

**American Bar Association
Task Force on the Attorney-Client Privilege**

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Thank you for the opportunity to provide input to the ABA Task Force. The work undertaken by the Task Force is both timely and critical. The legal profession as a whole stands to benefit, as do clients.

The Notice of Public Hearing identified four distinct challenges to the attorney-client privilege. These comments are limited to the fourth of those challenges: the increasing tendency of independent auditors to seek access to legal opinions in the context of financial statement audits.

The effort here is to be responsive to the Notice from the perspective of corporate tax practice. The “Background” section describes the circumstances behind the newly aggressive posture of independent auditors. Following that are comments on the “commonly-raised questions” restated in the Notice.

Background

Accounting firms are facing virtually unprecedented scrutiny. The reasons are well-known: Sarbanes-Oxley, the Public Company Accounting Oversight Board, an increasingly aggressive SEC, a restive AICPA.

The accounting literature is evolving rapidly. Auditing standards have already changed in ways that squarely confront the privilege. At least one pending change to substantive accounting rules – GAAP – also implicates the privilege. In particular, the collective weight of these and other changes directly challenges the viability and continuing relevance of the 1976 Treaty between the legal and accounting professions.¹

¹ ABA Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information (“ABA Statement”).

Evolving Auditing Standards

1. PCAOB Standards

Sarbanes-Oxley displaced the accounting profession's long-standing regime of self-regulation. The head of the SEC's Division of Enforcement recently and aptly characterized the overall impact of Sarbanes-Oxley as a "tectonic shift in our regulatory landscape."²

Sarbanes-Oxley is the driving force behind the rapid tightening of formal auditing standards. Section 103 of the Act mandated that the PCAOB develop, promulgate and enforce auditing, quality control, and independence standards and rules. That process is well under way.

Eight months ago the PCAOB finalized its Auditing Standard No. 3—*Audit Documentation*.³ Standard No. 3, broad in its language and application, requires auditors to develop and maintain documentation in sufficient detail to support the conclusions reached in the reports they issue.

Independent auditors frequently rely on Standard No. 3 to justify their demands for privileged information. Accordingly, it is important that the Task Force understand what the Standard does (and does not) contain.

The key determinant of sufficiency in Standard No. 3 is referred to as the "experienced auditor rule." An auditor's workpapers must reflect documentation of such quantity and quality that an experienced auditor not otherwise involved in the particular audit could review the auditor's files and grasp "the procedures performed, evidence obtained, and conclusions reached."⁴

Paragraph 5 of Standard No. 3 requires that there must be sufficient documentation to "[s]upport the basis for the auditor's conclusions concerning every relevant financial statement assertion." Paragraph 8 states that the auditor must document "significant findings or issues," including "accounting for complex or unusual transactions, accounting estimates, and uncertainties...."

In short, Standard No. 3 is all-encompassing yet essentially general in its mandates. It does not explicitly address documents covered by the attorney-client privilege. Indeed, it does not explicitly address the privilege at all.

² Steven Cutler, *The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program*, UCLA School of Law (9/20/04); <http://www.sec.gov/news/speech/spch092004smc.htm>.

³ PCAOB Release No. 2004-006, *Audit Documentation and Amendment to Interim Auditing Standards* (6/9/04); http://www.pcaobus.org/Rules_of_the_Board/Documents/Release2004-006.pdf.

⁴ *Id.* Para. 6.a. The "experienced auditor" standard would cover the PCAOB inspection teams.

2. AICPA Standards

Notwithstanding the ascendancy of the PCAOB and the resultant sharing of jurisdiction that is beginning to emerge, the AICPA remains the traditional source of Generally Accepted Auditing Standards.

AU Section 337 – *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* is the counterpart to the ABA Statement of Policy. Section 337 has been supplemented by various interpretations, the most germane of which as to the privilege is found in Section 9337 –

.08 *Question*—Section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, paragraph .05c states: "Examine documents in the client's possession concerning litigations, 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 the client to be subject to the lawyer-client privilege?

.09 *Interpretation* –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...section 337.05c is not intended to require an auditor to examine documents...subject to the lawyer-client privilege.⁵

A reasonable inference would be that the matter was settled. In April 2003, however, the AICPA issued an interpretation of AU Section 326 – *Evidential Matter* amounting to a direct challenge to the privilege with respect to tax opinions –

If the client's support for the tax accrual or matters affecting it, including tax contingencies, is based on an opinion issued by an outside advisor with respect to a potentially material matter, the auditor should obtain access to the opinion, notwithstanding potential concerns regarding attorney-client or other forms of privilege.⁶

This is the language most frequently cited by auditors as the source of their duty to demand tax opinions. There are a number of problems, however. First, both the Treaty and the explicit upholding of the privilege in AU Section 9337 are ignored.

Second, the "mandate" is premised on the client's using an outside tax opinion as its support. Accordingly, a fair inference would be that, if the client

⁵ AU Section 9337.08, -.09 (March 1977).

⁶ AU Section 9326.22 (April 9, 2003). There is no cross-reference to AU Section 9337.08, -.09.

can support its financial statement position without reliance on an outside opinion (regardless of whether it received one), the auditor should be satisfied.

Third, the same paragraph goes on to itemize a number of alternatives to obtaining the client's opinion even where there is reliance, including (1) that the auditor include "other sufficient documentation or abstracts supporting...the analysis and conclusions reached by the client" in its workpapers and (2) that the client provide negative assurance – i.e., "representations...that the client has not received any advice or opinions that are contradictory to the client's support for the tax accrual."

Perhaps the most succinct summary of AICPA guidance with respect to the privilege is this – it is inconsistent.

Evolving GAAP

Statement of Financial Accounting Standards No. 5 ("Accounting for Contingencies") has long been a battleground with respect to the privilege. FAS 5 deals with the recognition and disclosure of contingent liabilities, asserted and unasserted, in a company's financial statements. It also is the focus of the "Treaty" reflected in the ABA Statement and in corresponding provisions in the accounting literature.

As to tax contingencies, however, jurisdiction is shared between FAS 5 and FAS 109 ("Accounting for Income Taxes"). The Financial Accounting Standards Board is considering the promulgation of an interpretation of FAS 109 that, if adopted, would create a new and more stringent rule for recognizing benefits relating to "uncertain tax positions." Indications are that the imminent Exposure Draft will announce a bright-line legal opinion threshold below which tax benefits may not be recognized.

The FASB's project is styled "Uncertain Tax Positions (Recognition of Tax Benefits)."⁷ As currently proposed, tax benefits reflected in a company's tax returns must be "probable" of being sustained prior to recording the related tax benefit in the financial statements.

The FASB explicitly equates the traditional accounting term "probable" with a "should"-level tax opinion. In terms of the implicit challenge to the privilege, however, the FASB could use any tax opinion comfort level.

The problem is not the particular comfort level that will be specified in the Exposure Draft and eventual Interpretation. Rather, it is the clear implication that audit clients must communicate whether they have been advised that a

⁷ Details of the project are at http://www.fasb.org/project/uncertain_tax_positions.shtml.

given return position reflects the bright-line level of legal comfort whatever it might be. Any such communication would waive the attorney-client privilege.⁸

SEC Statements

A principal source of the challenge to the attorney-client privilege in the context of financial statement audits comes from the Securities and Exchange Commission, particularly the SEC's Office of the Chief Accountant.

Chief Accountant Donald Nicolaisen set the tone at a gathering of tax professionals in February 2004 –

Why is the accounting for income taxes so important? For most companies, income taxes typically equal 30 some percent – in some cases more – of pretax income, and significant portions of the recorded assets and liabilities are judgmental.... Accurately accounting for the income tax transactions of a company's transactions is critical to the credibility of the financial statements....

* * * *

I know that some of you might be reluctant to fully document information about sensitive transactions or issues with your independent auditor for fear that their workpapers might end up in the hands of the IRS. However the external auditor has to comply with the standards for auditor documentation. Anything less is a scope limitation. * * * [A]t the Commission, our policy has been that the auditor's obligation to report to shareholders on the company's financial statements takes precedence over any request from the company for confidentiality."⁹

Mr. Nicolaisen's comments miss the more common problem. The issue is likely to arise less often in efforts by the Internal Revenue Service to obtain auditor workpapers as it will in the inability of corporate taxpayers to assert the privilege in the audit context generally. Where a tax opinion – or even "the gist of the opinion" – has been provided to an independent auditor, the privilege will have been waived before the IRS audit process even begins.

The Commission's Deputy Chief Accountant, Scott Taub, echoed Mr. Nicolaisen's views in May 2004:

⁸ Alternatively, the privilege would not have attached in the first instance if a legal opinion is sought for the specific purpose of providing independent auditors with "evidence" that certain tax benefits are properly reflected in the financial statements. See, e.g., *U.S. v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982).

⁹ Remarks at the Tax Council Institute Conference on The Corporate Tax Practice: Responding to the New Challenges of a Changing Landscape (2/11/04); <http://www.sec.gov/news/speech/spch021104dtn.htm>.

Vague or overly broad disclosures that speak merely to litigation, tax, or other risks in general, without providing any information about the specific loss contingencies being evaluated are not sufficient. Registrants and their auditors and attorneys should be critically assessing the claims against the company....

* * * *

Some of you no doubt are thinking, "If we follow that guidance...we'd be providing a virtual roadmap for the IRS." * * * A company's concern about maintaining confidentiality in this area is understandable, but it has to be balanced with the need for the company's investors, analysts, and regulators to gain a clear understanding of liquidity and the financial position....

* * * Auditors should seek to review the company's own analyses of the issues, including the support for the conclusions as to whether an accrual is necessary, and what the possible range of loss is. If the only procedures that can be performed are face-to-face discussions with company personnel and with outside counsel, those discussions should be held * * * I would expect that the PCAOB inspection teams will be looking at the audit work done in these sensitive areas as they begin their first year of a full inspection schedule.¹⁰

Finally, Associate Chief Accountant Jane Poulin reiterated the message in December:

[W]e believe disclosures for both recorded and unrecorded exposures to contingent tax liabilities are required by FAS 5.... I'm sure many of you are thinking "if I follow the FAS 5 model for accrual and disclosure of these differences, I will provide a road map of my tax positions to the IRS." We have empathy for this but remind registrants that confidentiality concerns are not valid reasons for non-compliance with GAAP or the SEC's disclosure rules.

* * * It is equally important for auditors to recognize their responsibilities under auditing standards. Audit documentation for taxes, including tax contingencies, should follow the same high standard as in other audit areas. [T]he auditor's obligation to report to shareholders on the company's financial statements takes precedence over any request from the company for confidentiality.¹¹

To be fair, neither Mr. Nicolaisen nor any of his deputies who have made similar statements over the last twelve months have cited the attorney-client privilege by name. Nevertheless, their public statements have had a direct and cumulative impact and certainly have been understood as referring to the privilege.

¹⁰ Remarks at the University of Southern California Leventhal School of Accounting SEC and Financial Reporting Conference (5/27/04); <http://www.sec.gov/news/speech/spch052704sat.htm>.

¹¹ Remarks before the 2004 AICPA National Conference on SEC and PCAOB Developments (12/6/04); <http://www.sec.gov/news/speech/spch120604jdp.htm>.

Public Accounting Firms' Reaction

To the accounting profession the message has been loud and clear – the privilege is secondary to the investing public's need for reliable financial statements. As a result, accounting firms now are putting their clients to an unpleasant choice: either yield on matters of privilege or risk that the auditors will qualify their opinion on the financial statements or disclaim any opinion.

In August 2004 the PCAOB issued its 2003 “limited inspection” reports on Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers.¹² Each firm was cited for, among other things, “documentation deficiencies.” As to D&T, for example, one of the deficiencies related to the failure of the audit team to have included a legal opinion in the workpapers –

[T]he engagement team obtained a memo from the issuer that documented the company's conclusions regarding the loss contingency, and the engagement team documented in a memo to the work papers its conclusion that no accrual for this liability was required as of a particular date * * * [but] did not include a copy of a letter to the issuer from its counsel containing legal advice on which the issuer had based its conclusions. Nor did the work papers make any specific reference to such letter being maintained elsewhere.¹³

Deloitte's response indicated that the firm was heeding the admonition and amending its policies and practices –

Documentation is one of the most difficult challenges of the audit process, and we recognize that audit documentation must be improved throughout the profession. We are actively reviewing and revising our documentation policies and procedures to address the new standards proposed by the PCAOB.¹⁴

An indication of Deloitte's seriousness and follow-through is available in the form of a recent “Dbriefs” webcast. Commenting on AU Section 9326 (as discussed above), the firm's presentation slides stated flatly –

Denying auditors access to third-party opinions is a scope limitation.¹⁵

¹² Each of the inspection reports is available at the PCAOB website. See PCAOB Release No. 104-2004-001, *Statement Concerning the Issuance of Inspection Reports* (8/26/04).

¹³ *Report on 2003 Limited Inspection of Deloitte & Touche LLP Issued by the Public Company Accounting Oversight Board* (August 26, 2004) at Part I.B.2.c(1)(iii); [http://www.pcaobus.org/Inspections/Public Reports/2003/Deloitte and Touche.pdf](http://www.pcaobus.org/Inspections/Public%20Reports/2003/Deloitte%20and%20Touche.pdf).

¹⁴ *Id.*, Part III—Response of Deloitte & Touche to Draft Inspection Report (“Documentation Concerns”). The referenced proposed standards have now, of course, been finalized.

¹⁵ Rita Benassi & Kathy McEligot, *Contingent Tax Liabilities: Navigating the Coming Changes*, Slide 26 (12/7/04); http://www.webcast.on24.com/event/9736/1/documents/slidepdf/us_tax_corporate_tax_dbriefs_120704_v2.pdf.

The problem is not to be understated. The literature is clear that a material scope limitation faced by an auditor, particularly when imposed by the audit client, weighs negatively in the final judgment as to whether the auditor is able to express an opinion on the financial statements and, if so, whether that opinion must be qualified. The threat of a qualified opinion is a formidable one, “the ultimate trump card” not too strong a characterization.

Questions Presented by the Task Force

(1) To what extent do these encroachments actually interfere with corporate attorney-client relations and to what extent is the public interest thereby harmed?

Where an independent auditor insists that a client disclose legal opinions or other privileged communications, it must be assumed that such insistence will be backed up by the threat of a qualified opinion or a disclaimer of an opinion. It would be the rare audit client that would not ultimately back down if attempts at negotiation with the auditor were unsuccessful.

As to tax opinions, there should be no mistaking whether a claim of privilege still could be asserted after an opinion has been disclosed to an independent auditor. It could not. Nor can a corporation reliably assert the work product doctrine for tax opinions. Accordingly, tax opinions provided to auditors would be unprotected from the Internal Revenue Service.¹⁶

Our legal system is premised on justice reached through adversarial proceedings. These proceedings are premised on liberal principles of factual discovery not mirrored as to the opposing party’s legal theories and work product. In the tax context, such theories would be found both in the analysis included in formal tax opinions and in privileged “hazards memos” frequently prepared to support tax reserves.¹⁷

Ironically, the public interest at stake relates to the very segment sought to be protected by those who call for reliable financial statements. The notion that a balancing of interests must lead to yielding on the privilege “for the sake

¹⁶ The Internal Revenue Code grants the IRS full investigative and summons powers. See 26 U.S.C. § 7602 (“Examination of books and witnesses.”) and § 7604 (“Enforcement of summons.”). The Supreme Court has long since held that independent auditors’ workpapers are accessible to the IRS via these provisions. *United States v. Arthur Young*, 465 U.S. 805 (1984).

¹⁷ The form and content of most tax opinions are governed by Treasury regulations found in “Circular 230” (12/20/04); <http://www.irs.gov/pub/irs-reg/td9165.pdf>. While a summary of Circular 230 is beyond the present scope, it generally requires tax opinions to include analysis and conclusions with respect to “each significant Federal tax issue.”

of investors” overlooks the fundamental point that it is that same group – a corporation’s investors – who are the real beneficiaries of its seeking of legal advice as to the measure of taxes it finally owes.¹⁸

Corporations rarely rely on a “tax compliance” function unsupported by in-depth tax planning. The essence of such planning is due diligence toward determining the amount of taxes owed in the circumstances. A corporation that would engage in a material transaction or prepare and file a tax return without appropriate planning does a clear disservice to all of its stakeholders.

Corporations cannot generally fail to seek tax advice even if the current challenges to the privilege were to prevail. More likely they would attempt to “finesse” the situation – for example, declining to receive advice in writing until after the financial statement audit is completed. Alternatively, they might forego written legal advice except where legally or contractually required.

The first strategy simply may not work, as the auditor might demand conferences with the particular law firm. The second would have the obvious downside of risking a loss of institutional knowledge as to the particulars of the analysis. More importantly, it would deprive corporations of the ability to rely on the “advice of counsel” defense to IRS efforts to impose penalties.¹⁹

If corporations begin to avoid written legal opinions for fear that they would be (or become) unprotected, it is entirely predictable that there will follow both an increase in the measure of taxes paid and a higher penalty incidence. Investors would bear the ultimate cost.

(2) Under what circumstances, if any, should particular regulators legitimately request disclosure of privileged information, and what privileged information may legitimately be sought?

Independent auditors should act in a manner consistent with the ABA Statement and its counterpart in the accounting literature.

Only where an independent auditor has demonstrable reason to believe that financial statements are tainted by fraud should it insist on the disclosure of privileged communications. In such circumstances, of course, a waiver of the

¹⁸ Nor is the so-called “accountant-client privilege” a solution. In the first place, it is entirely derivative: “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....” 26 U.S.C. § 7525(a)(1). Second, for reasons that are beyond the present scope, corporations generally have not been able to take advantage of § 7525.

¹⁹ The traditional “advice of counsel” defense is codified at 26 U.S.C. § 6664. Where a legal opinion is offered as proof of reasonableness and good faith, it must have been received prior to the filing of the relevant tax return.

privilege by the audit client would be, or should be, moot in view of, *inter alia*, the “reporting up” rules promulgated under Sarbanes-Oxley section 307.

(3) When an organization must disclose privileged information to an outside regulator or auditor, under what circumstances should the disclosure waive the privilege in its entirety, and to what extent should the privilege be preserved vis-à-vis third parties?

The privilege should be preserved in its entirety in all cases in which tax advice would be unprotected because the client knew from the outset that the advice was to be shared with its independent auditor or because the privilege was waived. Any other result would see the IRS gaining access to taxpayers’ legal analysis and conclusions without taxpayers having corresponding rights.

Recommendations

In order to re-engage the accounting profession, the Task Force should consider recommending the following –

The SEC should be encouraged to temper its statements implicating the privilege and to acknowledge that the need for reliable financial statements must be balanced with investors’ interest in reasonable assurance that the companies they invest in will not be forced to sacrifice the “level playing field” on which tax controversies should be decided.

The PCAOB should be commended for not implicating the privilege in the standards it has issued to date, and encouraged not to do so in the future.

The AICPA should be encouraged to promulgate a clarification of the 2003 interpretation of AU Section 326 that has led accounting firms to conclude that they are compelled to seek privileged information. It should be encouraged to reaffirm the Treaty as well.

The FASB should be cautioned with respect to the challenge to the privilege that its expected Interpretation of FAS 109 would present, regardless of the comfort level finally established for the recognition of tax benefits.

Conclusion

Time is of the essence if the legal profession is to reassert the traditional protections for attorney-client communications and for work product. Lawyers must act quickly and collectively to re-engage the accounting profession and to work with its institutions toward an appreciation of the privilege in the post-Enron era, and toward renewal of the Treaty that was reached thirty years ago.

Again, thank you for the opportunity to provide input to the Task Force.