

**The Auditor's Need For The Client's Detailed Information
vs.
The Client's Need to Preserve the Attorney-Client Privilege and
Work Product Protection:
The Debate, The Problems and
Proposed Solutions**

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I. INTRODUCTION

This paper addresses an emerging problem of vital public interest identified by a broad consortium of public companies:¹ that is, whether recent developments in the independent audit process are undermining the ability of public companies to have privileged communications with counsel and to secure the effective and confidential assistance of counsel in handling disputes. This issue arises out of changes in law and policy that have strengthened the role of independent auditors in detecting corporate wrongdoing and have increased expectations that companies, for their part, will strengthen internal controls for dealing with alleged wrongdoing and will provide their auditors with detailed information on a myriad of legal compliance issues that may affect financial reporting. Companies necessarily depend on legal counsel to give advice and handle inquiries relevant to legal compliance, from conducting comprehensive investigations of alleged fraud to advising about employment problems, answering questions about whistleblower letters, advising directors about their duties in connection with major corporate transactions or establishing the bases for tax positions. A problem surfaces, however, when auditors request access to records reflecting counsel's efforts and advice. In providing auditors with access to privileged information, companies risk waiving the privileges and being forced to turn the information over to litigation adversaries.

This situation poses a serious threat to the public interest in preserving the attorney-client privilege and work product protections, which companies have long expected will be maintained by the courts: If the privileges are lost, or even if there is a potential that counsel's work and advice may be exposed to adversaries, then companies may be deterred from seeking the advice of counsel regarding compliance with the law, or deterred from conducting thorough internal investigations of potentially illegal conduct, as necessary to take remedial action. That good corporate governance and full cooperation in the audit process would lead to this result is incongruous and inimical to the public interest. It is also, we believe, unnecessary, and we propose several solutions to this growing problem at the conclusion of this paper.

This paper proceeds from the propositions that auditors must be provided with as much information as is necessary to perform their important public functions in assuring the accuracy of financial reporting, and that, at the same time, it is in the public interest to protect the ability of companies to maintain the confidentiality of attorney-client communications and work product. Thus, this paper discusses these two vital public interests – the public company audit function on the one hand, and the attorney-client privilege and work product protection on the other hand – as well as their intersection.

¹ These companies participate, through their General Counsels, in the General Counsel Working Group, convened by The Association of the Bar of the City of New York. The Working Group is an informal group of approximately fifteen General Counsels of major public companies in the Metropolitan New York area. Led by Michael Fricklas, General Counsel of Viacom, the Working Group meets periodically to discuss issues of importance to General Counsels and the companies they advise. It was in the course of such a meeting that the present issue was identified. As a result of that discussion, Latham & Watkins was asked to prepare a White Paper on the issues. The authors of this White Paper – David M. Brodsky, a litigation partner in the New York office of Latham & Watkins, Pamela S. Palmer, a litigation partner in the Los Angeles office, and Robert J. Malioneck, a senior litigation associate in the New York office – are members of the firm's Securities and Professional Liability Practice Group.

In summary, while auditors historically have planned and performed their audits to obtain reasonable assurance that a company's financial statements are not materially misstated due to error or corporate fraud – and auditors continue to do so – recent developments in federal law and policy have strongly encouraged auditors to intensify their vigilance. The corporate scandals of 2001 and 2002 sparked a firestorm of legislative action by Congress, rule-making and enforcement initiatives by the Securities and Exchange Commission (“SEC”), standard-setting by the Public Company Accounting Oversight Board (“PCAOB”) and initiatives by other oversight bodies, all of which have heightened the scrutiny over auditors' procedures to verify company positions and representations. This has, in turn, impacted generally accepted auditing standards (“GAAS”) and how auditors apply GAAS.²

These same developments in law and policy have led companies to step up their own efforts to establish and strengthen internal controls and procedures in order to detect and respond more effectively to allegations of inappropriate conduct and wrongdoing, including fraud. Companies retain counsel to redesign procedures, to advise of appropriate roles for officers and directors in corporate management and governance and, on occasion, to conduct investigations. Attorneys, in turn, generate work product and provide advice and results to corporate clients – in seeming confidence. To the extent that auditors, in performing their planned procedures, obtain access to this privileged information, however, companies increasingly lose any expectation that the information will remain confidential. Instead, companies must *expect* that otherwise privileged information will find its way into the hands of litigation adversaries – merely because companies have consulted with their attorneys, then cooperated with their independent auditors.

It has long been established that the ability of companies to obtain the advice and involvement of legal counsel in confidence is essential to the public interest in promoting corporate legal compliance and enabling companies to protect legitimate corporate interests. Whenever the privileges are debated, it is well-recognized that the kinds of advertent, inadvertent and sometimes virtually compelled privilege waivers that companies now are facing deny companies the effective assistance of counsel. This loss of privileges thereby undermines the public interest and presents a significant social detriment. Indeed, the thesis of this paper is that the recent and continuing shift in policy and regulations surrounding corporate America has thrown important public policies out of balance. While the public policy to detect and deter corporate fraud is being strengthened, the public policy to protect the confidentiality of attorney-client communications and work product is being weakened. This imbalance is at the heart of the emerging waiver problem.

The waiver problem is very real. Judicial development of the law governing waiver of privileges is, at best, mixed, affording no assurance to companies that privileged information disclosed to auditors will remain protected from adversaries. The solution is not that auditors should back off from obtaining clarification or substantiation of facts from their corporate clients. Rather, the solution – which has already been recognized in similar contexts

² SEC Enforcement Director Stephen M. Cutler recently referred to auditors as one of the three principal “gatekeepers” in our capital markets, or “sentries of the marketplace.” See Stephen M. Cutler, Director of the Division of Enforcement at the SEC, Remarks at the UCLA School of Law, Los Angeles, CA (September 20, 2004), “The Themes of Sarbanes-Oxley as Reflected in the Commission’s Enforcement Program” (transcript available at <http://www.sec.gov/news/speech/spch092004smc.htm>).

by the SEC and the PCAOB – is legislative protection of the privileges. Legislation is needed to strike the right balance in public policy by recognizing that it is just as important for companies to furnish all information to their auditors necessary for them to fulfill their role as “gatekeepers” as it is for companies to protect their privileged communications with counsel and litigation work product from disclosure to their adversaries.

II. THE PUBLIC INTEREST IN PRESERVING AND STRENGTHENING THE PUBLIC COMPANY AUDIT FUNCTION

Generally acceptable auditing standards have long recognized that auditors have particular responsibilities with respect to the discovery of corporate fraud during an audit. Statement of Auditing Standards (“SAS”) 1, *Codification of Auditing Standards and Procedures*, in fact, provides that the auditor has a responsibility to plan and to perform financial statement audits in order to obtain “reasonable assurance” that the financial statements are free of material misstatement, whether caused by error or fraud.³ In recent years, things have changed. In particular, the financial reporting scandals that have washed over the capital markets since 2001, leading to the Sarbanes-Oxley Act of 2002 and other laws and regulations, have placed new emphasis on assuring accurate financial reporting. Further, in today’s political and regulatory environment, audit firms and individual auditors are exposed to vastly greater risk of draconian liability and professional sanctions for shortcomings in the performance of audits and reviews.

In October 2002, the American Institution of Certified Public Accountants (“AICPA”) approved a new auditing standard designed to strengthen the role of the audit function in detecting fraud – SAS 99, *Consideration of Fraud in a Financial Statement Audit*.⁴ This new standard heightened previous GAAS standards governing what auditors are expected to do to fulfill their responsibility with respect to the detection of fraud. SAS 99, consistent with its predecessor standard in GAAS, recognizes that “it is management’s responsibility to design and implement programs and controls to prevent, deter, and detect fraud.” The auditor’s “interest,” however, is described as obtaining evidential matter regarding intentional acts that “result in a material misstatement of the financial statements.” Thus, the auditor is required to exercise professional skepticism when planning and performing the audit, to consider whether the presence of certain “risk factors” – *i.e.*, red flags – indicate the possible presence of fraud and, if risks of fraudulent, material misstatement are identified, consider the impact of this finding on the audit report and whether reportable conditions relating to the company’s internal controls

³ See AICPA Professional Standards, AU § 110.02, *Responsibilities and Functions of the Independent Auditor*.

⁴ SAS 99, adopted in October 2002 and codified at AU § 316, superseded SAS 82, which was adopted in 1997 and carried the same title. SAS 82 provided that “[t]he auditor has a responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.” AICPA, Auditing Standards Board, Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit* (codified in AU § 316). This standard, however, expressly disavowed any *per se* obligation on auditors to uncover all instances of corporate fraud; indeed, SAS 82 recognized that a properly performed and executed audit may fail to detect fraud. As it explained: “An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Because of (a) the concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documentation, and (b) the need to apply professional judgment in the identification and evaluation of fraud risk factors and other conditions, even a properly planned and performed audit may not detect a material misstatement resulting from fraud.” AU § 316.10.

exist and should be communicated to the company or its audit committee.⁵ An auditor's obligations to gather evidential matter to satisfy itself regarding the presence of fraud includes making inquiries "about the existence or suspicion of fraud" to any appropriate personnel within the company, and SAS 99 suggests that the auditor "may wish to direct these inquiries" to the company's in-house legal counsel.⁶

Other recent developments have focused heightened attention on the function of the auditor in the discovery of public company fraud as well, and in the process have further urged auditors to seek greater disclosure of privileged communications and work product from clients. In 2004, the PCAOB, acting as the new standard-setter for public company audits, issued standards on audit documentation and on audits of internal controls over financial reporting, both of which encourage more rigorous audit inquiries into areas involving legal compliance and advice of counsel.⁷ These developments in GAAS, spurred by the current political climate and legislative and regulatory developments, have generated a widely-held expectation that auditors are to apply more stringent efforts to uncover corporate fraud. But whatever the precise impetus, many public companies cite a sharp, recent increase in requests from independent auditors, not simply for relevant factual information to back up management's representations, but also for *privileged* information in order to perform financial statement audits and reviews.

Given the current regulatory climate and trends, the reported increase in such requests is not particularly surprising. Recent comments by the SEC's Deputy Chief Accountant, Scott Taub, pointedly suggest that auditors should seek out privileged information in auditing reserves or accruals for litigation losses and tax contingencies under FAS 5. Mr. Taub remarked as follows:

The difficulty in auditing [loss contingency accruals under FAS 5], however, should cause the auditor to spend more time on them, not less. *If a company's outside counsel is unwilling or unable to provide its expert views, the auditor should consider whether sufficient alternate procedures can actually be performed to allow the audit to be completed.*⁸

⁵ SAS 99, ¶¶ 5, 12, 31, 80.

⁶ *Id.* at ¶¶ 24-25. Other guidance found in GAAS suggests that an auditor may wish to obtain evidential matter through company counsel. For example, pursuant to an auditor's obligations regarding loss contingencies for litigation, claims and assessments pursuant to FAS 5, GAAS states that the "opinion of legal counsel on specific tax issues that he is asked to address and to which he has devoted substantive attention . . . can be useful to the auditor in forming his own opinion." See AU § 9326.17 (warning further, however, that "it is not appropriate for the auditor to rely solely on such legal opinion" in conducting the audit regarding these issues).

⁷ Auditing Standard No. 2: An Audit of Internal Control over Financial Reporting Conducted In Conjunction with an Audit of Financial Statements (PCAOB, June 2004); Auditing Standard No. 3: Audit Documentation (PCAOB, August 2004).

⁸ SEC Deputy Chief Accountant Scott A. Taub, Remarks at the University of Southern California Leventhal School of Accounting SEC and Financial Reporting Conference (May 27, 2004) (emphasis added) (transcript available at <http://www.sec.gov/news/speech/spch052704sat.htm>).

As Mr. Taub suggested, “[a]udit documentation” in this area should “follow the same high standards that apply to other areas of the audit” and warned “*that the PCAOB inspection teams will be looking at the audit work done in these sensitive areas.*”⁹

The PCAOB, in fact, has been given a public mandate to inspect, investigate and discipline auditors conducting public company audits.¹⁰ Although the PCAOB has only a short track record on inspections and enforcement, it has signaled an intention to be tough-minded in enforcing this mandate. In an August 2, 2004 interview, PCAOB Chairman, William McDonough, stated his view on whether it is the auditor’s *obligation* to detect client fraud.¹¹ He said:

We have a very clear view that it *is* their job [to detect fraud]. If we see fraud that wasn’t detected and should have been, we will be very big on the tough and not so [big] on the love. ... [A]uditors [need to] understand that, with relatively few exceptions, they should find it. To me, the relatively few exceptions are those cases where you would have some extremely dedicated, capable crooks. In most cases, though, the crooks either are not that smart or they don’t cover their tracks that well.¹²

Under the Sarbanes-Oxley Act and the PCAOB’s implementing regulations, *any* violation of laws, rules or policies by individual auditors or firms detected during inspections by the PCAOB of selected audit and review engagements will be identified in a written report and may be handed over to the SEC or other regulatory authorities and become the subject of further investigation and disciplinary proceedings.¹³ The PCAOB has stated that its inspections will assess compliance at all levels – *i.e.*, actions, omissions, policies and behavior patterns “from the

⁹ *See id.* (emphasis added).

¹⁰ The Sarbanes-Oxley Act, Sections 101-105, 15 U.S.C. §§ 7211-15.

¹¹ GAAS expressly recognizes that a properly performed and executed audit may fail to detect fraud. SAS 99, *Consideration of Fraud in a Financial Statement Audit*, explains how fraud is less likely to be detected when it involves concealment and collusion: “[A]bsolute assurance [that financial statements are free of material misstatement caused by fraud] is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud. A material misstatement may not be detected because of the nature of audit evidence or because the characteristics of fraud as discussed above may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent.” AU § 316.12.

¹² *The Enforcer*, CFO.com (Aug. 2, 2004) (emphasis added).

¹³ When the PCAOB believes that an act, practice or omission by a registered firm or individual auditor may violate the Sarbanes-Oxley Act, PCAOB rules or other professional standards or any securities law or regulation pertaining to audit reports or to the duties of accountants, the PCAOB may open an investigation. *See* PCAOB R. 5101. Such an investigation can lead to disciplinary proceedings, exposing the offending auditor or firm to penalties ranging from compulsory training and mandated quality control procedures to heavy civil fines and temporary or permanent suspension from audit practice.

senior partners to the line accountants.”¹⁴ The inspections will allow the PCAOB, in its own words, to “apply pressure to improve a firm’s audit practices.”¹⁵

On August 26, 2004, the PCAOB released its first limited inspection reports on each of the four major accounting firms.¹⁶ The Board “cheerfully admit[ted] it is being harsh” in acknowledging that the reports appear to be “laden with criticism” and “an unflinching candour with firms about the points on which we see a need for improvement.”¹⁷ Among its limited inspection reports, the PCAOB criticized two firms for audits that lacked adequate audit evidence, including the analysis of counsel regarding contingent liabilities under FAS 5.¹⁸

The public interest focus on the public company audit function has been mirrored in the SEC’s recent initiatives to enforce federal securities laws as well. In January 2002, then-SEC Chairman Harvey Pitt, discussing what he called the “Enron situation,” directed strong rhetoric towards auditors:

[T]here is a need for reform of the regulation of our accounting profession. We cannot afford a system, like the present one, that facilitates failure rather than success. Accounting firms have important public responsibilities. We have had too many financial and accounting failures. ... [T]he potential loss of confidence in our accounting firms and the audit process is a burden our capital markets cannot and should not bear.¹⁹

This proved to be more than rhetoric. The Sarbanes-Oxley Act, enacted later that year, directed the SEC to study enforcement actions over the prior five years to identify areas of financial reporting most susceptible to fraud.²⁰ The SEC’s review, presented in a January 2003 report to Congress (the “704 Report”), showed that of 515 enforcement actions in total, 18

¹⁴ Steven Berger, *PCAOB—Beyond The First Year*, 2004 WL 69983842, Monday Business Briefing (July 15, 2004).

¹⁵ Public Company Accounting Oversight Board 2003 Annual Report, p. 4, *available at* http://www.pcaobus.org/documents/PCAOB_2003_AR.pdf.

¹⁶ Each of the four 2003 Limited Inspection Reports issued by the PCAOB are available at <http://www.pcaobus.org/Inspections>.

¹⁷ *Watchdog Promises “Unflinching Candour,”* The Financial Times, 2004 WL 90109536 (Aug. 27, 2004). In the inspection reports, all of the firms came in for criticism with respect to the adequacy of audit documentation. The PCAOB also criticized the firms for having insufficient audit support for corporate tax reserves and valuation allowances in specific audits. *See* PCAOB, Report on 2003 Limited Inspection of Ernst & Young LLP (Aug. 26, 2004) at 23-24, n.5, *available at* http://www.pcaobus.org/documents/Inspections/2004/Public_Reports/Ernst_Young.pdf; PCAOB, Report on 2003 Limited Inspection of KPMG LLP (Aug. 26, 2004) at 19, n.4, *available at* http://www.pcaobus.org/documents/Inspections/2004/Public_Reports/KPMG.pdf.

¹⁸ PCAOB, Report on 2003 Limited Inspection of Deloitte & Touche LLP (Aug. 26, 2004) at 19-20, *available at* [Hhttp://www.pcaobus.org/documents/Inspections/2004/Public_Reports/Deloitte_Touche.pdf](http://www.pcaobus.org/documents/Inspections/2004/Public_Reports/Deloitte_Touche.pdf); KPMG Report, *supra*, at 23, n.4.

¹⁹ SEC Chairman Harvey L. Pitt, Public Statement by SEC Chairman: Regulation of the Accounting Profession (Jan. 17, 2002) (transcript available at <http://www.sec.gov/news/speech/spch535.htm>).

²⁰ The Sarbanes-Oxley Act, Section 704, 107 P.L. 204, Title VII, Section 704, 116 Stat. 745.

actions were filed against audit firms and 89 against individual auditors.²¹ In the vast majority of these actions, auditors were sanctioned, in the SEC's words, for "failing to gain sufficient evidence to support the issuer's accounting, failing to exercise the appropriate level of skepticism in responding to red flags, and failing to maintain independence."²² The 704 Report concludes that "audit failures most often arise from auditors accepting management representations without verification, truncating analytical and substantive procedures, and failing to gain sufficient evidence to support the numbers in the financial statements."²³

Administrative and enforcement actions filed in 2003 and 2004 reflect even greater scrutiny of the work of auditors who failed to catch fraud by their clients.²⁴ Recent

²¹ SEC, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (Jan. 24, 2003), available at <http://www.sec.gov/news/studies/sox704report.pdf>.

²² *Id.* at 3.

²³ *Id.* at 40.

²⁴ For example, in Matter of Barbara Horvath, CPA, Admin. Proc. File No. 3-10665, Accounting and Auditing Enforcement Release No. 1483 (Dec. 27, 2001), the SEC censured a Deloitte & Touche auditor for placing reliance on management representations as her principal source of audit evidence for the company's capitalization of expenses which, it turned out, were fraudulent. The SEC contended that she should have demanded more supporting documentation and followed up on "red flags." The SEC imposed a two-year suspension from practice upon another auditor (involved in the same audit) for sampling too few items when auditing the company's contract acquisition costs. See *In the Matter of Jeffrey Bacsik, CPA*, Admin. Proc. File No. 3-10664, Accounting and Auditing Enforcement Release No. 1482 (Dec. 27, 2001). The SEC's enforcement record includes numerous similar cases. See, e.g., *In the Matter of PricewaterhouseCoopers LLP*, Admin. Proc. File No. 3-11483, Accounting and Auditing Enforcement Release No. 2008 (May 11, 2004) (corporate fraud) (action against PwC in connection with audit of the Warnaco Group's financial statements from 1998 and alleged failure to correctly characterize the cause of an inventory overstatement as resulting from internal control deficiencies as opposed to changed accounting rules, as misrepresented by Warnaco in a press release); *In the Matter of Grant Thornton LLP, et al.*, Admin. Proc. File No. 3-11377, Accounting and Auditing Enforcement Release No. 1945 (Jan. 20, 2004) (corporate fraud) (administrative proceeding against Grant Thornton for aiding and abetting fraud and violating Section 10A, by allegedly failing to obtain sufficient audit evidence despite "red flags" that client failed to disclose material related party transactions); *In the Matter of Carroll A. Wallace, CPA*, Admin. Proc. File No. 3-9862, Accounting and Auditing Enforcement Release No. 1846 (Aug. 20, 2003) (probable corporate fraud) (KPMG auditor suspended for one year for undue reliance on management representations, failure to maintain an appropriate attitude of skepticism, failure to obtain sufficient evidential material to discover that the client investment fund's financial statements improperly stated that all of its shares were unrestricted); *In the Matter of Richard P. Scalzo, CPA*, Admin. Proc. File No. 3-11212, Accounting and Auditing Enforcement Release No. 1839 (Aug. 13, 2003) (corporate fraud) (auditor permanently barred from public practice based on audits of Tyco between 1997 and 2001 in which he became aware of facts that put him on notice regarding the integrity of Tyco's management but failed to perform additional audit procedures or reevaluate his risk assessment); *In the Matter of Warren Martin, CPA*, Admin. Proc. File No. 3-11211, Accounting and Auditing Enforcement Release No. 1835 (Aug. 8, 2003) (auditor suspended from public practice for two years for undue reliance upon management representations regarding the interpretation of contracts, thereby ignoring "unambiguous contractual language" that affected revenue recognition and led to a \$66 million restatement); *In the Matter of Michael J. Marrie, CPA and Brian L. Berry, CPA*, Admin. Proc. File No. 3-9966, Accounting and Auditing Enforcement Release No. 1823 (July 29, 2003) (corporate fraud) (suspending two auditors from public practice for failing to act with sufficient skepticism and obtain enough audit evidence with respect to confirmation of accounts receivable, sales returns and allowances, and a \$12 million write-off); *In the Matter of Phillip G. Hirsch, CPA*, Admin. Proc. File No. 3-11133, Accounting and Auditing Enforcement Release No. 1788 (May 22, 2003) (corporate fraud) (suspending PwC auditor for one year in settlement of

public statements by the Director of the Division of Enforcement, Stephen Cutler, called attention to the role of auditors, among others, being “the sentries of the marketplace.”²⁵ The Director also described the hope of the Enforcement Division that “accounting firms will take an even greater role in ensuring that individual auditors are properly discharging their special and critical gate-keeping role.”²⁶ All of these factors reflect the expectation that scrutiny on auditors will continue to increase as expectations for their increased role in monitoring and finding inappropriate corporate accounting behavior continue to grow.

The recent wave of scrutiny on auditors’ detection of fraud has also extended to the companies themselves. Companies have always been obliged, of course, to cooperate fully with their independent auditors. Recent legislation and regulatory developments have focused additional pressure on companies to do so – again, in the interest of strengthening the functionality of audits. Underscoring the company’s obligation to cooperate fully with its auditors, the SEC promulgated Regulation 13b2-2, “Representations and conduct in connection with the preparation of required reports and documents,” effective June 27, 2003.²⁷ The Regulation prohibits officers and directors of public companies from making a “materially false or misleading statement [or a material omission] to an accountant in connection with” an audit or other filing with the SEC. It further provides that officers and directors may not “directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements.”²⁸ Not surprisingly, auditors increasingly are asking companies to provide access to privileged information and attorney work product under various circumstances. For example, auditors are requiring clients to provide detailed information or open their files regarding whistleblower allegations, investigations and outcomes. These requests are often driven by Section 10A of the Exchange Act.²⁹ Section 10A, which was added by the Private Securities Litigation Reform Act of 1995 (“Reform Act”), requires auditors to plan “procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts.”³⁰

allegations that he did not ensure that sufficient audit procedures were conducted in light of PwC’s risk of fraud assessment and that he placed undue reliance on management representations despite awareness of evidence “from which he should have realized further audit work was required.”); *SEC v. KPMG*, Civil Action No. 02-cv-0671 (S.D.N.Y. January 29, 2003), Accounting and Auditing Enforcement Release No. 1709 (possible corporate fraud) (civil injunction against KPMG seeking disgorgement of fees and civil penalties in connection with the firm’s audit of Xerox based on allegation that auditors had evidence of manipulation of financial results and failed to ask Xerox to justify departures from GAAP).

²⁵ SEC Enforcement Director, Stephen Cutler, Remarks at the UCLA School of Law, Los Angeles, CA (September 20, 2004), “The themes of Sarbanes-Oxley as reflected in the Commission’s Enforcement Program” (*available at* <http://www.sec.gov/news/speech/spch092004smc.htm>).

²⁶ *Id.*

²⁷ 17 C.F.R. § 240.13b2-2.

²⁸ *Id.* at § 240.13b2-2(a) & (b).

²⁹ 15 U.S.C. § 78j-1. Section 10A was modeled after SAS 53, the predecessor to SAS 82.

³⁰ 15 U.S.C. § 78j-1. Section 10A is modeled after a predecessor of SAS 99, which provides that “[t]he auditor has a responsibility to obtain reasonable assurances about whether the financial statements are free of material misstatements, whether caused by error or fraud.” SAS 99: Consideration of Fraud in a Financial Statement Audit (codified in AICPA Professional Standards, AU § 316). Section 10A imposes

Modeled on SAS 82, the predecessor of SAS 99, Section 10A requires auditors to report evidence of fraud up the corporate ladder to management and to the audit committee under certain circumstances, but Section 10A added a requirement that the auditor report not only up, but *out* to the SEC if – after investigation of evidence of an illegal act uncovered during an audit – the auditor determines that (1) the audit committee or board is adequately informed of the illegal act, (2) the illegal act has a material effect on the financial statements, (3) the illegal act has not been appropriately remediated and (4) as a result, the auditor will be required to issue a qualified audit opinion or resign.³¹ Because auditors face potential civil liabilities imposed by the SEC under Section 10A for mere negligence – there is no scienter requirement for proceedings brought under Section 10A – this provision has grown, through the scandals of 2001, as a regulatory tool for increasing scrutiny of the performance of audits.

Because of their obligations under Section 10A, auditors require public company clients to provide information about potential illegal acts and remediation efforts. Under the Section 10A structure, if an auditor becomes aware of information “indicating that an illegal act (whether or not perceived to have material effect on the financial statements of the issuer) has or may have occurred,” the auditor must take certain steps to inform itself, advise the audit committee and ultimately satisfy itself that the company has taken appropriate remedial action. When alerted to allegations of potential illegal conduct, companies and/or their audit committees typically launch internal investigations, led by legal counsel and resulting in an accumulation of attorney-client communications, witness interviews, advice of counsel and other legal work product and analyses. Auditors in turn, frequently press for access to these privileged attorney-client communications and work product.

Similarly, auditors are seeking attorney work product and the disclosure of attorney-client communications arising from internal investigations triggered by the SEC’s August 2003 regulations implementing Section 307 of the Sarbanes-Oxley Act. In Section 307, Congress directed the SEC to set forth “minimum standards of professional conduct for attorneys appearing and practicing before the Commission.” The SEC’s regulations require attorneys to report “evidence of a material violation of securities law, or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or chief executive officer of the company.”³² Corporate counsel is required – much like auditors under Section 10A – to report evidence of misconduct up the corporate ladder and to satisfy itself that the company has taken appropriate remedial action. The Section 307 structure has therefore spawned internal investigations that generate attorney-client privileged communications and attorney work product. Increasingly, auditors are requiring public company clients to disclose this internal investigation information, including whether counsel has advised the company of evidence of any material violations of the law in the first place.

Moreover, internal investigations of potential misconduct frequently are undertaken by companies and their legal counsel as a matter of good corporate governance, irrespective of Sections 10A or 307. Indeed, companies’ efforts to establish controls to detect

essentially the same auditing obligations, but adds a potential “reporting out” requirement to the SEC and explicitly exposes auditors to SEC sanctions for non-compliance.

³¹ 15 U.S.C. § 78j-1.

³² 17 C.F.R. Part 205.

and respond to allegations of fraud – through involvement of their audit committees – has grown considerably under the Sarbanes-Oxley Act. Pursuant to Section 301, audit committees are charged with establishing procedures for receiving and handling complaints “regarding accounting, internal controls or auditing matters” and confidential submissions by corporate employees “regarding questionable accounting or auditing matters.”³³ In implementing these responsibilities, many public companies and their audit committees have gone beyond the minimum requirements of the law and established procedures for receiving and investigating all whistleblower complaints, on any subject relevant to the company, from any source. Internal investigations conducted pursuant to these procedures typically generate attorney-client privileged communications and attorney work product. On some occasions, auditors have required their corporate clients to share all information and work product, even confidential attorney communications and work product, regarding internal investigations of possible unlawful conduct within each company.

Auditors also may require public company clients to disclose legal advice and analyses concerning specific issues that could impact the financial statements. As part of an audit of the company’s financial statement assertions regarding tax assets, liabilities and contingencies, auditors frequently require companies to disclose privileged legal advice, analyses and judgments, including the potential tax consequences of transactions.³⁴ As part of an audit inquiry into loss contingencies for litigation, claims and assessments,, auditors may ask that corporate legal counsel disclose their judgments and supporting information regarding potential outcomes, range of loss and other issues.

In light of the comments of Messrs. Taub, Cutler and McDonough, and others, and the criticisms levied in the PCAOB’s limited inspection reports, noted above, auditors may conclude that it would be imprudent in this climate *not* to demand access to privileged information of the sort described above.

By both design and effect, these regulatory developments – Section 10A, SEC enforcement and PCAOB inspections and rule-making – have created a framework of enhanced government oversight of audits and auditors. These developments reflect government focus on the strong public interest in preserving and strengthening the audit function. These

³³ The Sarbanes-Oxley Act of 2002, Section 301, 15 U.S.C. § 78j-1.

³⁴ FAS 5, governing audits of loss contingencies for litigation, claims and assessments, specifically recognizes that the “opinion of legal counsel on specific tax issues that he is asked to address and to which he has devoted substantive attention ... can be useful to the auditor in forming his own opinion.” *See* AU §9326.17. The same standard warns further, however, that “it is not appropriate for the auditor to rely solely on such legal opinion” in conducting the audit regarding these issues. *Id.*

It should be noted that because tax advice frequently is rendered by non-lawyer tax professionals, the Internal Revenue Code establishes a confidentiality privilege equivalent to the attorney-client privilege for taxpayer communications by non-lawyers in the context of certain non-criminal tax matters. *See* 26 U.S.C. § 7525(a)(1) (“With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney”). Thus, when auditors require disclosure of these communications, this raises essentially the same waiver issue presented by disclosure to auditors of attorney work product and communications..

developments also may be driving auditors to seek more privileged and work product-protected materials than in the past.

The public interest in assuring that auditors have access to all information required to conduct proper audits, including information relevant to corporate fraud, is undeniable. This is how the audit function has, as described above, always worked and how it should continue to work. But as the public interest in fraud prevention has led to new audit standards, laws and regulations heightening the auditors' need for access to privileged information, such access should not come at the expense of other public interests that are just as important.

The waiver problem is squarely presented when companies are required to provide their independent auditors with attorney work product and privileged communications. The question is whether the public interest in preserving the attorney work product doctrine and attorney-client privilege is important enough to be protected at the same time that the public interest in the public company audit function is being strengthened . . . or whether a company's good corporate governance and cooperation with its auditors should come at the cost of waiver of these protections.

III. THE PUBLIC INTEREST IN PRESERVING THE ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT PROTECTION

A. HISTORICAL SIGNIFICANCE OF THE ATTORNEY-CLIENT PRIVILEGE AND WORK-PRODUCT DOCTRINE

The public interest in protecting the confidentiality of attorney-client communications and work product should be, like the public interest in a strong public company audit function, incontrovertible.

The attorney-client privilege is “the oldest of the privileges for confidential communications known to the common law.”³⁵ The purpose of the privilege is to “encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice.”³⁶

The strongest criticism of the attorney-client privilege – and, indeed, of any evidentiary privilege – is that, in court or other proceedings, potentially valuable evidence may be suppressed and the “truth” harder to find. This debate has been raised countless times, and no doubt it is being raised again now as the risk of waiver by companies increases in proportion with the volume of auditor requests for disclosure of the company's confidential information. But in our society, the debate has been settled consistently; as one court has described: “The social good derived from the proper performance of the functions of lawyers acting for their clients is believed to outweigh the harm that may come from the suppression of the evidence in

³⁵ *Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981).

³⁶ *Id.*

specific cases.”³⁷ As the Supreme Court has held, this social good extends to corporations as well as to individuals.³⁸

Protecting the confidentiality of work product likewise furthers vital public interests. “[T]he work product privilege [exists] . . . to promote the adversary system by safeguarding the fruits of an attorney’s trial preparations from the discovery attempts of the opponent.”³⁹ Work product protection encourages parties and their counsel to prepare for litigation and trial without concern that their work will be discoverable by the opposition. Work product protection supports a fair adversary system by “by affording an attorney ‘a certain degree of privacy’ so as to discourage ‘unfairness’ and ‘sharp practices.’”⁴⁰ As one Supreme Court Justice wrote in a concurring opinion to the seminal decision supporting the doctrine, “[d]iscovery was hardly intended to enable a learned profession to perform its functions . . . on wits borrowed from the adversary.”⁴¹ The work-product doctrine is simply a recognition that a lawyer’s work on behalf of a client preparing a response to litigation or a potential claim – even when not subject to the attorney-client privilege – must also be protected, lest all lawyers be discouraged from conducting those preparations effectively, the clients be punished and their adversaries be unfairly rewarded. Those who fear that the work product generated by their counsel in determining an appropriate response will be disclosed to their adversaries and promptly used against them may, not surprisingly, be reluctant to seek legal assistance at all.

Protection of attorney work product is codified in Federal Rule of Civil Procedure 26(b)(3), which extends protection to the work of a party’s representatives, “including an attorney, consultant, surety, indemnitor, insurer, or agent” in anticipation of litigation or for trial. Work product is not discoverable by an opposing party absent a showing of “substantial need for the materials in the preparation of the party’s case and [inability] without undue hardship to obtain the substantial equivalent of the materials by other means.” But even when an opposing party makes this showing, courts must protect against disclosure of the “mental impressions, conclusions, opinions or legal theories of an attorney or other representative of a party.”⁴²

As Rule 26(b)(3) codifies, disclosure of the diligent work performed by an attorney to his client’s litigation opponent would undermine the adversarial underpinnings of our legal system itself. It is because of this underlying rationale that work product protection may not be waived – unlike the attorney-client privilege – by mere disclosure to a third party, “but

³⁷ *United States v. United Shoe Mach. Corp.*, 89 F. Supp. 357, 358 (D. Mass. 1950). See *Trammel v. United States*, 445 U.S. 40, 50 (1980) (the privilege “promotes a public goal transcending the normally predominant principle of utilizing all rational means for ascertaining the truth.”).

³⁸ *Upjohn*, 449 U.S. at 389-90.

³⁹ *In re Raytheon Securities Litig.*, 218 F.R.D. 354, 359 (D. Mass. 2003) (quoting *United States v. Amer. Tel & Tel. Co.*, 642 F.3d 1286, 1299 (D.C. Cir. 1980)).

⁴⁰ Joint Drafting Committee of the American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations* (March 2002), at 6, quoting *Hickman v. Taylor*, 329 U.S. 495, 510-11 (1946).

⁴¹ *Hickman v. Taylor*, 329 U.S. 495, 516 (1946) (Jackson, J., concurring).

⁴² Fed. R. Civ. P. 26(b)(3).

rather only if a disclosure runs counter to the principles embodied by the adversary system.”⁴³ The policy goal of the doctrine, grounded in fairness, is to protect work product from adversaries. Thus, it is *only when it would not be unfair* for an adversary to obtain that work product – *i.e.*, when the adversary meets its burden to show that it “has substantial need of the materials in the preparation of the party’s case and is unable without undue hardship to obtain the substantial equivalent of the materials by other means”⁴⁴ – that the policy to protect work product will not apply.

Companies expect that the work product of their counsel prepared as a result of an internal investigation will be protected, and legitimately so. Increasingly, companies and, on occasion when the circumstances call for it, their audit committees or other independent committees, use counsel to investigate evidence of alleged corporate or employee wrongdoing by interviewing company employees, identifying relevant documents, analyzing the facts and law and formulating conclusions and recommendations. Internal investigations, conducted by and at the direction of legal counsel, are a critical tool by which companies and their boards assess potential violations of law, breaches of duty and other misconduct that may expose the company to liability and damages. Internal investigations are an essential predicate to enabling companies to take remedial action and to formulate defenses, where appropriate. Companies are, therefore, entitled to and afforded work product protection from adversaries, so long as the investigations are not merely being conducted in the ordinary course of business. As one commentator has noted: “The general rationale for finding work product protection is that litigation is virtually assured if the investigation confirms the allegations. Since the corporation would be required to report the results to shareholders and government agencies, the possibility of a suit following is considered inevitable.”⁴⁵

Work product protection does not mean that, where internal investigations involving legal counsel are conducted, all facts related to the issue under investigation are inherently protected against disclosure to auditors or third parties. The *facts*, including underlying documents, regarding an issue are properly discoverable, and routinely produced, in litigation. By contrast, what is protected from disclosure is the work performed, materials generated and considerations of the lawyers in connection with the investigation and any recommendations to the company – this is the heart of what is protected by the work product doctrine, due to the inherent unfairness of giving an adversary access to counsel’s analysis of the facts, law, strengths and weaknesses of the company’s position. The distinction is an important one that is well-accepted in the law.⁴⁶

⁴³ *Philippines v. Westinghouse Elec. Corp.*, 132 F.R.D. 384, 389 (D.N.J. 1990).

⁴⁴ Fed. R. Civ. P. 26(b)(3).

⁴⁵ John William Gergacz, *Attorney-Corporate Client Privilege* § 7.37 (West 2000), at 7-53 (reporting that “[m]ost of the cases hold that intracorporate investigations of possible corporate illegal activity are performed with sufficient anticipation of litigation to give rise to work product protection”). The author also reports that it is not only the inevitability of litigation, but also “the importance of not discouraging corporate self-investigation, [which] provides the underlying basis for the finding of work product protection.” *Id.* at 7-54.

⁴⁶ *See Sporck v. Peil*, 759 F.2d 312, 315 (3rd Cir. 1985) (lawyer’s choice of documents with which to prepare deponent is work product even if the underlying documents themselves are not, “[b]ecause identification of

B. THE RISK OF EROSION OF THE ATTORNEY-CLIENT PRIVILEGE AND WORK-PRODUCT DOCTRINE

A legal system that fails to assure public companies the benefits of the attorney-client privilege and work product protection denies those companies the effective assistance of counsel when potentially illegal corporate behavior is discovered.⁴⁷ As the Supreme Court has stated, impairment of these privileges and protections would “not only make it difficult for corporate attorneys to formulate sound advice when their client is faced with a specific legal problem but also threaten to limit the valuable efforts of corporate counsel to ensure their client’s compliance with the law.”⁴⁸ Further, absent assurance that attorney-client communications and work product can be protected as confidential, companies that seek the assistance of legal counsel would only do so in the face of an unacceptable risk that counsel will be converted “into a conduit of information between the client” and its adversaries.⁴⁹

These concepts supporting the protection of attorney work product and privileged communications are not incompatible with the function of auditors and their ability to obtain the

documents as a group will reveal defense counsel's selection process, and thus his mental impressions...”); *see also In re Grand Jury Subpoenas Dated October 22, 1991 and November 1, 1991*, 959 F.2d 1158, 1166-67 (2d Cir. 1992) (noting that work product exception is only found when there is “real, rather than speculative concern that the thought process of [the client's] counsel... would be exposed,” and allowing production of all telephone records from a specified period) (internal citations and quotations omitted); *In re Grand Jury Subpoenas Dated March 19, 2002 and August 2, 2002*, 318 F.3d 379, 386-87 (2d Cir. 2003) (finding that lower court was correct in allowing discovery of disputed materials because producing party had failed to disclose any strategy *ex parte* to the district court judge, making it impossible for judge to determine whether the responsive subset of documents reflected lawyers’ selection or was simply the product of document retention policies); *Shelton v. American Motors Corp.*, 805 F.2d 1323, 1326 (8th Cir. 1987) (“We hold that where, as here, the deponent is opposing counsel and has engaged in a selective process of compiling documents from among voluminous files in preparation for litigation, the mere acknowledgment of the existence of those documents would reveal counsel’s mental impressions, which are work product.”).

⁴⁷ For example, in disclosing information to auditors regarding the handling of whistleblower allegations, companies risk waiving privileges to the extent that the information includes attorney-client communications, witness interviews, advice of counsel, and other legal work and analyses. This type of information is at the heart of what companies reasonably expect – through long-standing and sound precedent – will be protected from actual and potential litigation adversaries.

⁴⁸ *Upjohn Co. v. U.S.*, 449 U.S. 383, 392 (1981). This point was made forcefully in the recently-published *Comments of the ABA’s Section of Antitrust Law On The Proposed Amendments To The Sentencing Guidelines For Organizations*, at 5-7, available at http://www.abanet.org/antitrust/comments/2004/sentencing_guidelines0704.pdf.

⁴⁹ *See United States v. Chen*, 99 F.3d 1495, 1500 (9th Cir. 1996) (the “valuable service of counseling clients and bringing them into compliance with the law cannot be performed effectively if clients are scared to tell their lawyers what they are doing, for fear that their lawyers will be turned into ... informants”); Joint Drafting Committee of the American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations* (March 2002), at 11. In addition, the Antitrust Law Section’s paper, cited above, makes the point if companies cannot protect privileged information from litigation adversaries, they naturally will be deterred from conducting thorough internal investigations and documenting findings, analyses and recommendations. Likewise, employees will be deterred from cooperating in investigations if they know that candor will only expose them to personal liability or make them witnesses for the company’s adversaries. *See Comments of the ABA’s Section of Antitrust Law, supra*, at 11-14.

information that they need to conduct proper audits. In 1975, the audit and legal professions debated the issue and reached an accord – or “Treaty,” as it is sometimes called – regarding the waiver problem arising when auditors ask their clients for privileged information and the opinions of company counsel regarding loss contingencies for litigation, claims and assessments.⁵⁰ This “Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information,” as adopted by the ABA and consented to by the AICPA, struck a balance between two very important public interests: first, to promote confidence in the capital markets by assuring reliable financial reporting of loss contingency accruals and disclosures under FAS 5, and second, to encourage companies to consult freely with counsel by protecting the confidentiality of lawyer-client communications. The ABA Statement of Policy struck the balance by limiting the range of acceptable disclosures that lawyers may make to auditors with the client’s informed consent, and thus defined the scope of what the auditors may request from lawyers regarding confidential attorney information.⁵¹ In 1977, the AICPA affirmed this protection and limitation regarding auditor access to privileged information and work product maintained by the client.⁵²

⁵⁰ American Bar Association, “Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information” (1975), available at <http://www.abanet.org/buslaw/catalog/5070426i/secure.html>.

Thoughtful texts and law review articles discuss the tensions that led to the Treaty, including incidents of auditors asking lawyers open-ended questions seeking general information about the client’s potential illegal acts and liability exposures. See Erbstoesser and Matson, *Lawyers’ Letters to Auditors*, Chpt. 8, Drafting Legal Opinion Letters, at 366, nn. 1 & 2 (2d ed. 1992); Deer, *Lawyers’ Responses to Auditors’ Requests for Information*, 28 Bus. Law. 947 (1973). The ABA Statement of Policy and SAS 12 ended these types of broad requests by clarifying that GAAS did not require them.

The Treaty involves three pieces of professional literature. The obligation of lawyers to limit their responses to auditor inquiries is set forth in the ABA Statement of Policy. The obligation of clients to accrue for and/or disclose loss contingencies properly is set forth in FAS 5, which is part of generally accepted accounting practices (“GAAP”). See Financial Accounting Standards Board, Statement of Accounting Standards No. 5: Accounting for Contingencies (March 1975). The obligation of auditors to inquire concerning litigation, claims and assessments is governed by GAAS and, specifically, SAS 12, adopted by Auditing Standards Executive Committee of the American Institute of Certified Public Accountants (“AICPA”) in the wake of the ABA Statement of Policy. See AICPA, Auditing Standards Board, Statement on Auditing Standards No. 12: Inquiry of a Client’s Lawyer Concerning Litigation, Claims and Assessments (Jan. 1976) (codified in AICPA Professional Standards, AU § 337). The ABA Statement of Policy is an exhibit to SAS 12.

⁵¹ Pursuant to the ABA Statement of Policy, a lawyer may provide information to a client’s auditors on matters to which the lawyer has devoted substantive attention regarding overtly threatened or pending litigation and, with the client’s further specific consent, regarding unasserted possible claims or assessments or contractually-assumed obligations, and may provide specific confirmations regarding the lawyer’s role for the client. Only in rare circumstances may the lawyer express to the auditors any professional judgment regarding the potential outcome of the matters. The lawyer may only provide information and evaluation of unasserted possible claims specifically identified by the client if the client has determined that it is “probable” the claims will be asserted, that there is a “reasonable possibility” that the outcome will be unfavorable and that the resulting liability will be material to the client’s financial condition. ABA Statement of Policy, par. 5.

⁵² See AICPA Professional Standards, AU § 9337 (4), Documents Subject to Lawyer-Client Privilege (March 1977). The interpretive release poses the question: “[SAS 12 states:] ‘Examine documents in the client’s possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.’ Would this include a review of documents at the client’s location considered by the lawyer and

As recognized by both the auditing and legal professions through the continued viability of the Treaty today, promoting effective corporate governance and responsiveness to allegations of wrongdoing depends, in part, on protecting the attorney-client privilege and work product doctrine. The ABA Statement of Policy, in fact, begins with this recognition:

The public interest in protecting the confidentiality of lawyer-client communications is fundamental. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.⁵³

Thus, while auditors require access to attorney-client information – as part of their job of performing audits – they recognize the importance of the privileges by cooperating in a “Treaty” designed to uphold the public interest in protecting these privileges in certain contexts.

The SEC is also on record promoting work product protection for the internal investigation files of public company counsel.⁵⁴ The SEC argued in *United States v. Bergonzi* that its responsibilities would be frustrated if companies were deterred from sharing their work product from internal investigations with the SEC, and because of this concern, such production “should not result in waiver of work-product protection because preserving work-product protection is in the public interest.”⁵⁵ The SEC pointed out that there are “significant benefits to the public” when a company can share its work product with the SEC, thereby allowing the SEC to fulfill its oversight function, without fear by the company that its work product will end up in

the client to be subject to the lawyer-client privilege?” and answers as follows: “No. Although ordinarily an auditor would consider the inability to review information that could have a significant bearing on his audit as a scope restriction, in recognition of the public interest in protecting the confidentiality of lawyer-client communications, [SAS 12] is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege.” (Emphasis added)

⁵³ ABA Statement of Policy, Preamble (emphasis added).

⁵⁴ Indeed, a Practising Law Institute conference on securities litigation and enforcement held September 1, 2004 included a panel of attorneys who practice before the SEC who commented that internal investigations conducted by a company to respond to fraud allegations “may cause more harm than good” because the SEC now regularly demands waiver of privileges, and “[t]hat information is then discoverable by plaintiffs’ lawyers in civil litigation.” *Conference Panelists Discuss Securities Litigation and Enforcement*, SEC Today (CCH Sept. 16, 2004), at 1. One panelist suggested that “the waivers of attorney/client privilege will have a chilling effect on the information provided by clients to their lawyers, which is what the privilege is intended to protect.” *Id.* at 2.

⁵⁵ *United States v. Bergonzi*, 9th Cir. Case No. 03-10024, Brief of the Securities and Exchange Commission, 2003 WL 22716310 (Apr. 29, 2003), at *3-4. The ABA Section of Antitrust Law recently echoed this same argument, stating its belief that a waiver of these protections based upon disclosure by a company of its privileged or work product materials to the government “will reduce the availability of information from an organization’s management and employees, and impede the development and operation of effective compliance programs.” *See Comments of the ABA’s Section of Antitrust Law, supra*, at 2.

the hands of civil litigation adversaries: “The choice is thus between disclosure only to government agencies, which will increase the effectiveness and efficiency of governmental investigations, and no disclosure at all – not a choice between disclosure only to government agencies and disclosure to all parties.”⁵⁶

The same policies underlie public company disclosure of privileged communications and work product to independent auditors. Disclosure of such material may be part of an effective and comprehensive audit, but it would be *unfair* for companies to be forced to waive their privileges as to their adversaries – who stand ready to use this sensitive information to file civil lawsuits and obtain an immediate advantage in litigation – simply because the companies maintain effective internal controls for responding to allegations of wrongdoing and cooperate with their auditors. This is the waiver problem, and it is growing.

IV. THE WAIVER PROBLEM

While both the attorney-client protections and the public company audit function serve important public policies, it is not the case that, today, each is on equal footing with the other. In the wake of the recent, high-profile corporate scandals, the public and governmental response has been to strengthen the audit function – and appropriately so – as well as to strengthen the primary responsibility of companies to establish anti-fraud controls. This renewed focus has led to increased government scrutiny of the performance of audits and, as reported by many public companies, increased requirements by auditors for confidential information relevant to internal anti-fraud activities that go far beyond the exchange contemplated by the 1975 ABA Statement of Policy. It is becoming increasingly clear that corporations have reason to be concerned. The attorney work product and confidential communications generated through internal investigations involving counsel, recognized as privileged by long-standing law and policy, are being sacrificed to civil litigation adversaries for the mere reason that the corporation and their auditors are doing their jobs.

A. CASE LAW REGARDING WAIVERS BASED UPON DISCLOSURE TO AUDITORS

The ABA Statement of Policy expressed the drafter’s expectation that judicial developments regarding disclosure of confidential information provided to auditors would not prejudice clients “engaged in or threatened with adversary proceedings,” but also provided that if judicial developments were adverse, revision of the ABA Statement might be needed.⁵⁷ Indeed,

⁵⁶ *United States v. Bergonzi*, SEC Brief, *supra*, at *16-17. The SEC also took the position that, “[t]he Commission cannot compel public companies to produce work product, and even cooperative companies generally will not produce work product for fear that production will waive work-product protection as to third parties.” *Id.* at *22-23 (as support for this position, which the SEC stated was the “likely” result, *id.* at *30, the SEC cited to pages of the record on appeal but did not describe the information therein). This paper disclaims any suggestion that, as to its *auditors*, companies do not provide requested work product; indeed, companies have a vested interest in ensuring that their auditors obtain the information that is needed to assess whether an unqualified audit opinion may be given.

⁵⁷ ABA Statement of Policy, Commentary, par. 1 (“The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary

the case law has been neither favorable nor consistent with respect to the protection of confidential information disclosed by clients to auditors.

With a few notable exceptions, the case law in this country concerning waiver of the attorney client privilege and work product based on disclosure to auditors has generally arisen in the narrow context of discovery of attorney analyses of litigation loss contingencies under the ABA Statement of Policy, made in response to auditor inquiries.

1. **Waivers of Attorney-Client Privilege**

Courts generally hold that disclosure of attorney-client communications to auditors, for purposes of providing litigation loss contingency information, waives the attorney-client privilege.⁵⁸ Courts reason that because the purpose of the privilege is to protect the confidentiality of the communications, almost any disclosure to an outsider breaches the confidence and waives the privilege. Thus, unless an accountant is helping the attorney to advise the client (a role that an auditor could rarely, if ever, undertake given independence constraints), disclosure to the outside accountant waives the privilege.⁵⁹

The only jurisdictions in which disclosure may not result in a waiver are states that, by statute, recognize an accountant-client privilege. Only fifteen states have any such statute and, of those, only seven have expressly extended the privilege to independent auditors by statute or judicial ruling.⁶⁰ In every other jurisdiction, including all federal courts, the common law rule applies that communications between outside auditors and clients are not privileged.⁶¹

to this expectation, appropriate review and revision of the Statement of Policy may be necessary.”). In 1989, following an early adverse court decision on the issue of waiver, another ABA committee sought to mitigate the risk of further waiver rulings. The committee issued a report advising lawyers to state expressly in their communications to auditors that neither the client nor the auditor intended any waiver of the attorney-client or work product privileges. See Subcommittee on Audit Inquiry Responses, Law and Accounting Comm., ABA Section of Business Law, Report by the American Bar Association’s Subcommittee on Audit Inquiry Responses (1989), reprinted in *Lawyers’ Letters to Auditors*, *supra*, at 381-84. As the committee said, such language “simply makes explicit what has always been implicit, namely ... that neither the client nor the lawyer intended a waiver.” The AICPA agreed with the ABA committee in a 1990 interpretation of SAS 12 advising auditors that such language in a lawyer’s letter did not impose a scope limitation requiring a qualified audit opinion. See AICPA, Auditing Interpretation: Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments – Use of Explanatory Language about the Attorney-Client Privilege or the Attorney Work Product Privilege, J. Acct. (Feb. 1990), reprinted in *Lawyers’ Letters to Auditors*, *supra*, at 384-85.

⁵⁸ See, e.g., *Gutter v. E.I. Dupont De Nemours and Co.*, 1998 WL 2017926, at *3 (S.D. Fla. May 18, 1998) (“[d]isclosure to outside accountants waives the attorney-client privilege”); *In re Pfizer Inc. Securities Litig.*, 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993) (“Disclosure of documents to an outside accountant destroys the confidentiality seal required of communications protected by the attorney-client privilege, notwithstanding that the federal securities laws require an independent audit”).

⁵⁹ See *Ferko Nat’l Assoc. for Stock Car Auto Racing*, 218 F.R.D. 125, 135 (E.D. Tex. 2003), citing *United States v. Kovel*, 296 F.2d 918, 921-22 (2d Cir. 1961), which extended the attorney client privilege to attorney-accountant communications for the purpose of assisting the lawyer to advise the client.

⁶⁰ The fifteen states are listed below and the seven states that have clearly extended the privilege to the audit context are underlined: Arizona, ARIZ. REV. STAT. § 32-749; Colorado, COLO. REV. STAT. § 13-90-107; Florida, FLA. STAT. ANN. § 90.5055; Georgia, GA. CODE ANN. § 43-3-32; Idaho, IDAHO CODE § 9-203A

2. Waivers of Work Product Protection

With respect to whether work product protection survives disclosure to auditors, courts have divided at several analytical points. Some courts never reach the question of waiver, but nonetheless refuse to compel third-party discovery on the grounds that attorney analyses of loss contingencies are neither evidence nor relevant – or, to the extent that these analyses have any probative value, that value is outweighed by unfair prejudice and public interest concerns.⁶²

In another line of authority, courts have held that attorney evaluations of litigation risk and loss exposure prepared in response to an audit inquiry do not constitute work product at all because the work was prepared primarily for a business purpose (*i.e.*, auditing financial statements), rather than “in anticipation of litigation or for trial.”⁶³ This line of authority, however, is older, has attracted no recent followers and reflects a minority view.

AND IDAHO ST. REV., Rule 515; Illinois, 225 ILL. COMP. STAT. 450/27; Indiana, IND. CODE. § 34-46-2-18; Kansas, KS. STAT. ANN. § 1-401; Louisiana, LA. CODE EVID. ANN. art. 515; Maryland, MD. CODE ANN., CTS. & JUD. PROC. § 9-110; Michigan, MICH. COMP. LAWS § 339.732; Missouri, MO. REV. STAT. § 326.322; New Mexico, N.M. STAT. ANN. § 38-6-6; Pennsylvania, PA. STAT. ANN. tit. 63 § 9.11; and Tennessee, TENN. CODE ANN. § 62-1-116.

Other states have statutes requiring accountants and auditors to maintain the confidentiality of client materials, but not purporting to establish any evidentiary privilege from discovery. *See* Alabama, ALA. CODE § 34-1-21; California, 16 CAL. CODE REGS. tit. 16, § 54 ; Connecticut, CONN. GEN. STAT. ANN. § 20-281j; Iowa, IOWA CODE ANN. § 542.17; Kentucky, KY. REV. STAT. ANN. § 325.440; Massachusetts, MASS. GEN. LAWS ANN. ch. 112 § 87E; Minnesota, MINN. STAT. ANN. § 326A.12; Mississippi, MISS. CODE. ANN. § 73-33-16; Montana, MONT. CODE. ANN. § 37-50-402; New Jersey, N.J. STAT. ANN. § 45:2B-65; North Dakota, N.D. CENT. CODE § 43-02.2-16; Oregon, OR. REV. STAT. § 673.385; Rhode Island, R.I. GEN. LAWS § 5-3.1-23; Vermont, VT. CODE R. § 81; Washington, WASH. REV. CODE ANN. § 18.04.405.

⁶¹ *See Couch v. United States*, 409 U.S. 322, 335 (1973) (“no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases”).

⁶² In the following cases, courts rejected attempts by client adversaries to discover documents created by counsel and provided to auditors, generally consisting of audit-inquiry responses concerning assessment of pending and potential litigation. *See Laguna Beach County Water District v. Superior Court*, 124 Cal. App. 4th 1453, 1461 (2004)(attorney analysis of litigation position provided to auditors did not waive work product privilege as to litigation adversary because disclosure did not contravene the purpose of the work product doctrine); *Tronitech, Inc. v. NCR Corp.*, 108 F.R.D. 655, 655-56 (S.D. Ind. 1985) (attorney letter to auditors was not discoverable under Fed. R. Civ. Proc. 26(b)(1) because it was not legally relevant or reasonably calculated to lead to the discovery of admissible evidence); *United States v. Arthur Young & Co.*, 1984 U.S. Dist. LEXIS 22991, at *11 (N.D. Okla. Oct. 5, 1984) (“If some theory of relevance can be advanced concerning the documents under review, the Court would conclude its probative value is substantially outweighed by the danger of unfair prejudice and public interest concerns.”); *In re Genentech, Inc. v. Securities Litig.*, Case No. C-99-4038 (N.D. Cal. 1999) (unpublished) (noting that attorney’s opinions are not relevant or at issue in the lawsuit); *Comerica Bank of Calif. v. Lloyd Raymond Free*, Case No. 88-20880 (N.D. Cal. 1999) (unpublished) (noting “tangential relevance” of information and finding public policy in favor of protecting attorney’s work-product to be more important); *Teberg v. Am. Pacific Int’l, Inc.*, Case No. C 196448 (Los Angeles Superior Ct., April 29, 1982) (unpublished) (relevance of documents was outweighed by the public policy of promoting candid and full disclosure by counsel to auditor and by the right of privacy).

⁶³ *See* Fed. R. Civ. P. 26(b)(3); *United States v. Gulf Oil Corp.*, 760 F.2d 292, 296-97 (Temp. Emerg. CA 1985) (attorney letters in response to audit inquiries, although containing the mental impressions of defendant’s attorney regarding litigation exposure, did not qualify for work product protection because they were not created in anticipation of litigation, but rather “created, at [the auditor’s] request, in order to allow

The majority view, followed in several recent cases, is that work product includes any material prepared “because of” actual or potential litigation, thus encompassing analysis of litigation exposure prepared in response to an audit inquiry.⁶⁴ These authorities reject the earlier, parochial construction of “work product” and find the “because of” construction to be more faithful to the language of Rule 26(b)(3) and to the purpose of the work product doctrine.⁶⁵

Where courts find that attorney letters to auditors are, indeed, work product, they also generally conclude that disclosure to auditors does not waive the protection *vis à vis* the client’s litigation adversaries.⁶⁶ These courts acknowledge that, unlike the attorney-client

[the auditor] to prepare financial reports which would satisfy the requirements of the federal securities laws”); *United States v. El Paso Corp.*, 682 F.2d 530, 543-44 (5th Cir. 1982) (lawyer’s analysis and memoranda “written ultimately to comply with SEC regulations” were prepared “with an eye on [the company’s] business needs, not on its legal ones” and did not “contemplate litigation in the sense required to bring it within the work product doctrine”); *Independent Petrochemical Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 292, 298 (D.D.C. 1987) (work product protection did not apply to lawyer’s letters to an auditor because the letters were not prepared to assist the company in litigation but rather to assist the auditor “in the performance of regular accounting work”).

⁶⁴ The following courts rejected the narrow construction of “work product” and found that litigation analysis prepared for auditors is work product. See *United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998) (observing, in *dicta*, that the work-product doctrine would protect an audit-inquiry response and approving the rule adopted by the Third, Fourth, Seventh, Eighth, and D.C. Circuits that a document is work product if “in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained *because of* the prospect of litigation”) (emphasis in original); *In re Honeywell Int’l, Inc. Securities Litig.*, 2003 WL 22722961, at *6 (S.D.N.Y. Nov. 18, 2003) (rejecting plaintiff’s argument that the “preeminent business purpose” of an audit rendered the work product doctrine inapplicable and finding that defendant’s “assertion of work product protection for ... audit letters and litigation reports prepared by its internal and external counsel, as well as PWC documents memorializing ... opinion work product, is proper.”); *Southern Scrap Material Co. v. Fleming*, 2003 WL 21474516, at *9 (E.D. La. June 18, 2003) (“The audit letters ... were prepared by outside counsel at the request of [party’s] general counsel with an eye toward litigation then ongoing. [Thus] ... they are attorney work product of the opinion/mental impression/litigation strategy genre.”); *In re Raytheon Securities Litig.*, 218 F.R.D. at 358 (citing cases in the Third, Fourth, Seventh, Eighth and D.C. Circuits that have adopted the “because of” definition of work product); *Vanguard Sav. and Loan Assoc. v. Barton Banks*, 1995 U.S. Dist. LEXIS 13712, at *11-12 (E.D. Pa. 1995) (lawyer letters regarding litigation, prepared to assist client in reporting loss contingencies for a regulatory examination, were work product and protected even though created “primarily” for a business purpose); *Tronitech, Inc.*, 108 F.R.D. at 657 (“an audit letter is not prepared in the ordinary course of business but rather arises only in the event of litigation. It is prepared because of the litigation ... [and] should be protected by the work product privilege”).

⁶⁵ Protection of work product under Rule 26(b)(3) reaches not only documents “prepared . . . for trial” but also prepared “in anticipation of litigation.” As the Second Circuit observed, “[i]f the drafters intended to limit [work product] protection to documents made to assist in preparation for litigation, the ‘prepared ... for trial’ language would have adequately covered it.” *Adlman*, 134 F.3d at 1198-99. Further, while an adverse party may obtain discovery of ordinary work product upon a showing of “substantial need,” mental impression or opinion work product is not discoverable at all. Fed. R. Civ. P. 26(b)(3). Thus, “it would oddly undermine [the work product doctrine’s] purposes if such documents were excluded from protection merely because they were prepared to assist in the making of a business decision expected to result in the litigation.” *Id.* at 1199.

⁶⁶ See *Southern Scrap*, 2003 WL 21474516, at *9 (finding no waiver because disclosure of legal analysis to auditors was not like “one of those cases where a party deliberately disclosed work product in order to obtain a tactical advantage or where a party made testimonial use of work product and then attempted to invoke the work product doctrine to avoid cross-examination”); *Gutter*, 1998 WL 2017926, at *5 (“[t]ransmittal of documents to a company’s outside auditors does not waive the work product privilege

privilege, which protects the confidentiality of the communication, work-product protection is “intended only to prevent disclosure to the opposing counsel and his client” – so, it is not necessarily waived by disclosure to other third-parties.⁶⁷ As one federal court explained:

[T]he work product privilege does not exist to protect a confidential relationship, but rather to promote the adversary system by safeguarding the fruits of an attorney’s trial preparations from the discovery attempts of the opponent. The purpose of the work product privilege is to protect information against *opposing parties*, rather than against *all others*, in order to encourage effective trial preparation.⁶⁸

Under this analysis – which is consistent with the Supreme Court’s decision establishing the doctrine in *Hickman v. Taylor* – waiver of work product protection only occurs if a disclosure substantially increases the opportunity for potential adversaries to obtain the information. Thus, most courts find that disclosure to auditors does not waive the protection because disclosure is made on an assurance of confidentiality and auditors are not considered to be conduits to potential adversaries.⁶⁹

because such a disclosure ‘cannot be said to have posed a substantial danger at the time that the document would be disclosed to plaintiffs’”); *Vanguard Sav. and Loan Assoc. v. Barton Banks*, 1995 U.S. Dist. LEXIS 13712, at *13-14 (finding no waiver because company did not make disclosure to auditors with “conscious disregard of the possibility that an adversary might obtain the protected materials”); *In re Pfizer*, 1993 WL 561125, at *6 (finding no waiver because auditor was not reasonably viewed as a conduit to a potential adversary); *Gramm v. Horsehead Indus., Inc.*, 1990 U.S. Dist. LEXIS 773, at *19 (S.D.N.Y. Jan. 25, 1990) (finding no waiver upon disclosure to auditors because “disclosure to another person who has an interest in the information but who is not reasonably viewed as a conduit to a potential adversary will not be deemed a waiver of protection of the rule”); *Tronitech*, 108 F.R.D. at 657 (no waiver upon disclosure of work product to auditors since “audit letters are produced under assurances of strictest confidentiality”); *Arthur Young & Co.*, 1984 U.S. Dist. LEXIS 22991, at *10 (“[t]here is no waiver of the work product privilege where, as here, the documents were provided to [the auditors] under a specific assurance of confidentiality”). See also *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 2004 WL 2389822 (S.D.N.Y. Oct. 26, 2004) (rejecting the notion that a company’s disclosure to its auditors of attorney work product prepared in connection with an internal investigation waived the privilege afforded by the attorney work product doctrine).

⁶⁷ *Tronitech, Inc.*, 108 F.R.D. at 657.

⁶⁸ *In re Raytheon*, 218 F.R.D. at 359.

⁶⁹ For example, in one recent decision, *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 2004 WL 2389822 (S.D.N.Y. Oct. 26, 2004), the court rejected the notion that a company’s disclosure to its auditors, Deloitte & Touche of attorney work product prepared in connection with an internal investigation waived the privilege afforded by the attorney work product doctrine. The court stated that “the critical inquiry – to me – must be whether Deloitte & Touche should be conceived of as an adversary or a conduit to a potential adversary.” *Id.* at *6. Concluding that a company and its auditors are not adversaries, notwithstanding the “tension between an auditor and a corporation that arises from an auditor’s need to scrutinize and investigate a corporation’s records and book-keeping practices,” the court reasoned that “[a] business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud.” Most importantly, the court recognized the influence that judicial process has over the effectiveness of this relationship by upholding privileges historically afforded to the work product and communications generated throughout the course of an effective attorney-client relationship: “Indeed, this is precisely the type of limited alliance that courts should encourage.” *Id.* It is this logic – too infrequently employed in

Significantly, however, there is a split of authority on the issue of waiver of attorney work product protection. At least one federal court recently held that disclosure of work product to auditors waives the protection. In *Medinol, Ltd. v. Boston Scientific Group*, 214 F.R.D. 113, 115 (S.D.N.Y. 2002), the defendant engaged counsel to perform an investigation into the termination of several high-ranking employees and to report the results of the investigation to a Special Litigation Committee (“SLC”) of the Board. Minutes of the SLC meeting reflecting counsel’s investigation were provided to the defendant’s auditors in connection with their audit of loss contingency reserves. The court held that the disclosure waived the work product protection:

While Boston Scientific held meetings of its Special Litigation Committee with an eye to litigation, the disclosures to the independent auditor had no such purpose. *Boston Scientific and its outside auditor Ernst & Young did not share ‘common interests’ in litigation*, and disclosures to Ernst & Young as independent auditors did not therefore serve the privacy interests that the work product doctrine was intended to protect.⁷⁰

In holding that the auditor and client did not share “common interests,” the court cited the “independent” role of the auditor as described by the Supreme Court:

By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public. This ‘public watchdog’ function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.⁷¹

The “common interest” concept on which *Medinol* relied is derived from authorities holding that co-parties or allies, such as co-defendants, may share work product without waiving the protection as to a common adversary.⁷² Since the auditor-client relationship does not fit neatly into this analytical box, the *Medinol* court found a waiver.⁷³ The “common

recent months and years – which this paper wishes to advance. Notably, counsel for Merrill Lynch did not pursue an argument that there was no waiver of the attorney-client privilege.

⁷⁰ 214 F.R.D. at 116-17 (emphasis added).

⁷¹ *Id.* at 116 (quoting *Arthur Young & Co.*, 465 U.S. at 817-818).

⁷² *See, e.g., Stix Prods. Inc. v. United Merch. and Mfrs., Inc.*, 47 F.R.D. 334, 338 (S.D.N.Y. 1969).

⁷³ The argument which may be crafted in support of a “common interest” between a company and its auditors sufficient to preclude a waiver of the attorney-client privilege or work product protection is simply this: Auditors and clients share the common goal, under the strict scrutiny of regulators and watchful eyes of many others, of ensuring full and accurate financial disclosures to the public in accordance with GAAP. *See North River Ins. Co. v. Columbia Casualty Co.*, 1995 WL 5792, *4 (S.D.N.Y. Jan. 5, 1995) (“[T]he determination of whether the common interest doctrine applies cannot be made categorically. . . . What is important is not whether the parties theoretically share similar interests but rather whether they demonstrate actual cooperation toward a common legal goal.”). The common interest doctrine may attach even if two parties share interests which are not completely congruent, and which are part legal and part commercial.

interest” analysis in *Medinol* also has been invoked by other federal courts in considering the issue of waiver following a disclosure to auditors.⁷⁴

To summarize the case law, while most authorities support the argument that disclosure of work product to auditors should not waive the protection as to adversaries, the decisions are not uniform and some courts would hold that disclosure constitutes a waiver. The bottom line is that, while most authorities support the argument that disclosure of work product to auditors should not waive the protection as to litigation adversaries, some courts affirmatively hold that disclosure constitutes a waiver. Because the case law is not uniform, companies have no guarantee that courts will protect attorney work product from waiver as to the companies’ adversaries if these materials are disclosed to auditors. This uncertainty undermines the purpose of the privilege: As the United States Supreme Court said, “[a]n uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all.”⁷⁵

3. Summary of Waiver Case Law: Lack of Uniformity, Growing Uncertainty

To the extent that some courts *have* protected privileged information disclosed to auditors from discovery by third-party adversaries, the lynchpin has been the auditors’

See Duplan Corp. v. Deering Milliken, Inc., 397 F. Supp. 1146, 1172 (D.S.C. 1975) (“The fact that there may be an overlap of a commercial and a legal interest for a third party does not negate the effect of the legal interest in establishing a community of interest.”).

While it is true that outside auditors must be independent, the “independence in mental attitude” standards under GAAS do not preclude auditors from sharing a common legal and commercial goal with their client. As described by the AICPA, “independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness” to all those affected by a business, including management, owners and creditors. AICPA, AU §220.02. Auditors are not expected to have an *adversarial* relationship with the companies they audit; indeed, the AICPA Code of Conduct recognizes that even the threat of adversity between an auditor and client can itself impair independence. *See* AICPA, ET § 101.08.

It should be noted that a written agreement outlining two parties’ common interests and need for confidentiality is persuasive (and sometimes mandatory) evidence that sharing of attorney-client privileged communications and work product will not constitute a waiver. *See In re Beville, Bressler & Schulman Asset Management Corp.*, 805 F.2d 120, 126 (3d Cir. 1986) (finding “no evidence that the parties had agreed to pursue a joint defense strategy”); *United States v. Weissman*, 1996 WL 751386 (S.D.N.Y. Dec. 26, 1996) (requiring either an explicit agreement or demonstrated cooperation in formulating a common defense strategy). There should be no reason that auditors cannot enter into such confidentiality agreements with clients with their “independence” intact.

⁷⁴ Although the Massachusetts District Court in *In re Raytheon*, citing *Medinol*, noted that “the existence of common interests” was relevant to whether disclosure to auditors created a waiver, the court also found that “there is no evidence that materials disclosed to an independent auditor are likely to be turned over to the company’s adversaries except to the extent that the securities laws and/or accounting standards mandate public disclosure,” and concluded that the record was inconclusive on the ultimate waiver issue. 218 F.R.D. at 360-61. *But see In re Pfizer*, 1993 WL 561125, at *6 (finding that a company’s legal counsel and outside auditors share “common interests” in information generated by counsel for purposes of an audit and, accordingly, there was no waiver of work product).

⁷⁵ *Upjohn*, 449 U.S. at 392.

professional obligation to maintain the information in confidence.⁷⁶ Certified Public Accountants are members of the AICPA and thus bound by AICPA Code of Professional Conduct Rule 301, which prohibits disclosure of client confidential information without “the specific consent of the client.”⁷⁷ The only exceptions under Rule 301 are when disclosure is compelled by legal process (*e.g.*, a subpoena), or required in connection with review of the auditor’s professional practice or with investigative or disciplinary proceedings conducted by the AICPA or another oversight body. In the latter circumstances, Rule 301 prohibits the AICPA and other oversight bodies from disclosing any auditor’s “confidential client information that comes to their attention in carrying out those activities.”⁷⁸ Further, auditors have accepted the constraints on disclosure under the ABA Statement of Policy, which provides that a lawyer’s responses may be used by the auditor only in connection with the audit, and may not be quoted or referenced in the client’s financial statements, or filed with any government agency, or disclosed in response to any subpoena or other process without the lawyer’s consent or upon at least 20 days’ prior notice.⁷⁹ This expectation of confidentiality by the client has been key to court decisions rejecting the proposition that a company’s cooperation with its auditors waives work product protection.⁸⁰

Unfortunately, however, developments in the post-Sarbanes-Oxley Act world have arguably weakened this expectation of confidentiality. Under the Sarbanes-Oxley Act, it is the PCAOB – not the AICPA – which is charged with establishing standards (subject to SEC approval) for auditing, attestation, quality control, ethics and independence with respect to public company audits.⁸¹ In April 2003, the PCAOB adopted interim, transitional standards which generally directed public company auditors to continue to comply with AICPA standards. The interim *ethics* standards, however, selectively identify only certain rules of the AICPA Code of Professional Conduct for adoption – *not* including Rule 301.⁸² While auditors should abide by Rule 301 as members of the AICPA, the rule has not explicitly been adopted or endorsed by the

⁷⁶ Lawyers, of course, are bound by rules of ethics and professional responsibility not to reveal client confidences without client consent; hence, informed consent is a central feature of the ABA Statement of Policy. See Rule 1.6 of the ABA Model Rules of Professional Conduct, available at http://www.abanet.org/cpr/mrpc/rule_1_6.html.

⁷⁷ AICPA, Rules of Professional Conduct, ET Section 301: Confidential Client Information, Rule 301.01 (Jan. 1992, as amended) (“A member in public practice shall not disclose any confidential client information without the specific consent of the client.”)

⁷⁸ *Id.*

⁷⁹ ABA Statement of Policy, par. 7.

⁸⁰ Confidentiality agreements have likewise been crucial in the handful of decisions finding non-waiver despite disclosure of work product to government investigators. See, *e.g.*, *Saito v. McKesson HBOC, Inc.*, 2002 WL 31657622, at *6, 11 (Del. Ch. Ct. Nov. 13, 2002) (“[P]ublic policy seems to mandate that courts continue to protect the confidentially disclosed work product in order to encourage corporations to comply with law enforcement agencies.”); *Maruzen Co., Ltd. v. HSBC USA, Inc.*, 2002 WL 1628782, at *2 (S.D.N.Y. June 23, 2002) (denying motion to compel because defendants had confidentiality agreements with U.S. Attorney’s Office to whom documents were disclosed (citing *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2nd Cir. 1993)).

⁸¹ The Sarbanes-Oxley Act, Section 103, 15 U.S.C. § 7214.

⁸² See PCAOB R. 3500T, adopting Interim Ethics Standards. The complete standards and rules of the PCAOB are available at http://www.pacobus.org/documents/rules_of_the_board/all.pdf.

PCAOB. This omission may place public companies at greater risk that courts will find waivers when privileged information is disclosed to auditors.

B. CLOSING THE FLOODGATES: CURRENT LEGISLATION DESIGNED TO MITIGATE SIMILAR WAIVERS OF PRIVILEGES

The real and significant waiver problem presented by auditor requests for access to privileged information is underscored by legislative efforts to ensure that the government agencies charged with overseeing compliance with the securities laws and accounting standards – the SEC and PCAOB – may be exempted from the waiver problem, thereby increasing their potential effectiveness. This has been addressed through two significant pieces of federal legislation – H.R. 2179, currently pending before Congress, and Section 105 of the Sarbanes Oxley Act. Both pieces of legislation provide that disclosure of privileged information to the government does not waive privileges as to anyone else. Both are designed to enable the government to obtain work product and attorney-client communications from regulated entities without exposing those entities to claims of waiver and wholesale discovery by other adversaries. Both recognize that preservation of privileges following disclosure to the government cannot be left to the courts, which are bound to apply common law principles of waiver. Neither, however, solves the waiver problem presented in this paper.

1. H.R. 2179

The SEC will consider a company’s voluntary cooperation with an investigation as a mitigating factor in determining appropriate enforcement action, if any. The SEC has promulgated guidelines identifying factors that it will consider in assessing the quality of a company’s cooperation, and those guidelines emphasize the importance of a company’s decision to waive attorney-client privileges and work product protections.⁸³ The threat of an enforcement action that might be avoided by cooperating fully places strong pressure on companies to waive privileges, which, in turn, risks further waiver and compelled disclosure to other adversaries.

Recognizing this serious dilemma for companies, the SEC has adopted the position that waiver of privileges in order to cooperate with the SEC should not result in a broader waiver as to other parties.⁸⁴ This “selective waiver” concept, however, has been rejected by many courts which hold that a company’s production of privileged information to the SEC or

⁸³ One of the questions the SEC asks itself is “Did the company produce a thorough and probing written report detailing the findings of its internal review?” *In the Matter of Gisela de Leon-Meredith*, Exchange Act Release No. 44970 (October 23, 2001), available at <http://www.sec.gov/litigation/investreport/34-44969.htm>.

The DOJ has taken a similar position on cooperation; thus, under its guidelines, “[o]ne factor the prosecutor may weigh in assessing the adequacy of a corporation’s cooperation is the completeness of its disclosure including, if necessary, a waiver of the attorney-client privilege and work product protections, both with respect to its internal investigation and with respect to communications between specific officers, directors, and employees, and counsel.” Memorandum Regarding Principles of Federal Prosecution of Business Organizations, U.S. Deputy Attorney General Larry D. Thompson, January 20, 2003, available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

⁸⁴ See Amicus Brief of the United States Securities and Exchange Commission, *McKesson HBOC, Inc. v. Adler*, No. 99-C-7980-3 (Ga. Ct. App. Filed May 13, 2001).

another government agency constitutes a full waiver of all privileges and protections that otherwise might have applied against any other adversaries.⁸⁵

Given the SEC's strong desire to obtain the fruits of investigation by a company's lawyers and other privileged information – and recognizing that the waiver problem is a serious impediment to this – the SEC recommended that Congress enact legislation to “enhance the Commission's access to significant, otherwise unobtainable, information.”⁸⁶ Members of Congress responded with H.R. 2179, introduced on May 21, 2003, which, as currently drafted, proposes an amendment to the 1934 Securities and Exchange Act, as follows:

Notwithstanding any other provision of law, whenever the Commission or an appropriate regulatory agency and any person agree in writing to terms pursuant to which such person will produce or disclose to the Commission or the appropriate regulatory agency any document or information that is subject to any Federal or State law privilege, or to the protection provided by the work product doctrine, *such production or disclosure shall not constitute a waiver of the privilege or protection as to any person other than the Commission or the appropriate regulatory agency to which the document or information is provided.*⁸⁷

This legislation is designed to help the SEC secure maximum cooperation from companies in the form of disclosure of privileged communications and work product by alleviating the potential harm to companies from a waiver of privileges as to other adversaries.

But even if H.R. 2179 becomes law, the contemplated protection for companies may be illusory. While a company's privileges would be intact with respect to information provided to the SEC, if the *auditors* obtain disclosure of the same information, the company will face the same waiver problem. H.R. 2179 does not shield any disclosure to the auditors from operating as a waiver: Thus, the company's adversaries will simply look to the company and its auditors for the privileged information.

2. Section 105 of The Sarbanes-Oxley Act

The Sarbanes-Oxley Act establishes a blanket evidentiary privilege and discovery immunity for all information provided to the PCAOB or prepared in connection with PCAOB inspections and investigations of registered audit firms. Section 105(b)(5) provides:

⁸⁵ See, e.g., *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289, 291 (6th Cir. 2002); *Bank of America, N.A. v. Terra Nova Ins. Co.*, 212 F.R.D. 166, 167 (S.D.N.Y. 2002); *United States v. Massachusetts Inst. of Tech.*, 129 F.3d 681, 687 (1st Cir. 1997); *Westinghouse Elec. Corp. v. Philippines*, 951 F.2d 1414, 1458 (3d Cir. 1992); *In re Martin Marietta Corp.*, 856 F.2d 619, 622-23 (4th Cir. 1988).

⁸⁶ U.S. Securities and Exchange Commission, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (Jan. 24, 2003), available at [Hhttp://www.sec.gov/news/studies/sox704report.pdf](http://www.sec.gov/news/studies/sox704report.pdf), at p. 45.

⁸⁷ H.R. 2179, 108th Cong. 1st Sess. (May 21, 2003). On June 1, 2004, H.R. 2179 was discharged by the House Committee on the Judiciary and placed on the Union Calendar for a vote. See *Securities Regulation & Law Report* (July 5, 2004), vol. 36, no. 27 (BNA), at 1225 (emphasis added).

[A]ll documents and information prepared or received by or specifically for the [PCAOB], and deliberations of the [PCAOB] and its employees and agents, in connection with an inspection under section 104 or with an investigation under this section, *shall be confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process) in any proceeding in any Federal or State court or administrative agency, and shall be exempt from disclosure ...*⁸⁸

Section 105(b)(5) goes on to provide that, “without the loss of its status as confidential and privileged in the hands of the [PCAOB],” the foregoing information may be provided to the SEC and, at the discretion of the PCAOB, to other federal and state regulators. State regulators are tasked with maintaining “such information as confidential and privileged.”⁸⁹ This provision has been implemented in the PCAOB’s Ethics Code and Rules.⁹⁰

Section 105(b)(5) addresses the same waiver problem that gave rise to H.R. 2179. It reflects Congress’ recognition that disclosure of confidential information by audit firms to an oversight body exposes the audit firm to waivers of privilege.⁹¹ This provision is designed to facilitate effective oversight by the PCAOB and cooperation by audit firms by assuring that confidential information will not be discoverable by others.

As with H.R. 2179, however, this provision does nothing to address the waiver problem facing companies whose *auditors* obtain privileged information. If a company’s privileged information winds up in the hands of the PCAOB during an inspection or investigation of the audit firm, Section 105(b)(5) assures that no one can take discovery from the PCAOB. But the company remains exposed to the risk of waiver by having provided privileged information to its auditors in the first place. Both the company and its auditors may be subject to discovery attempts by the company’s adversaries, simply because of the company’s good corporate governance and compliance with its obligations to cooperate fully with its auditors.

⁸⁸ The Sarbanes-Oxley Act, Section 105(b)(5)(A), 15 U.S.C. § 7215(b)(5)(A) (emphasis added).

⁸⁹ *Id.* at § 105(b)(5)(B), 15 U.S.C. § 7215(b)(5)(B).

⁹⁰ *See* EC9 (“Unless authorized by the Board, no Board member or staff shall disseminate or otherwise disclose any information obtained in the course and scope of his or her employment, and which has not been released, announced, or otherwise made available publicly.” The requirement of confidentiality extends even after the member’s or staff’s termination of employment with PCAOB.); *see also* PCAOB R. 5108(a) (“Informal inquiries and formal investigations, and any documents, testimony or other information prepared or received specifically for the Board or the staff of the Board in connection with inquiries and investigations, shall be confidential unless and until presented in public proceedings or released in connection with Section 105(c) of the Act, and the Board’s Rules thereunder”).

⁹¹ A May 17, 2002 report by the General Accounting Office, based on a study by an agency then-charged with oversight of the public accounting profession, found that “[t]he self-regulatory system lacks the power to protect the confidentiality of investigative information regarding alleged audit failures or other disciplinary matters concerning members of the accounting profession. As the Panel reported, the lack of such protective power hinders the timing of investigations.” U.S. Gen. Accounting Office, “The Accounting Profession: Status of the Panel on Audit Effectiveness Recommendations to Enhance the Self-Regulatory System,” GAO Rep. No. 02-411 (May 17, 2002).

V. CONCLUSION

The Preamble to the ABA Statement of Policy eloquently presents the public interests at stake in the waiver problem. While “our legal, political and economic systems depend to an important extent on public confidence in published financial statements,” this confidence should not come by means of intrusion upon the relationship between companies and their legal counselors:

On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between attorney and client, thereby strengthening corporate management’s confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel’s advice.⁹²

In other words, the importance of the public company audit function, as well as the oversight functions of the SEC and PCAOB, must not be allowed to jeopardize a company’s ability to utilize one of the primary tools it has at its disposal to comply with its corporate governance obligations – its legal counsel. Unless the attorney work-product doctrine and attorney-client privilege are maintained when companies provide otherwise-protected information to their auditors, companies will be penalized for their compliance efforts and for engaging in full and complete audit cooperation by laying the groundwork for their litigation adversaries to obtain sensitive and otherwise privileged information. Under prevailing legal doctrine, the courts do not provide assurance that disclosure of privileged information to auditors will not result in waivers as to others.

This result is untenable and, we submit, unnecessary. Instead, we offer proposals for resolving the tension between cooperation with auditors and protecting appropriate privileges:

1. The principle proposal – the one with the promise of greatest effectiveness – is for the SEC and PCAOB, joined by the corporate counsel community and the principal auditors of the vast majority of U.S. public companies, to propose and support federal legislation, modeled on H.R. 2179, that would permit companies to provide privileged attorney-client communications and work product to their auditors in connection with audits, reviews, attestations and compliance with Section 10A of the 1934 Securities and Exchange Act without waiving any privileges as to others.

2. The PCAOB should issue interpretive guidance, with approval by the SEC, advising that an auditor is generally expected to obtain adequate evidence to support its conclusions without demanding information protected by the attorney-client privilege or work product doctrine. An auditor should only require such information if it determines that there are no other sources from which it can fulfill its professional obligations.⁹³

⁹² ABA Statement of Policy, Preamble.

⁹³ This approach is consistent with the AICPA’s 1977 guidance regarding SAS 12, discussed above.

By issuing such guidance, the PCAOB and the SEC would acknowledge and support the compelling public interest served by protecting the confidentiality of attorney-client communications and work product, as did the AICPA in issuing its guidance that auditors need not seek access to a client's privileged information under SAS 12, beyond the Treaty, in order to audit litigation contingency reserves.

3. The PCAOB should adopt an ethical rule, modeled on Rule 301 of the AICPA Code of Professional Conduct requiring auditors to maintain the confidentiality of all client information, and carving out the exceptions set forth in Rule 301 – *i.e.*, compliance with compulsory legal process and the auditor's obligation to cooperate with its own oversight bodies. The rule should also provide that auditors must give clients notice before producing client information pursuant to compulsory legal process in order to provide clients with adequate time to seek judicial protection against disclosure.⁹⁴

In taking this action, the PCAOB would assist companies that are forced to seek judicial protection of privileged information that has been disclosed to auditors. When auditors do require access to privileged information in order to perform professional services, the risk of waiver is squarely presented. Those courts that have been willing to protect work product from waiver (if not attorney-client communications) after disclosure to auditors have relied heavily on the auditor's obligation to maintain the information in confidence.

4. The PCAOB should promulgate guidance that an auditor does not violate independence standards by entering into a written agreement with a client providing for the confidential treatment of client information provided to the auditor, subject to the auditor's professional obligation to cooperate with the PCAOB and other oversight bodies.

In taking this step, the PCAOB would further assist companies that must make their case in court for non-waiver by allowing auditors to enter into confidentiality agreements with clients. Confidentiality agreements have been crucial in the handful of decisions finding non-waiver despite disclosure of work product to government investigators.⁹⁵

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⁹⁴ The rule should also recognize that auditors are entitled to use client information in connection with disputes between the client and auditor or arising out of the professional services engagement.

⁹⁵ *See, e.g., Saito v. McKesson HBOC, Inc.*, 2002 WL 31657622, at *6, 11 (Del. Ch. Ct. Nov. 13, 2002) (“[P]ublic policy seems to mandate that courts continue to protect the confidentially disclosed work product in order to encourage corporations to comply with law enforcement agencies.”); *Maruzen Co., Ltd. v. HSBC USA, Inc.*, 2002 WL 1628782, at *2 (S.D.N.Y. June 23, 2002) (denying motion to compel because defendants had confidentiality agreements with U.S. Attorney's Office to whom documents were disclosed (citing *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2nd Cir. 1993))).