remains protected so long as the privileged is not waived. The disclosure of privileged material to a third party will waive the privilege. Waiver may be inadvertent or implicit. A waiver may be designated as "selective." Waivers may also be consensual, however, and if not managed properly such waivers may result in a subject matter waiver.

Both the U.S. Securities and Exchange Commission and the IRS have taken the position on occasion that a "selective waiver" of the privilege is possible. The rationale is that the waiver of privilege in order to cooperate with the SEC or the IRS should not result in a broad waiver as to other parties.[10] The concept of "selective waiver," however, has been rejected by several courts which have held that a company's production of privileged information to the SEC or other government agency constitutes a full waiver of all privileges and protections.[11]

The Work Product Doctrine

The work product doctrine protects the thoughts and mental processes ("the work product") of a party's attorney and/or his representatives in connection with anticipated litigation. Such material is protected from disclosure to a party's adversary unless the adversary can establish a substantial need for the document and that withholding the document

results in undue hardship. Work product protection is determined on a document-by-document basis, so that waiver of the protection also occurs on a document-by-document basis.

Work product protection may apply to written material concerning certain types of analyses performed prior to implementation of a transaction. The issue of whether dual-purpose material created in the context of tax matters, for example, material that is also used in connection with FIN 48 analyses, can qualify as protected "work product" is the subject of continuing litigation**.**

Work product protection may apply to the drafting of responses to the IRS at the Exam level, material created in connection with the preparation and presentation of a Protest to IRS Appeals, and material created in connection with anticipated or pending litigation. *[A petition for* certiorari *was filed December 24, 2009, seeking review of the First Circuit's 3–2* en banc *decision in* United States v. Textron, Inc., *No. 07-2631 (1st Cir. Aug. 18, 2009).]*

Protected material includes documents or other tangible things, including ESI, that are prepared in anticipation of litigation by or for a party or its representative where such material has not been shared with the party's adversary. Work product may include materials created in connection with issuing a tax opinion. "Work product" traditionally encompasses material created in developing strategies, and reflects the mental impressions and theories of counsel. Most litigation-related materials are potentially protected work product.

Work product may be created by attorneys or by nonattorneys, depending upon the nonattorney's role. Accountants, appraisers, actuaries and other advisors may create work product under certain circumstances.

Federal Tax Advisor Privilege

For federal tax advisors that practice as accountants rather than attorneys, Code Sec. 7525 provides a limited form of privilege, similar in application to the attorney-client privilege, for tax advice given by an authorized tax practitioner. The protection is only applicable in federal civil tax proceedings, and cannot be raised with respect to written advice given in connection with tax shelters, as defined in Code Sec. 6662(d)(2)(C)(ii). The privilege only applies to "tax advice," not accounting or business advice. The privilege does not apply to advice rendered in connection with the preparation of a tax return, or advice provided in connection with criminal matters.

To ensure that privileges and protections are maintained and not waived, care must be taken at the front end to segregate privileged material from nonprivileged material. Privileged material must not be shared with anyone not included in the privileged relationship. In the electronic world, that can be more easily said than done in many instances. A tax controversy increases the likelihood that privileges or work product protection may be waived, and even inadvertent waivers can nonetheless cause the advice to lose its protected status. The discovery process can be fast and furious, and although attempts have been made to build some fail safes into the processes, the danger of waiver remains.

Overview of the Amendments to the FRCP and the Tax Court's Rules of Practice and Procedure

> *Smokey, this is not 'Nam. This is bowling. There are rules.*[12]

ESI that is created in connection with the provision of tax advice will be subject to "rules" in the event of litigation. Thus, tax advisors should have some familiarity with the operation of the rules before ESI is created or shared. In a nutshell, the rules provide a definition of ESI and a framework for incorporating ESI into the existing rules applicable to the preservation and production of evidence. The rules emphasize counsel's expanded responsibilities in ensuring compliance with the rules both by raising the bar in terms of fact gathering concerning the existence of ESI and by requiring increased coordination and cooperation with adversaries during the discovery process.

The Federal Rules of Civil Procedure (FRCP) were amended to provide specific rules applicable to e-discovery and ESI effective December 1, 2006. The U.S. Tax Court adopted conforming amendments to its Rules of Practice and Procedure on September 18, 2009, and those amendments are generally effective January 2010. The Tax Court's amendments are consistent with the general principles expressed in the Advisory Committee Notes to the amendments to the FRCP. The following provides a summary of the amendments, highlighting the most important concepts for tax advisors.

Initial Disclosures and Agreed Discovery Plan

Parties to litigation are required to provide detailed initial disclosures to their adversaries. Rule 26(a) of the FRCP addresses these initial disclosures, and provides that prior to any discovery request, a party must provide other parties a copy of, or a description by category and location of all documents, electronically stored information, and tangible things in its possession that it may use to support its claims and defenses.

In addition, the parties are required to develop a proposed discovery plan concerning any issues relating to the identification and disclosure of ESI. The purpose of these rules is to encourage parties to reach a comprehensive agreement covering all aspects of preservation, collection and production of ESI. Parties will need to identify whether information is "reasonably accessible," as well as agree on preservation requirements and production formats. Finally, parties may want to incorporate agreements for assertion of privileges after inadvertent production, such as "claw backs" or "quick peeks."

The initial disclosures are used in reaching agreement at the scheduling conference required by Rule 26(f) of the FRCP. Courts may incorporate the agreements reached in the Rule 26(f) conference in the Rule 16(b) scheduling order, which may include provisions for disclosure or discovery of ESI and agreements for asserting claims of privilege after inadvertent production.

Issues arose concerning the effect of Rule 26(b)(5)(B) agreements on the ability to assert claims of privilege in other contexts after an inadvertent production. Because a "claw back" agreement does not govern whether a waiver actually occurred, this left the door open for third parties to assert that a subject matter waiver occurred. As a result, Rule 502 of the Federal Rules of Evidence was amended to provide that subject matter waiver extends to undisclosed communication concerning same subject matter only if that undisclosed information should in fairness be considered with the disclosed communication.

The explanations to the amendments to the Tax Court's Rules of Practice and Procedure amendments quote extensively from the Advisory Committee Notes to the amendments to the FRCP. The Tax Court "expects the parties to attempt to attain the objectives of discovery through informal consultation or communication before utilizing the discovery procedures provided in these Rules."

Duties Concerning "Inaccessible" Data

A party's duty to produce "inaccessible" data is limited pursuant to Rule 26(b)(2)(B) of the FRCP. A party ordinarily need not produce ESI from sources that are not reasonably accessible because of undue burden or cost. Under appropriate circumstances, a court may order production of inaccessible date for "good cause." The determination of "reasonably accessible" and "good cause" may require staged proceedings, such as sampling.

The Committee Notes to the amendments clarify that although a party does not have to produce inaccessible data absent a motion to compel, a party's identification of sources of electronically stored information as not reasonably accessible does not relieve the party of its common-law or statutory duties to preserve evidence

Responses Provided by Reference to ESI

Rule 33(d) of the FRCP provides an option to produce electronic records where the answer to an interrogatory may be derived from electronic documents and data. Rule 34 of the FRCP provides guidelines for production formats and applies to both documents and "dynamic databases." The responding party may need to "translate" information into a "reasonably usable form." Absent court order, party agreement or a request for a specific format for production, a party may produce e-discovery in the form in which the party ordinarily maintains its data or in any reasonably usable form.

The Committee Notes clarify that if the responding party ordinarily maintains the information in a way that makes it searchable by electronic means, the information should not be produced in a form that removes or significantly degrades this feature.

The revisions to the Tax Court's Rules of Practice and Procedure applicable to ESI include revisions to Rule 71, applicable to interrogatories. The rule provides that answers to interrogatories may be derived from business records, including ESI. The responding party must afford the requesting party reasonable opportunity to examine and make copies.

With respect to the production of documents, Rule 72 was amended to include ESI as a specific category. Similar to the FRCP, the requester may specify the form or forms of production, although the responding party may object, and state the form

in which it will produce. Unless otherwise stipulated or ordered by the Court, a party shall produce all ESI kept in the usual course of business in the form it is ordinarily maintained or in reasonably usable form or forms. Note that a party need not produce the same ESI in more than one form, so that decisions made in connection with the initial production of ESI are important.

Safe Harbor for Production Failures

Rule 37(f) of the FRCP creates a "safe harbor" for parties failing to produce responsive ESI. Absent exceptional circumstances, a court may not impose sanctions on a party for failing to provide ESI lost as a result of the routine, good-faith operation of an electronic information system. Routine operations may need to be suspended once the duty to preserve arises. The rule is not intended to shield parties that intentionally destroy information because of its relevance to litigation.

The Tax Court rules also include a safe harbor corollary. Rule 104 provides that absent unusual circumstances, sanctions will not be imposed for ESI lost as a result of routine, good-faith operation of an electronic information system.

Application to Third-Party Subpoenas

Rule 45, which governs third-party subpoenas, was amended to apply to ESI. The amendments were designed to align Rule 45 to the amendments to FRCP, including specifying production format, and providing limitations concerning the production of information that is not reasonably accessible. The Federal Subpoena form was updated in January 2007 to reflect electronic discovery amendments.

Rule 147 of the Tax Court's Rules of Practice and Procedure was also amended to add ESI as a specific category of production in connection with complying with subpoenas.

Keeping on Top of Your Obligations

> *I want all of you to get up right now and go to the window. Open it, and stick your head out, and yell "I'm mad as hell, and I'm not going to take this anymore!"*[13]

The developments in e-discovery law are rapid and plentiful. The overarching theme of case law addressing compelled production and/or sanctions is consistently articulated as "if anything goes wrong, blame the lawyers." Courts are quick to emphasize that the attorneys and advisors will be held to a very high standard. Counsel is charged with the duty to effectively communicate discovery obligations to his or her client. Counsel must ensure that all relevant information is discovered, preserved and produced. The nature and extent of these obligations breaks new ground for many attorneys, and these obligations may be particularly unfamiliar to tax advisors that have not been active in litigating tax controversies. Nonetheless, given that litigation may be anticipated at the audit stage or even before the audit, tax advisors must be cognizant of their duty to identify and preserve potentially relevant ESI.

Once the duty to preserve attaches, counsel must identify all of the sources of discoverable information. This includes an obligation on the part of counsel to speak directly to key players. This obligation also includes speaking directly with the client's information technology personnel in order to better understand how the client creates, organizes, stores, preserves and destroys ESI.

When the duty to preserve attaches, counsel has the duty to establish appropriate litigation holds. In connection with that process, counsel must make it known to all relevant employees by speaking with them directly. Counsel must reiterate these instructions regularly, and monitor compliance. Counsel must call for employees to produce copies of relevant ESI, and must arrange for the segregation and safeguarding of any archival media that party has a duty to preserve.[14]

What's the Worst That Could Happen?

> *If there is a hell to which disputatious, uncivil, vituperative lawyers go, let it be one in which the damned are eternally locked in discovery disputes with other lawyers of equally repugnant attributes.*[15]

The Committee Notes document the intention of the drafters that the rules be rigorously enforced:

> Because of the asserted reluctance to impose sanctions on attorneys who abuse the discovery rules, Rule 26(g) makes explicit the authority judges now have to impose appropriate sanctions and requires them to use it.[16]

It is fair to say that the judges are using it. Failing to abide by discovery rules can lead to severe sanctions,

including default judgments, preclusion of claims and/or defenses, adverse inferences, deemed admissions, and monetary sanctions. Attorneys are responsible for their client's and their own compliance with discovery rules. Not only can clients be severely punished, but courts are ever-increasingly letting their frustration be known by sanctioning the attorneys directly.

The case law in this area is surreal for those of us more familiar with handling tax controversies than general civil litigation. The litigation very quickly ceases having anything to do with the matters that caused the dispute in the first place. Instead, the actions—or inaction or just plain e-incompetence—of the litigants and their counsel takes center stage.

You May Be Sanctioned for Not Producing Something No One Knew Existed

In a case in which the defendant's motion to dismiss for lack of subject matter jurisdiction was granted, both the defendant and its counsel were nonetheless sanctioned because of their "grossly negligent" behavior in discovery. No doubt both the defendant and defendant's counsel wish they had filed that motion sooner in retrospect. In *Phoenix Four, Inc. v. Strategic Resources Corp.*,[17] the "grossly negligent" behavior causing sanctions to be imposed was the late production of documents neither the defendant nor defendant's counsel knew existed until after the close of discovery. The record reflects that the defendant immediately notified the plaintiff of the discovery and began reviewing the material for responsiveness, but the court was not impressed.

A freelance computer technician made a service call to the office of a former executive of the defendant in response to a complaint concerning a malfunctioning server. The malfunctioning server was one of the two servers that the defendant had taken with it when it vacated its prior office. After accessing the hard drive on the server, the technician found about 25 gigabytes of data—as much as 2,500 boxes—stored in a dormant, partitioned section of the server. The technician stated that "someone using a computer connected to that server could not 'view' or gain access to that section of the hard drive and would have no way of knowing of its existence."[18]

The court noted that counsel had a duty to properly communicate with its client to ensure that '"all sources of relevant information [were] discovered.'"[19] Counsel was expected to be fully familiar with the client's document retention policy and data retention architecture. Thus, the court expected counsel to have communicated with the client's information technology personnel and the key players in the litigation to understand how electronic information was stored.[20] The court expected counsel to ask what happened to the computers that used to be at the defendant's office.[21] In other words, the court expected the attorney to have figured out that there was a considerable amount of data on a partitioned section of a server that no one knew existed and that users currently connected to the servers couldn't view. Failure to do so was grossly negligent.[22]

The Court Might Not Impose a "Severe" Sanction, Just One That Means You Lose

Discovery abuses ultimately led a court to hand the case to the plaintiff by precluding the defendant from raising its key defense—the availability of certain safe harbor provisions in connection with copyright infringement claims. *Arista Records LLC v. Usenet.com* establishes that a client's non-compliance with discovery rules can be detrimental—even fatal—to the substantive case. *Arista Records* is an interesting case study because it illustrates iterative abuses and the escalating costs of those abuses.

Plaintiff's first request for sanctions alleged spoliation of usage data, digital music files and highly incriminating promotional materials that were previously available on the defendant's Web site.[23] The plaintiff alleged that the defendant deliberately destroyed this material even though it was the subject of discovery requests and was relevant to the plaintiff's claims of the defendant's infringement of the plaintiff's copyrighted sound recordings.[24]

After the close of discovery, the plaintiff learned of more instances of the defendant's discovery violations, including that although the defendant regularly used e-mail and stored e-mails on local hard drives, certain key internal documents had not been turned over.[25] Defendant's counsel acknowledged for the first time that he was in possession of seven computer hard drives. Counsel then conceded that four of the seven hard drives had been "wiped" and suggested producing documents from the remaining three drives.

The defendant subsequently conceded that the remaining three drives also had the majority of their

contents deleted. Over time, defendant's successive explanations for the "wiping" of the hard drives were met with increasing skepticism:

- The hard drives had been found in storage, and that they had been purchased blank on eBay and never used.
- Although the hard drives had all been pulled directly from the active workstations of defendant's employees, the drives "would have appeared wiped" as a result of having upgraded to the new Windows Vista operating system.[26]

The record also includes allegations by the plaintiff that the defendant:

- ensured that other work-issued computers became unavailable for production;[27]
- deliberately sent witnesses out of the country to avoid them being deposed[28]; and
- knowingly served false responses to interrogatories.

Even though the court agreed that the defendant destroyed critical evidence and used, at best, dilatory tactics, the court found that entry of a default judgment was too severe of a sanction.[29] Instead, the court precluded the defendant from asserting an affirmative defense of a statutory safe harbor provision, which in the end really didn't seem all that different from a default judgment. The safe harbor provision was the core of the defendant's case, thus the defendant's motion for summary judgment was mooted and dismissed.[30] The plaintiff was then granted its summary judgment on its contributory copyright infringement claim.[31]

You Could Lose Your Right to Assert the Self-Defense Exception to Attorney-Client Privilege and Be Ordered to Attend a "Collaborative Process" to Get in Touch with Your E-Discovery Sins

Although the dispute leading to litigation in *Qualcomm Inc. v. Broadcom Corp.* was patent infringement, the case has also become known for illustrating the severity of sanctions that can be levied against the client and its attorneys due to discovery violations. The plaintiff in this instance was sanctioned about $8.6 million, plus interest, in attorneys' fees and other litigation costs due to the late of production of hundreds of thousands of pages of documents that were only disclosed upon cross-examination of a plaintiff witness during trial.

The U.S. Magistrate Judge's opinion in connection with the order granting in part and denying in part the defendant's motion for sanctions was highly critical of the conduct of some of Qualcomm's attorneys. The defendant's motion sought to sanction attorneys—both in-house counsel and outside counsel—individually in addition to the sanctions requested against Qualcomm.[32]

There was no direct evidence that the plaintiff told its attorneys about the existence of the damaging documents; however, the attorneys were prohibited from providing any testimony on point. The plaintiff asserted the attorney-client privilege, and the magistrate judge refused to recognize the federal common law self-defense exception to disclosing privileged or confidential information.[33] The court found that six out of the 19 attorneys were personally responsible for the discovery violations.[34]

The court ordered that the plaintiff pay the defendant all fees and costs incurred in the litigation.[35] The magistrate judge referred the sanctioned attorneys to the state bar for an appropriate investigation and possible additional sanctions.[36] Finally, the court ordered the sanctioned attorneys and the plaintiff's in-house counsel to participate in a collaborative program designed to identify the failures in case management and discovery protocol that resulted in the violations. An exhibit to the opinion contains the attorneys' educational backgrounds and details concerning their involvement in the case.[37]

The attorneys filed objections, and the case was returned to the trial court.[38] The attorneys argued that the federal common law self-defense exception to disclosing privileged or confidential information applied, which would allow them to disclose attorney-client privileged information.[39] The trial court vacated the magistrate's order in recognition of the attorneys' due process rights to defend themselves in the sanctions hearing where their alleged conduct regarding discovery was in conflict with that alleged by their client.[40] Thus, the magistrate court's order was vacated and remanded as to the sanctioned attorneys.[41]

You Could Lose and Pay the Winner's Attorneys' Fees Before the Case Even Starts

Finally, the ultimate in discovery sanctions, often referred to as "the death penalty": a case-ending

sanction imposed against a party because of discovery violations. In our study case, this occurred before the trial even started, and also included payment of the winner's attorneys' fees. In *Metropolitan Opera Ass'n v. Local 100*,[42] the plaintiff filed suit against the defendant asserting causes of actions such as defamation, unlawful boycotting and tortuous interference with business relations.

The court highlighted the following noncompliant behavior:

- Defendant's counsel repeatedly represented that all responsive documents were produced when, in fact, a thorough search had never been made—counsel had no basis for making such representations.
- Defendant's counsel knew that its client's files were in disarray and that it had no document retention policy, but counsel failed to cause its client to create and adopt a document retention policy to prevent the destruction of responsive documents.
- Defendant's counsel failed to explain to the nonlawyer in charge of the document production that a "document" included drafts and nonidentical copies.
- The nonlawyer in charge of the document production failed to speak to all individuals who might have had relevant documents, never followed up with individuals and failed to contact all of the internet service providers to attempt to retrieve deleted e-mails even though defendant's counsel represented that he would.
- No lawyer ever inquired of the nonlawyer in charge of the document production whether he conducted a search and what steps he took to assure a complete production.
- Defendant's counsel failed to ask several important witnesses about documents until the night before their depositions.
- Defendant's counsel lied about witness vacation schedules to delay depositions.[43]

The court found that defendant's counsel was not merely negligent, but "aggressively willful."[44] Thus, the court granted the plaintiff's motion for judgment as to liability against the defendant and for additional sanctions in the form of attorneys' fees against the defendant and its counsel.[45] A motion for reconsideration was subsequently denied, and the sanctions against the defendant and its counsel were upheld.[46]

E-Discovery from the IRS Perspective

> *I ... I don't know exactly how to put this, sir, but are you aware of what a serious breach of security that would be? I mean, he'll see everything, he'll ... he'll see the Big Board!*[47]

Electronically stored information and "e-discovery" also pose problems for the IRS in its efforts to identify, preserve and produce information related to litigation. Certainly, the vast volume of electronic data generated by the IRS poses challenges in connection with protecting taxpayer privacy, but the IRS, and Chief Counsel, have demonstrated a rather restrictive attitude in terms of discussing what taxpayers may be provided in connection with their requests to the IRS for information:

> You're not entitled to anything … That's an over exaggeration. But the reality is that the government generally takes the position that you're not entitled to information that's behind the assessment. ... [The IRS has] an obligation to attempt as best we can to isolate and preserve that information that we know relates to the issue in either the anticipated litigation or the actual litigation itself.[48]

In connection with ensuring that information is protected from disclosure, the delegation order governing the assertion of executive privilege was recently revised. Delegation Order (DO) No. 30-4 was released October 21, 2009, and provides for disclosure "only after full and deliberate consideration" of stakeholder privacy interests including "public accountability, safeguarding national security, law enforcement effectiveness, and candid and complete deliberations." The previous delegation order had permitted executive privilege to be asserted only if disclosure of IRS records "would significantly impede or nullify Internal Revenue Service actions."

Chief Counsel Notice CC-2007-007 was issued in connection with the amendments to the FRCP.[49] The notice states that the amendments to FRCP "do not purport to change what is and what is not discoverable." The notice points out that although the amendments are not applicable in the Court of Federal Claims and the Tax Court, they nonetheless may have an impact on future litigation in those courts. The notice clarifies that Chief Counsel personnel are

expected to be familiar with applicable electronic records and document retention policies. Electronic records that are potentially relevant to ongoing or expected litigation should be retained to serve the litigation needs and obligations of the IRS and the Office of Chief Counsel and to avoid any potential spoliation inference.

It is worth noting that Chief Counsel intends for the IRS to provide ESI to taxpayers in paper form, notwithstanding the clear intent of the amendments to the FRCP that ESI be provided in the form it is ordinarily kept. The notice states: "Consistent with past practice and absent any unusual or exceptional circumstances, Department attorneys will be instructed to either enter into stipulations or move for an order providing that ESI will be produced in paper form."

The notice also addresses the need for litigation holds to be put in place for issues or cases that may be subject to litigation. Counsel personnel must be sensitive to potential for litigation holds, as well as mindful that an obligation to preserve may arise before litigation is actually commenced if litigation can be reasonably anticipated. Although not addressed in the notice, it may be appropriate for Chief Counsel to institute a cross-check using the procedures required per CC-2006-016, *Procedures for Identifying Certain FOIA and Other Information Requests*. That Chief Counsel notice addresses FOIA responses concerning issues or cases that have been identified as likely to be, or currently subject to litigation. The notice institutes a process whereby notations can be made on the IRS database to alert anyone searching for information and/or responding to FOIA requests that the information may be protected work product or privileged information.

Chief Counsel Notice CC-2007-007 was supplemented by Chief Counsel Notice CC-2009-024, *Procedures for Complying with the E-Discovery to the Federal Rules of Civil Procedure* (Aug. 3, 2009). The later notice states that it expands and clarifies CC-2007-007. The procedures described in the notice are to apply in all cases, except when the manager responsible for assigning the case determines that ESI will not be an issue. The notice describes how to identify potentially relevant ESI, as well as defining applicable litigation hold procedures. Template versions of forms are provided, including forms for *Initial Notification E-Mail, Second Notification E-Mail, Litigation Hold Notice and Request for Search & Preservation* and *IT Search Memo.*

An additional Chief Counsel notice was issued addressing privilege waivers in connection with e-discovery agreements. Chief Counsel Notice CC-2009-023, *Federal Rule of Evidence 502* (August 3, 2009) acknowledges that parties may enter agreements concerning the effect of disclosure, but expresses concern about both the process and the nature and effect of the agreements. The notice explains that FRE 502 allows a federal court to enter an order finding that, for the purpose of other litigation, disclosure in the proceeding before that court does not result in a waiver.

The notice states that the use of quick-peek agreements is inconsistent with a party's duty to take reasonable steps to prevent disclosure of privileged or protected information. As such, Chief Counsel is concerned that such agreements will be sought even when documents not privileged or protected in the first instance. Reading between the lines, there might be a concern that entering into a quick-peek agreement in connection with certain categories of ESI to be produced—for example ESI in connection with a request for tax accrual work papers—could be interpreted as a concession that tax accrual work papers may contain privileged or protected material.

The notice also points out that entering into the agreements at the audit stage presents problems, because such an agreement may later be determined to be binding on Counsel or Department of Justice.

How Is It Going So Far?

Fasten your seat belts, it's going to be a bumpy night.[50]

ESI at the Audit Stage

The IRS has historically requested electronic data from taxpayers under appropriate circumstances. The type of electronic data requested has evolved, of course, and the IRS's requests are becoming more targeted. There is anecdotal evidence from companies that the IRS is requesting ESI with increasing frequency in the course of its audits. Available template IDRs seem to confirm this practice:

The Following Definitions and Instructions Apply to this IDR:

- The word "document" includes all forms of written or recorded information, including e-mail or other electronically stored documents that are in the taxpayer's possession, custody or control.[51]

Beyond evidencing increased sophistication in identifying and targeting ESI relevant to the devel-

opment of tax issues, the IRS is generating IDRs that contain detailed instructions concerning the delivery to the IRS of ESI:[52]

Delivery Instructions for Documents in Electronic Format:

- To the extent documents are stored in computerized, electronic media or other machine-sensible formats, please provide a copy of the electronic file in its native format. For example, if your electronic documents were created and used in Microsoft Word PowerPoint, *etc.*, do not convert the documents to a different format, such as a Tagged Image File Format (TIFF) or a Portable Document File (PDF), in preparation for producing the documents pursuant to this request. Please provide the documents in an unprotected form that will allow them to be printed, electronically searched, and analyzed.
- Each document produced should be an exact unaltered image, produced as a multi-page, searchable image, such as PDF text mode, that treats each complete document as a discrete file.
- These documents should be produced in read-only form on CD, DVD or hard drive.
- To ensure readability of any requested document in electronic format, provide the files with an image resolution of at least 300 dots per inch (dpi).
- To the extent that any electronic indexes or other listings relating to the requested documents are created in preparation for submitting them to the IRS, please provide that information with your response to assist in organizing and reviewing the documents.
- For delivery purposes, it is also preferred that the documents be produced and organized with load files from commercially available software, such as Summation, IPRO, Concordance, *etc.* This request is not intended to seek the submission of a proprietary executable file, nor should it be interpreted to do so.
- If the electronic data provided cannot be read or efficiently searched or processed with commercially available software, then provide copies of any proprietary software necessary to retrieve and analyze the requested documents and data, plus all manuals and similar documents related to using this software.

In light of the above, it will be important for tax advisors to be familiar with the rules applicable to electronic discovery so that the provision of ESI at the audit stage is consistent with parties' rights and obligations. The concern expressed in Chief Counsel Notice CC-2009-023 that any agreements made at the audit stage may be determined to be binding upon the parties in later litigation is a concern that should be taken into account by taxpayers as well.

Discovery Violation Claims and Requests for Sanctions

The IRS has already demonstrated that it will vigorously pursue spoliation claims and sanctions against taxpayers under appropriate circumstances. In a case that was litigated in the U.S Court of Federal Claims, the IRS alleged that the taxpayer "destroyed emails in 2000, at a time when it was anticipating litigation."[53] As a result, the IRS requested a sanction of "an adverse inference that the destroyed information, if now available, would have been favorable to the United States and harmful to Consolidated Edison" ("Con Ed").[54]

Con Ed conceded that some e-mail was inadvertently lost when Con Ed migrated from a Linux-based e-mail system to a Microsoft Outlook Exchange-based e-mail system. The court analyzed the concept of "anticipation of litigation" in the audit context, and spent some amount of time discussing the nature of the audit process and the development of controversies in that context.[55] The court ultimately determined that there was no indication of bad faith on the part of Con Ed and no duty to preserve. Harsh sanctions must be judiciously reviewed, and the court declined to impose sanctions on Con Ed under the circumstances.[56]

Resisting Discovery Requests for ESI

IRS has also demonstrated that it may resist production of ESI. In a recent District Court case, the taxpayer alleged that the IRS production was incomplete and requested certain information be produced, including e-mail. IRS asserted it produced (or would be producing) all responsive e-mail. The IRS provided the declaration of its Chief Technology Officer concerning retention/destruction of e-mail, which in the normal course required destruction after 180 days. Interestingly, the court fashioned a remedy that recognized both the extent of IRS production to date, and the potential for imposing excessive burden given the additional production requested by the taxpayer. The court stated that it was "convinced that there is a need for the Government to supplement its discovery responses to verify, under oath, that all responsive documents have been produced." The court also

required a detailed declaration supporting the IRS's deliberative process claims.[57]

Where Do We Go from Here?

Lawyers should never marry other lawyers. This is called inbreeding, from which comes idiot children and more lawyers.[58]

From the Sedona Conference Web site:

> In the past several weeks the legal, business, and popular press has been abuzz with articles on electronic discovery and the increasing cost and burden of litigation. The Sedona Conference®, the nation's leading non-partisan, non-profit law-and-policy think tank, is actually doing something about it. Leading jurists, trial attorneys, corporate counsel, government lawyers, and others are signing onto "The Cooperation Proclamation." By doing so, they are pledging to reverse the legal culture of adversarial discovery that is driving up costs and delaying justice; to help create "toolkits" of model case management techniques and resources for the Bench, inside counsel, and outside counsel to facilitate proportionality and cooperation in discovery; and to help create a network of trained electronic discovery mediators available to parties in state and federal courts nationwide, regardless of technical sophistication, financial resources, or the size of the matter.[59]

The Web site contains links to the most up-to-date case law in which The Cooperation Proclamation is cited and/or relied upon for the findings and rulings made by the court. There is also a link to judicial endorsements—the list as of October 31, 2009, demonstrates robust judicial endorsement, and is frequently cited by courts in connection with decisions rendered on motions to compel and for sanctions.[60]

The Sedona Conference Cooperation Proclamation is a well-coordinated effort to promote cooperation by all parties to the discovery process to achieve the goal of a "just, speedy, and inexpensive determination of every action." The Cooperation Proclamation contends that cooperation in discovery is consistent with zealous advocacy. That point is well taken in light of the case-wrecking sanctions that we have seen imposed by courts for e-discovery violations.

Recent opinions available on The Sedona Conference Web site emphasize the need for meaningful initial disclosures, as well as informed and cooperative participation in "meet and confer" meetings.[61] The Sedona Conference Cooperation Proclamation provides for the following:

- Utilizing internal ESI discovery "point persons" to assist counsel in preparing requests and responses
- Exchanging information of relevant data sources, including those not being searched, or scheduling early disclosures on the topic of Electronically Stored Information
- Jointly developing automated search and retrieval methodologies to cull relevant information
- Promoting early identification of form or forms of production
- Developing case-long discovery budgets on proportionality principles
- Considering court-appointed experts, volunteer mediators, or formal ADR programs to resolve discovery disputes

It is too early to tell just how all this will play out in the context of tax controversies. One might assume that when the Tax Court announced that the several of the amendments conform the Tax Court's Rules more closely with selected procedures from the Federal Rules of Civil Procedure, one would err on the side of favoring the intent of the FRCP in the gap.

Interestingly, Chief Counsel's recently released Notice CC-2010-003 (December 2, 2009) addressing the Amendments to the Tax Court's Rules of Practice and Procedure offers a slightly different take on the proper interpretation of the Tax Court's amendments:

> The court did not adopt a mandatory discovery conference as provided in the Federal Rules of Civil Procedure but rather continues to rely on the informal discovery process, during which it expects the parties to discuss and exchange information relevant to the discovery of ESI. These discussions should address what information is reasonably available and the form or format in which it should be produced.

The Tax Court's commentary to the amendments could also be interpreted to say that the imposition of a mandatory "meet and confer" was unnecessary because the Branerton conference already performs that function:

> Rule 70(a)(1) states in pertinent part that "the Court expects the parties to attempt to attain the objectives of discovery through informal consultation or communication before utiliz-

ing the discovery procedures provided in these Rules." See *Branerton v. Commissioner*, 61 T.C. 691, 692 (1974). Rule 70(a)(1) is akin to so much of Fed. R. Civ. P. 26(a) as imposes on the parties an affirmative duty to disclose basic information (without awaiting formal discovery).[62]

Closing Thoughts

You come in here with a skull full of mush and you leave thinking like a lawyer.[63]

There are important concepts in dispute regarding the very nature of the advice we provide as tax practitioners. Regardless of how we slice and dice our work—the specific services we provide, how we provide them, when we provide them, or who amongst us provides them—certain types of the advice we give is, and should remain, protected from disclosure by the attorney-client privilege, work product protection, and/or the Code Sec. 7525 tax practitioner privilege. When those privileges and protections are challenged in connection with tax advice, it is in all of our best interests to work collaboratively toward the result championed by the Sedona Conference Cooperation Proclamation: a just, speedy, and inexpensive determination of every action.

Endnotes

* This article is based on the Luncheon Talk I gave at the University of Chicago Law School 62nd Annual Federal Tax Conference on November 6, 2009. I would like to thank Sarah S. Sandusky, associate with Latham & Watkins LLP, Chicago, for her helpful research and analysis in preparing my Luncheon Talk and revising it for this paper.

1 The Matrix (Groucho II Film Partnership, 1999).

2 A final version of the Amendments was adopted on Sept. 18, 2009.

3 Blade Runner (The Ladd Co., 1982). Screenplay by Hampton Fancher and David Webb Peoples.

4 The Sedona Conference at *www.thesedonaconference.org/*.

5 The Federal Judicial Center at *www.fjc.gov/*.

6 Braveheart (Icon Entertainment International, 1995). Screenplay by Randall Wallace.

7 Amy S. Elliott, *IRS Developing New Disclosure Policy For Uncertain Corporate Tax Positions*, 2009 TNT 206-3 (Oct. 28, 2009).

8 "We're going to continue with our very energetic and strategic litigation program." Highlights include privilege issues in connection with tax accrual work papers, and, conversely, what taxpayers can discover from the IRS. *Comments attributed to IRS Deputy Chief Counsel Clarissa Potter,* 206 DTR K-1 (Oct. 28, 2009).

9 Lee A. Sheppard, *Tax Schemes Are Proliferating, Official Tells NYU Conference*, 2009 TNT 200-1 (Oct. 20, 2009).

10 *See U.S. Securities and Exchange Commission, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002*, at 45 (Jan. 27, 2003), *available at www.sec.gov/news/studies/sox704report.pdf;* Announcement 2002-2, 2002-1 CB 304.

11 *See, e.g., In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F3d 289 (6th Cir. Tenn. 2002); *Mass. Inst. of Tech.,* CA-1, 97-2 USTC ¶50,955, 129 F3d 681 (*cited with approval in, United States v. Bergonzi*, 216 F.R.D. 487, 496 (N.D. Cal. 2003).

12 The Big Lebowski (Polygram Filed Entertainment, 1998). Screenplay by Ethan Coen and Joel Coen.

13 Network (Metro-Goldwyn-Mayer, 1976). Screenplay by Paddy Chayefsky.

14 *See Zubulake v. UBS Warburg LLC*, 229 F.R.D. 422 (S.D.N.Y. 2004).

15 *Network Computing Servs. Corp. v. Cisco Sys., Inc.*, 223 F.R.D. 392 (D.S.C. 2004) (quoting *Krueger v. Pelican Prod. Corp.*, No. CIV-87-2385-A, slip op., (W.D. Okla. Feb. 24, 1989)).

16 Fed. R. Civ. P. 26 Advisory Committee's notes on 1983 amendments (internal citation omitted).

17 *Phoenix Four, Inc. v. Strategic Res. Corp.*, 2006 U.S. Dist. LEXIS 32211 (S.D.N.Y. May 22, 2006).

18 *Id.,* at *8 (quotation omitted).

19 *Id.,* at *16 (quoting *Zubulake, supra* note 14, at 432).

20 *Id.,* at *17.

21 *Id.,* at *18.

22 *Id.,* at *19.

23 *Arista Records LLC v. Usenet.com, Inc.*, 608 F.Supp.2d 409 (S.D.N.Y. Jan. 26, 2009).

24 *Id.*

25 *Arista Records LLC v. Usenet.com, Inc.*, 633 FSupp2d 124, 135 (S.D.N.Y. June 30, 2009).

26 *Id.* Analysis by plaintiffs' forensic expert revealed this explanation was not plausible.

27 *Id.*, at 136.

28 *Id.,* at 137.

29 *Id.,* at 139.

30 *Id.*, at 142.

31 *Id.,* at 156.

32 *Qualcomm Inc. v. Broadcom Corp.*, 2008 U.S. Dist. LEXIS 911 (S.D. Cal. Jan. 7, 2008).

33 *Id.,* at *43–44.

34 *Id.,* at *47.

35 *Id.,* at *63.

36 *Id.,* at *64–65.

37 *Id.,* at *65–66.

38 *Qualcomm Inc. v. Broadcom Corp.*, 2008 U.S. Dist. LEXIS 16897 (S.D. Cal. Mar. 5, 2008).

39 *Id.*

40 *Id.*

41 The parties continued to litigate on various procedural grounds until the petition for writ of certiorari was dismissed pursuant to Rule 46 of the Rules of the Supreme Court, indicating that the matter was likely settled. *Qualcomm Inc. v. Broadcom Corp.,* 129 SCt 2182, 2009 U.S. LEXIS 3801 (U.S. May 15, 2009).

42 *Metro. Opera Ass'n v. Local 100*, 212 F.R.D. 178, 2003 U.S. Dist. LEXIS 1077 (S.D.N.Y. Jam. 28, 2003).

43 *Id.,* at 181–82.

44 *Id.,* at 222.

45 *Id.,* at 231.

46 *Metro. Opera Ass'n v. Local 100*, 2004 U.S. Dist. LEXIS 17093 (S.D.N.Y. Aug. 27, 2004).

47 Dr. Strangelove or How I Learned to Stop Worrying and Love the Bomb (Columbia Pictures Corp., 1964). Screenplay by Stanley Kubrick, Terry Southern, and Peter George.

48 Amy S. Elliott, *Official Explains IRS Position on Electronically Stored Information*, 2008 TNT 180-14 (Sept. 16, 2008) (comments attributed to Glen Melcher, Branch Chief, IRS Office of Chief Counsel (Procedure and Administration)).

49 Chief Counsel Notice CC-2007-007, *E-Discovery Amendments to the Federal Rules of Civil Procedure* (Feb. 23, 2007).

50 All About Eve (Twentieth Century-Fox Film Corp., 1950). Screenplay by Joseph L. Mankiewicz.

[51] *See* IRS FTC Generator Information Document Request (IDR) 2, *www.irs.gov/businesses/article/0,,id=204527,00.html* (last updated Aug. 18, 2009).
[52] *Id.*
[53] *Consol. Edison Co. of N.Y. v. United States*, 2009 U.S. Claims LEXIS 335 (Fed. Cl. Oct. 21, 2009).
[54] *Id.*
[55] *Id.*, at 28–44.
[56] *Id.*, at 43.
[57] *Ford Motor Company*, DC-MI, 2009-2 USTC ¶50,511.
[58] ADAM'S RIB (Loew's, 1949). Screenplay by Ruth Gordon and Garson Kanin.
[59] Sedona Conference, *The Sedona Conference Cooperation Proclamation*, *www.thesedonaconference.org/content/tsc_cooperation_proclamation* (last visited Dec. 18, 2009).
[60] Litigants in tax controversies tried before the Hon. Francis M. Allegra in the U.S. Court of Federal Claims will want to be aware that Judge Allegra has endorsed The Cooperation Proclamation.
[61] Examples include *Oracle USA, Inc. v. SAP AG*, 2009 U.S. Dist. LEXIS 71365 (N.D. Cal. Aug. 12, 2009) and *Wells Fargo Bank, N.A. v. LaSalle Bank Nat'l Ass'n*, 2009 U.S. Dist. LEXIS 70514 (S.D. Ohio July 24, 2009).
[62] Press Release, U.S. Tax Court (Sept. 18, 2009), available at www.ustaxcourt.gov/press/091809.pdf.
[63] THE PAPER CHASE (Thompson Films, 1973). Screenplay by James Bridges.