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New Opportunities for Obtaining and Using Litigation Reserves and Disclosures

MATTHEW J. BARRETT*

In the previous volume of Ohio State Law Journal, "Opportunities for Obtaining and Using Litigation Reserves and Disclosures" highlighted the helpful information about litigation reserves that a litigator can often detect or discover from an opponent's financial statements, accounting books and records, tax returns, public filings with the Securities and Exchange Commission (the "SEC"), and auditor. Following the article's publication, two important regulatory developments occurred in early 2003 that create additional opportunities to obtain information about an opponent's assessments of (i) expected liability in the underlying case or (ii) settlements or actual or estimated obligations in similar cases. First, pursuant to the Sarbanes-Oxley Act of 2002, the SEC issued final regulations that require new disclosures from many public companies about certain contractual obligations, including litigation settlements and, perhaps, other estimated amounts necessary to resolve litigation, in the Management's Discussion and Analysis section of various securities filings that contain financial statements for fiscal years ending on or after December 15, 2003. Second, the Treasury Department issued new tax shelter regulations, effective February 28, 2003, that require taxpayers to disclose specified confidential transactions, including certain out-of-court settlements, to the Internal Revenue Service on Form 8886, Reportable Transaction Disclosure Statement. Finally, this update notes that the SEC's new rules on the Improper Influence on Conduct of Audits, which became effective on June 27, 2003, further threaten the viability of the American Bar Association's Statement of Policy Regarding Lawyer's Responses to Auditor's Requests for Information.

I. INTRODUCTION

In the few months since *Ohio State Law Journal* published my article, "Opportunities for Obtaining and Using Litigation Reserves and Disclosures,"¹ press reports and securities filings have repeatedly documented that publicly traded companies continue to record accruals for estimated amounts that management considers necessary to resolve pending or expected litigation,

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¹ Matthew J. Barrett, *Opportunities for Obtaining and Using Litigation Reserves and Disclosures*, 63 OHIO ST. L.J. 1017 (2002).

especially in matters involving asbestos, Enron-related investigations, health-care fraud, and tax disputes. Recently settled cases² offer the following examples:

* Halliburton Company reached an agreement in December 2002 to pay about \$4 billion in cash and stock to settle more than 300,000 asbestos claims.³ When Halliburton announced its results for the 2002 fourth quarter in February 2003, *The Wall Street Journal* reported that those results included only a \$214 million charge for asbestos liability,⁴ suggesting that the company had previously established reserves for the uninsured balance.⁵

* J.P. Morgan Chase & Co. ("J.P. Morgan") agreed in July 2003 to pay \$162.5 million to settle civil charges that the company helped Enron Corp. to commit securities fraud.⁶ About three months earlier, a subsidiary, J.P. Morgan Securities Inc. ("JPMS"), agreed to pay \$80 million to settle enforcement actions brought by federal and state regulators and arising from conflicts of interest between the company's research and investment banking activities in the aftermath of the recent financial scandals involving Enron, WorldCom, and other

² Again, this update tries to avoid using examples involving currently pending litigation. See *id.* at 1025 n.11.

³ *Halliburton Co.: Charge for Asbestos Liability Contributes to a Quarterly Loss*, WALL ST. J., Feb. 21, 2003, at B8. As of September 30, 2003, some of the conditions for the settlement remained unsatisfied. Halliburton, however, announced that it would not seek to extend a temporary restraining order that had stayed more than 200,000 pending asbestos claims against a subsidiary. The company stated that given "an increase in the estimated number of current asbestos claims, the cash required to fund the settlement may modestly exceed \$2.775 billion." Press Release, Halliburton Co., Halliburton Will Not Request Stay Extension (Sept. 29, 2003), available at http://www.halliburton.com/news/archive/2003/corpnws_092903.jsp (last visited Oct. 2, 2003).

⁴ *Halliburton Co.: Charge for Asbestos Liability Contributes to a Quarterly Loss*, *supra* note 3.

⁵ Halliburton's 2002 Form 10-K discloses that the company accrued asbestos and silica claims liability and defense costs in both the second and fourth quarters of 2002. HALLIBURTON CO., FORM 10-K, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934, at 75, 77 (for the fiscal year ended Dec. 31, 2002) (filed Mar. 28, 2003) (stating that the company used a \$2.2 billion estimate, the low end of an outside expert's range of liabilities, to accrue liability and defense costs for various asbestos claims during the second quarter of 2002 and, then, \$3.5 billion, the upper end of that range, during that year's fourth quarter).

⁶ Mitchell Pacelle & Laurie P. Cohen, *J.P. Morgan, Citigroup Will Pay \$305 Million to Settle Enron Case*, WALL ST. J., July 29, 2003, at A1. The underlying settlement agreements require J.P. Morgan to pay \$135 million to the Securities and Exchange Commission, \$12.5 million each to the state and city of New York, and \$2.5 million to the Manhattan district attorney's office as reimbursement for expenses. *Id.*

companies.⁷ On January 2, 2003, J.P. Morgan announced that it had established a \$900 million reserve related to regulatory inquiries and other private litigation involving Enron and other material legal actions, proceedings, and investigations.⁸

* AstraZeneca PLC agreed in June 2003 to pay \$355 million to settle federal fraud charges after accruing \$350 million to cover anticipated settlement costs in late 2002.⁹

* AutoNation Inc. settled a tax dispute with the Internal Revenue Service (“IRS”) during the 2003 first quarter. The settlement allowed the company to reverse an expense that it had recognized in a prior period for an amount in excess of the actual settlement, thereby increasing the company’s net income for the current period by \$127.5 million.¹⁰

My original article highlighted the helpful information about litigation reserves that a savvy litigator could potentially obtain from an opponent’s public

⁷ SEC v. J.P. Morgan Securities Inc., No. 03 CV 2939 (WHP) (S.D.N.Y. Apr. 28, 2003), available via SEC Litigation Release No. 18114 (Apr. 28, 2003), at <http://www.sec.gov/litigation/litreleases/lr18114.htm> (last visited Oct. 5, 2003).

⁸ Jathon Sapsford, *J.P. Morgan Loss Widened in Quarter*, WALL ST. J., Jan. 23, 2003, at B2; see also J.P. MORGAN CHASE & CO., FORM 8-K, CURRENT REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934, at 2 (filed Jan. 2, 2003) (reporting that the firm “had established a reserve of \$900 million (pre-tax) related to other private litigation and regulatory inquiries involving Enron and other material legal actions, proceedings and investigations with which it is involved”); J.P. MORGAN CHASE & CO., FORM 10-K, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934, at 10 (for the fiscal year ended Dec. 31, 2002) (filed Mar. 19, 2003) (stating that “\$600 million [of the \$900 million reserve] has been allocated to the various cases, proceedings and investigations associated with Enron”).

⁹ Scott Hensley, *AstraZeneca to Settle Fraud Charges*, WALL ST. J., June 23, 2003, at A2; see also ASTRAZENECA PLC, ASTRAZENECA ANNUAL REPORT AND FORM 20-F 2002, at 68, 104 (2003) (stating that “although no final agreement has been concluded [with federal and state authorities conducting a civil and criminal investigation into the sale and marketing of Zoladex,] the Company believes it appropriate to accrue \$350m to cover estimated settlement costs”), included as EXHIBIT 10.1 TO ASTRAZENECA PLC, FORM 20-F, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (for the fiscal year ended Dec. 31, 2002) (filed Mar. 25, 2003).

¹⁰ *AutoNation Inc.: Net Soars on IRS Settlement, But Revenue Decreases 6.1%*, WALL ST. J., Apr. 29, 2003, at C13; see also AUTO NATION, INC., FORM 10-Q, QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934, at 12 (for the quarterly period ended Mar. 31, 2003) (filed Apr. 29, 2003) (stating that, “[a]s a result of the settlement, the Company has recognized an income tax benefit of \$127.5 million from the reduction of previously recorded deferred tax liabilities”); AUTO NATION, INC., FORM 10-K, ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934, at 70 (for the fiscal year ended Dec. 31, 2002) (filed Feb. 28, 2003) (reporting that approximately \$670 million of the net deferred tax liabilities at December 31, 2002 relates to transactions with tax implications that the IRS is challenging).

filings with the Securities and Exchange Commission (“SEC”) and federal income tax returns, including any related revenue agent reports proposing changes to those returns.¹¹ In particular, the original article used the litigation in the 1990s between Merrill Lynch & Co., Inc. (“Merrill Lynch”) and Orange County, California (“Orange County”) over the county’s failed derivatives-based investment scheme to illustrate how the disclosures in the Management’s Discussion and Analysis (“MD&A”) section of various securities filings and the amounts and descriptions on Schedule M-1, Reconciliation of Income (Loss) per Books With Income (Loss) per Return, in partnership returns of income, corporation income tax returns, and tax returns for subchapter S corporations could provide, or lead to, information about litigation reserves related to the underlying litigation.¹²

After the publication of the original article, two important regulatory developments occurred in early 2003 that potentially create additional opportunities to obtain information about an opponent’s assessments of expected liability in the underlying case or obligations or settlements in similar cases.¹³

¹¹ Barrett, *supra* note 1, at 1027.

¹² *Id.* at 1021–25, 1069–81.

¹³ In addition, a third regulatory development further threatens the viability of the American Bar Association’s Statement of Policy Regarding Lawyer’s Responses to Auditor’s Requests for Information (the “Statement of Policy”). See generally Barrett, *supra* note 1, at 1029 (arguing that because previous legal developments have negated the articulated expectation that communications between lawyers and auditors under the Statement of Policy would not prejudice clients in adversary proceedings, the American Bar Association should review the Statement of Policy). In May 2003, the SEC promulgated a final rule, effective June 27, 2003, to implement section 303 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303, 116 Stat. 745, 778 (codified at 15 U.S.C.A. § 7242 (West Supp. 2003)), which directed the SEC to prescribe rules or regulations to prohibit any officer or director of an issuer, or any other person acting under the direction of an officer or director, from taking any action to fraudulently influence, coerce, manipulate, or mislead the issuer’s independent auditor for the purpose of rendering the issuer’s financial statements materially misleading. Improper Influence on Conduct of Audits, Financial Reporting Release No. 71, 68 Fed. Reg. 31,820 (May 28, 2003) (to be codified at 17 C.F.R. § 240.13b2-2(b)), available at <http://www.sec.gov/rules/final/34-47890.htm> (last visited Oct. 5, 2003). Among other things, the final rule prohibits various actions toward an independent auditor by any person acting under the direction of an officer or director if that person “knew or should have known that such action, if successful, could result in rendering the issuer’s financial statements materially misleading.” *Id.* at 31,830 (to be codified at 17 C.F.R. § 240.13b2-2(b)(1)) (emphasis added). In the commentary accompanying the final rule, the SEC lists “misleading legal analysis” as an example of conduct that could violate the rule. *Id.* at 31,823. At least as to the words “coerce, manipulate, or mislead,” the SEC’s final rules seek to impose a negligence standard. *Id.* at 31,823, 31,826–27. In addition, the SEC acknowledges that the phrase “knew or should have known” has historically indicated a negligence standard. Especially given such a standard, this author joins those lawyers who have expressed concerns about the effects of the new rule on the accord between the accounting and legal professions and the Statement of Policy. These lawyers worry that if law firms for

First, pursuant to the Sarbanes-Oxley Act of 2002 (“SOx”),¹⁴ the SEC issued final regulations that require new disclosures about off-balance sheet arrangements and aggregate contractual obligations.¹⁵ Those regulations require registrants other than small business issuers¹⁶ to disclose in tabular format the amounts due within specified time periods under certain contractual obligations somewhere in the MD&A section of various securities filings.¹⁷ Second, the Treasury Department issued new tax shelter regulations that require taxpayers to disclose specified confidential transactions, including certain out-of-court settlements.¹⁸ The IRS requires taxpayers to use Form 8886, Reportable Transaction Disclosure Statement, for such disclosures.¹⁹

Part II of this update overviews the new SEC regulations that require tabular disclosures about aggregate contractual obligations in the MD&A section of various disclosure documents that certain registrants must file with the SEC. Although more sensitive to the detection and discovery opportunities that my original article described than the proposed rules that the SEC issued in November 2002, at a minimum the final rule creates an additional opportunity to obtain information about a litigation opponent’s obligations or settlements in similar cases. Part III discusses the potential reach of the tax shelter disclosure requirements to certain confidential settlement agreements. Until judicial or administrative developments eliminate these opportunities, Part IV concludes that, where applicable, litigants and their attorneys should: (1) pay careful attention to the new tabular disclosures about contractual liabilities in the MD&A sections of certain securities filings and (2) consider trying to discover any Form 8886s that a litigation opponent may attach to its federal income tax returns to

public companies become overly concerned about violating Rule 13b2-2, such firms may begin to disclose more information in audit responses than they have in the past. As my original article describes in some detail, disclosure to the auditor typically destroys the attorney-client privilege as to the subject matter under federal law. Barrett, *supra* note 1, at 1088–91.

¹⁴ Pub. L. No. 107-204, § 303, 116 Stat. 745.

¹⁵ Disclosure in Management’s Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 68 Fed. Reg. 5982 (Feb. 5, 2003), available at <http://www.sec.gov/rules/final/33-8182.htm> (last visited Oct. 5, 2003) [hereinafter Final Rules].

¹⁶ Under the SEC’s rules, domestic or Canadian companies whose revenues and public float, which refers to the aggregate market value of outstanding common equity held by non-affiliates, both fall below \$25 million can qualify as “small business issuers.” 17 C.F.R. § 228.10(a)(1) (2003).

¹⁷ See *infra* notes 23–39 and accompanying text.

¹⁸ Tax Shelter Regulations, 68 Fed. Reg. 10,161 (Mar. 4, 2003); see also *infra* notes 42–52 and accompanying text.

¹⁹ INTERNAL REVENUE SERV., U.S. DEP’T OF TREASURY, FORM 8886, REPORTABLE TRANSACTION DISCLOSURE STATEMENT (2003) [hereinafter FORM 8886].

disclose any information about confidential out-of-court settlements in related cases.

II. TABULAR DISCLOSURES ABOUT AGGREGATE CONTRACTUAL OBLIGATIONS IN MANAGEMENT'S DISCUSSION AND ANALYSIS

SOx section 401(a) directed the SEC to issue final rules to require each annual and quarterly report that registrants must file with the Commission to disclose "all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) . . . that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."²⁰ Pursuant to that charge and after issuing proposed rules in November 2002,²¹ the SEC issued final rules regarding disclosures about off-balance sheet arrangements and aggregate contractual obligations on January 28, 2003.²² Although the final rules technically became effective on April 7, 2003, the additional disclosure requirements apply only to registration statements, annual reports, and proxy or information statements that must include financial statements for the fiscal years ending on or after December 15, 2003.²³

Although the final regulations require registrants to explain their off-balance sheet arrangements in a separately captioned subsection of the MD&A portion of disclosure documents, the final regulations specifically exclude "[c]ontingent liabilities arising out of litigation, arbitration or regulatory actions" from the definition of off-balance sheet arrangements.²⁴ Those regulations, however, require a registrant other than a small business issuer to disclose in tabular format somewhere in the MD&A section of the registrant's disclosure documents the amounts of payments due under certain known contractual obligations, as of the

²⁰ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 401(a), 116 Stat. 745, 786 (codified at 15 U.S.C.A. § 78m(j) (West Supp. 2003)).

²¹ Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, 67 Fed. Reg. 68,054 (Nov. 8, 2002), available at <http://www.sec.gov/rules/proposed/33-8144.htm> (last visited Oct. 5, 2003) [hereinafter Proposed Rules].

²² Final Rules, *supra* note 15.

²³ *Id.*

²⁴ 17 C.F.R. §§ 228.303(c)(instruction 3), 229.303(a)(4)(instruction 3) (2003); see also Final Rules, *supra* note 15, at 6002, 6004 (setting forth similar instructions for foreign private issuers and certain Canadian issuers under 17 C.F.R. §§ 249.220f, .240f (2003)). The final regulations, however, do not exempt "liabilities arising out of litigation, arbitration or regulatory actions" from the category of known contractual obligations about which registrants other than small business issuers must provide additional tabular disclosures. See *infra* notes 25–29 and accompanying text.

latest fiscal year-end balance sheet date.²⁵ Such registrants must aggregate the information by type of contractual obligation and by period due, including, at a minimum, separate figures for the total amount due and the amounts due in less than one year, from one to three years, from three to five years, and in more than five years.²⁶ One of those specified categories includes “Other Long-Term Liabilities Reflected on the Registrant’s Balance Sheet under GAAP.”²⁷ Unlike the other four categories, the final regulations do not define this last category.²⁸ According to the release accompanying the final regulations, however, this fifth and final category “captures *all other long-term liabilities* that are reflected on the registrant’s balance sheet under the registrant’s applicable [generally accepted accounting principles].”²⁹

This description raises the question of whether the phrase “all other long-term liabilities” literally means all other long-term liabilities or only all other long-term *contractual* obligations. Under either interpretation, that fifth category would, at a minimum, include any amounts that a settlement agreement obligated a registrant to pay more than one year after the balance sheet date to resolve actual or threatened litigation in any similar cases.³⁰ To illustrate, Merrill Lynch did not pay the \$400 million that the June 1998 settlement with Orange County required until September 1999.³¹ Given the requirement that the tabular disclosures must

²⁵ 17 C.F.R. § 229.303(a)(5)(i) (2003); *see also* Final Rules, *supra* note 15, at 5982, 5990, 6000, 6002, 6003–04 (setting forth similar instructions for foreign private issuers and certain Canadian issuers under 17 C.F.R. §§ 249.220f, .240f (2003)). Because the final regulations require the tabular disclosures “as of the latest fiscal year end balance sheet date,” the regulations do not require this information for interim periods. Registrants, however, should update the table from their annual report by disclosing material changes outside the ordinary course of business. *Id.* at 5990 n.116; *see also* 17 C.F.R. § 229.303(b) (instruction 7) (2003); Final Rules, *supra* note 15, at 6002, 6004 (setting forth similar instructions for foreign private issuers and certain Canadian issuers under 17 C.F.R. §§ 249.220f, .240f (2003)).

²⁶ 17 C.F.R. § 229.303(a)(5)(i) (2003); *see also* Final Rules, *supra* note 15, at 5982, 5990, 6002, 6003 (setting forth similar instructions for foreign private issuers and certain Canadian issuers under 17 C.F.R. §§ 249.220f, .240f (2003)).

²⁷ 17 C.F.R. § 229.303(a)(5)(i) (2003); *see also* Final Rules, *supra* note 15, at 5982, 5990, 6002, 6003 (setting forth similar instructions for foreign private issuers and certain Canadian issuers under 17 C.F.R. §§ 249.220f, .240f (2003)). By definition, a long-term liability or obligation is not scheduled to mature for more than one year after the date of the enterprise’s balance sheet. CLASSIFICATION OF SHORT-TERM OBLIGATIONS EXPECTED TO BE REFINANCED—AN AMENDMENT OF ARB NO. 43, CHAPTER 3A, Statement of Financial Accounting Standards No. 6, ¶ 2 (Financial Accounting Standards Bd. 1975).

²⁸ *See* 17 C.F.R. §§ 229.303(a)(5)(ii)(A)–(D) (2003); *see also* Final Rules, *supra* note 15, at 6002, 6003–04 (setting forth similar instructions for foreign private issuers and certain Canadian issuers under 17 C.F.R. §§ 249.220f, .240f (2003)).

²⁹ Final Rules, *supra* note 15, at 5986 (emphasis added).

³⁰ *See supra* note 27.

³¹ Barrett, *supra* note 1, at 1021, 1080 n.221.

also present separate figures for the total amount due and the amount due in less than one year, however, all unpaid amounts related to such a settlement should appear under that fifth category in the table.³² If that fifth category applies literally to “all other long-term liabilities,” when a registrant has accrued some amount that it expects to pay in more than one year to resolve the underlying litigation, the tabular disclosures may reveal important information, not only about other previously settled cases, but also about any estimated liabilities related to the underlying case. When necessary and appropriate,³³ therefore, litigators will try to discover information about the detail underlying the aggregate amounts in this fifth category. For example, counsel might schedule depositions or submit interrogatories and request production of various documents to obtain a detailed listing of each item above a certain threshold included in the aggregate amounts for each period.³⁴

Although the proposed rules would have imposed additional disclosure requirements for contingent liabilities and commitments,³⁵ the SEC decided to delete those provisions from the final regulations.³⁶ The release that accompanied the final regulations, however, stated that the SEC would continue to assess the costs and benefits of an MD&A disclosure requirement for aggregate contingent liabilities and commitments during the Commission’s ongoing review of MD&A.³⁷ In particular, the release noted that the SEC was considering future rule proposals or interpretative releases to improve MD&A disclosure.³⁸ In the meantime, the SEC advised registrants to refer to the guidance in a recent statement on MD&A to determine whether investors would benefit from tabular disclosure of aggregate commercial commitments.³⁹ Even though tabular

³² See *supra* note 26 and accompanying text.

³³ Before requesting any information from a litigation opponent, smart litigators will consider whether the opponent can request similar information from their client.

³⁴ See, e.g., Barrett, *supra* note 1, at 1025 (illustrating this technique to obtain additional details about amounts described in the text of MD&A).

³⁵ In addition to the tabular disclosure about aggregate contractual obligations, the proposed rules would have required registrants other than small business issuers to provide either tabular or textual disclosure about contingent liabilities and commitments, including the expected amount, range of amounts or maximum amount of contingent liabilities or commitments, aggregated by type and by time period of the expiration of the commitment. Proposed Rules, *supra* note 21, at 68,056, 68,062–63, 68,076–78.

³⁶ Final Rules, *supra* note 15, at 5986.

³⁷ *Id.* at 5987.

³⁸ *Id.* at 5987 n.75. Such proposals might, for example, require registrants to overview the company’s situation or to provide information about the trends that management follows and evaluates in deciding how to guide the company’s operations. *Id.*

³⁹ *Id.* at 5987; see also Commission Statement about Management’s Discussion and Analysis of Financial Condition and Results of Operations, 67 Fed. Reg. 3746 (Jan. 25, 2002), available at <http://www.sec.gov/rules/other/33-8056.htm> (last visited Oct. 5, 2003).

disclosure of aggregate commercial commitments may not often help litigation opponents obtain access to information about management's evaluation of the registrant's exposure in an underlying legal dispute, litigators should continue to monitor potential SEC action regarding contingent liabilities generally.

III. TAX SHELTER DISCLOSURES ABOUT CONFIDENTIAL TRANSACTIONS ON FORM 8886

Section 6011 of the Internal Revenue Code (the "Code") gives the Secretary of the Treasury or his delegate (the "Secretary") authority to require, by regulation, any person liable for any tax under the Code to file a return or statement according to the forms and regulations that the Secretary may prescribe.⁴⁰ That same provision also requires each taxpayer to supply the information that those forms and regulations require.⁴¹ Pursuant to this authority, in early 2003 the Department of the Treasury and the IRS issued final regulations, effective February 28, 2003 for transactions entered into on or after that date, that mandate the disclosure of certain information related to potentially abusive tax shelters on federal income tax returns.⁴²

The final regulations require every taxpayer that both has participated in a "reportable transaction" and must file a federal income tax return to attach a disclosure statement to its tax return. Among the six categories of reportable transactions listed in the final regulations, so-called "confidential transactions" could conceivably require the disclosure of information related to out-of-court

⁴⁰ I.R.C. § 6011(a) (2000); *see also* I.R.C. § 7701(a)(11)(B) (2000). Unless otherwise stated, all references to the Internal Revenue Code, sometimes referred to as the "Code," are to the Internal Revenue Code of 1986, found at 26 U.S.C., as amended.

⁴¹ I.R.C. § 6011(a) (2000)..

⁴² Tax Shelter Regulations, 68 Fed. Reg. 10,161, 10,163 (Mar. 4, 2003) *see also* Treas. Reg. § 1.6011-4(h) (as amended in 2003). For transactions entered into after December 31, 2002, and before February 28, 2003, taxpayers may choose between the final or the previously applicable temporary regulations. *Id.*

The Secretary and the IRS originally issued temporary and proposed regulations on February 28, 2000. After the Treasury Department concluded that taxpayers and their advisors were interpreting the requirements narrowly and the exceptions broadly in an effort to avoid disclosing tax avoidance transactions, the Secretary and the IRS issued revised temporary and proposed regulations on October 17, 2002. The final regulations generally adopt the revised temporary regulations, but attempt to target potentially abusive transactions more closely. James A. Doering, *The Final Disclosure and List Maintenance Tax Shelter Regulations*, TAXES, May 2003, at 31-32.

settlements.⁴³ Until the IRS exempts out-of-court settlements from the definition of a confidential transaction, a litigator should consider trying to discover any Form 8886 that a litigation opponent has filed with its federal income tax return in an effort to obtain information about confidential settlements that the litigation opponent may have reached in similar cases. Form 8886 requires a taxpayer to identify the type of reportable transaction, describe the facts, identify the expected tax benefits, and estimate the amount of the expected tax benefits for each affected year, including prior and future years.⁴⁴ A taxpayer must generally file a separate Form 8886 for each reportable transaction.⁴⁵ In interpreting the limited confidentiality privilege for communications between a taxpayer and a tax practitioner under Code section 7525,⁴⁶ courts continue to hold that information

⁴³ Although the final regulations also require taxpayers to disclose: (1) certain loss transactions that exceed various amounts ranging from \$50,000 for individuals to \$10 million for corporations and partnerships with only corporations as partners and (2) other transactions that produce differences between book and tax income that exceed \$10 million, the final regulations specifically allow the Secretary to exempt certain transactions in both categories by published guidance. Treas. Reg. § 1.6011-4(b)(5), (6), (8) (as amended in 2003); *see also* Tax Shelter Regulations, 68 Fed. Reg. at 10,165, 10,166. The loss transaction rules only apply to transactions where the taxpayer claims a loss under section 165. Treas. Reg. § 1.6011-4(b)(5) (as amended in 2003); *see also* Tax Shelter Regulations, 68 Fed. Reg. at 10,165. Most taxpayers, however, will deduct amounts for damages or other sums necessary to resolve pending or threatened litigation as trade or business expenses under section 162. I.R.C. § 162(a) (2000). In addition, in Revenue Procedure 2003-24, the IRS exempted certain transactions that give rise to losses under section 165 from the disclosure rules. Rev. Proc. 2003-24, 2003-11 I.R.B. 599. Similarly, Revenue Procedure 2003-25 exempts items that arise when a taxpayer reports a book loss or expense before or without a loss or deduction for federal income tax purposes. Rev. Proc. 2003-25, 2003-11 I.R.B. 601. Recall that the economic performance requirement in Code section 461(h) prevented Merrill Lynch from deducting amounts, presumably under section 162(a), that the company had previously accrued on its books related to the Orange County litigation until Merrill Lynch actually paid those amounts in 1999. Barrett, *supra* note 1, at 1080. Even if the final regulations that the IRS issued in early 2003 had applied at the time that Merrill Lynch accrued estimated amounts believed necessary to settle the Orange County litigation on its books, Revenue Procedure 2003-25 would have excused Merrill Lynch from reporting those amounts as “transactions with significant book-tax differences.” Rev. Proc. 2003-25, 2003-11 I.R.B. 601.

⁴⁴ FORM 8886, *supra* note 19.

⁴⁵ INTERNAL REVENUE SERV., U.S. DEP’T OF TREASURY, INSTRUCTIONS FOR FORM 8886, REPORTABLE TRANSACTION DISCLOSURE STATEMENT (2003). A taxpayer, however, may report more than one transaction on a Form 8886 if the transactions qualify as the same or substantially similar. Transactions qualify as substantially similar if (1) the taxpayer expects them to produce the same or similar types of tax consequences and (2) the transactions are either (a) factually similar or (b) based on the same or similar tax strategy. *Id.*

⁴⁶ I.R.C. § 7525 (2000); *see also* Barrett, *supra* note 1, at 1091 n.262.

transmitted to a tax practitioner to prepare the tax return does not qualify for the privilege.⁴⁷

Under the final rules, a taxpayer has participated in a confidential transaction if the taxpayer's return reflects a tax benefit from the transaction.⁴⁸ A tax benefit can include a deduction; an exclusion from gross income; a tax credit; an adjustment, or the absence of an adjustment, to the basis of property; or the nonrecognition of gain.⁴⁹ The final regulations define a "confidential transaction" as "a transaction that is offered to a taxpayer under conditions of confidentiality."⁵⁰ After this circular definition, the final regulations provide that the IRS will consider a transaction as offered under conditions of confidentiality if an express or implied understanding or agreement limits the taxpayer's disclosure of the tax treatment or tax structure of the transaction. Such an understanding or agreement, however, must qualify as with or for the benefit of any person who makes or provides an oral or written statement to, or for the benefit of, the taxpayer as to the transaction's potential tax consequences.⁵¹ The final regulations conclude by stating that the IRS will consider all the facts and circumstances relating to the transaction, including the prior conduct of the parties, when determining whether the promoter offered the transaction to a taxpayer under conditions of confidentiality.⁵²

Assume, for example, that counsel for the defendant in a personal injury action makes a statement about the tax consequences of a proposed settlement to the plaintiff. Further assume that the plaintiff is willing to accept the proposed settlement if the defendant agrees to keep the financial terms of the settlement

⁴⁷ See, e.g., *United States v. KPMG LLP*, 237 F. Supp. 2d 35, 39 (D.D.C. 2002) (also citing other cases); see also Lee A. Shepard, *No Privilege for Tax Planning*, TAX NOTES TODAY, Jan. 14, 2003, at 9-9, at <http://www.taxanalysts.com/www/website.nsf/Web/TaxNotesToday> (last visited Oct. 5, 2003) (analyzing the KPMG decision and discussing related cases).

⁴⁸ Treas. Reg. § 1.6011-4(c)(3)(i)(B) (as amended in 2003).

⁴⁹ *Id.* § 1.6011-4(c)(6) (as amended in 2003).

⁵⁰ *Id.* § 1.6011-4(b)(3)(i) (as amended in 2003). Although the final regulations create exceptions for restrictions on disclosure reasonably necessary to comply with securities laws and or until certain set times in mergers and acquisitions, those exceptions do not affect this particular discussion. *Id.* § 1.6011-4(b)(3)(ii) (as amended in 2003). Similarly, the presumption for certain express written authorizations would seemingly not apply in this context. See *id.* § 1.6011-4(b)(3)(iii) (as amended in 2003).

⁵¹ *Id.* In addition, the IRS will consider a transaction as offered under conditions of confidentiality if the taxpayer knows or has reason to know that a proprietary or exclusive claim or other circumstances in any way limit the taxpayer's use or disclosure of information relating to the transaction's tax treatment or tax structure for the benefit of any person, other than the taxpayer, who makes or provides an oral or written statement to, or for the benefit of, the taxpayer as to the potential tax consequences that may result from the transaction. *Id.*

⁵² *Id.*

confidential and that the final settlement agreement so requires. Under these assumptions, such an out-of-court settlement arguably qualifies as a “confidential transaction” under the disclosure requirements.⁵³ Perhaps for this reason, at least two legal periodicals have reported that senior officials at the Treasury Department have indicated that the Treasury and the IRS are considering administrative action to exclude out-of-court settlements from the disclosure requirements accompanying “confidential transactions” or otherwise modify the regulations to fix their overbreadth.⁵⁴ Until such administrative action occurs, perhaps via a revenue procedure, litigation opponents and their tax return preparers may disclose information about out-of-court settlements entered on or after January 1, 2003 on Form 8886. As a result, litigators should consider requesting information about confidential transactions arising from out-of-court settlements on any Form 8886s that a litigation opponent may attach to its federal income tax returns.

IV. CONCLUSION

To take advantage of these new SEC and IRS regulations, well-versed litigators will carefully review the new tabular disclosures about contractual

⁵³ See *supra* notes 48–52 and accompanying text; see also Letter from Tax Executives, Inc. to Pamela F. Olson, Assistant Secretary (Tax Policy), Department of the Treasury, & Mark W. Everson, Commissioner of Internal Revenue (Aug. 8, 2003), TAX NOTES TODAY, Aug. 11, 2003, at 154–49 [hereinafter Tax Executives], at <http://www.taxanalysts.com/www/website.nsf/Web/TaxNotesToday> (last visited Oct. 5, 2003) (recommending, among other things, that the IRS issue a revenue procedure that would exempt routine commercial transactions, including severance or employment contracts, agreements settling employment or commercial disputes, and agreements resolving environmental, tax, or other disputes with state or federal agencies, from the definition of confidential transactions). Given, however, that the IRS will consider all the facts and circumstances relating to a transaction when determining whether it was offered to the taxpayer under conditions of confidentiality and out-of-court settlements do not typically involve so-called tax shelters, the taxpayer and the return preparer could conceivably conclude that the regulations do not require disclosure of a particular settlement agreement.

⁵⁴ Alison Bennett, *Treasury, IRS Considering Carve-Outs From Confidentiality Filter in Shelter Rules*, CORP. L. DAILY, May 6, 2003; Kenneth A. Gary, *IRS Officials Discuss Scope of Disclosure Regs, Confidentiality Filter*, TAX NOTES TODAY, Sept. 30, 2003, at 189-4, at <http://www.taxanalysts.com/www/website.nsf/Web/TaxNotesToday> (last visited Oct. 5, 2003) (observing that the failure to disclose carries a \$50,000 penalty per transaction); Warren Rojas, *ABA Tax Section Meeting: Treasury to Tighten Tax Shelter Confidentiality Filters*, TAX NOTES TODAY, Sept. 15, 2003, at 178-2, at <http://www.taxanalysts.com/www/website.nsf/Web/TaxNotesToday> (last visited Oct. 5, 2003) (describing the overhaul as “‘very high priority’ for Treasury”); Lee A. Sheppard, *More Changes Coming for Shelter Disclosure Rules*, TAX NOTES TODAY, May 6, 2003, at 87-2, at <http://www.taxanalysts.com/www/website.nsf/Web/TaxNotesToday> (last visited Oct. 5, 2003); see also Tax Executives, *supra* note 53.

liabilities. Registrants other than small business issuers must include such disclosure in the MD&A sections of their registration statements, annual reports, and proxy or information statements that contain financial statements for fiscal years ending on or after December 15, 2003. When appropriate, these litigators will try to depose witnesses, submit interrogatories or request production of various documents to discover information about the detail underlying the category for "Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP." In addition, they should consider requesting information about any confidential transactions that a litigation opponent entered into on or after January 1, 2003 and disclosed to the IRS in any Form 8886 attached to the opponent's federal income tax returns. Given the possibility of further administrative releases by both the SEC and IRS, enlightened litigators and transactional lawyers should continue to monitor developments in these areas.

