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

Salt Lake City, Utah
February 11, 2005

The Section of Taxation welcomes this opportunity to address an issue of emerging concern with respect to the attorney-client privilege as identified by the Task Force Reporter, specifically:

4. Potential Public Company Accounting Oversight Board rules and the tendency of independent auditors to require corporations to provide privileged materials.

Background

On April 9, 2003, the American Institute of Certified Public Accountants (“AICPA”) amended its interpretation of auditing standard AU section 326, Evidential Matter, as it pertains to the effect of an inability to obtain evidential matter relating to income tax accruals. The AICPA’s revised interpretation states as follows:

If the client’s support for the tax accrual or matters affecting it, including tax contingencies, is based upon an opinion issued by an outside adviser 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*. The audit documentation should include either the actual advice or opinions rendered by an outside adviser, or other sufficient documentation or abstracts supporting both the transactions or facts addressed as well as the analysis and conclusions reached by the client and adviser. Alternatives such as redacted or modified opinions may be considered, but must nonetheless include sufficient content to articulate and document the client’s position so that the auditor can formulate his or her conclusion. Similarly, it may be possible to accept a client’s analysis summarizing an outside adviser’s opinion, but the client’s analysis must provide sufficient competent evidential matter for the auditor to formulate his or her conclusion. In addition, client representations may be obtained stating that the client has

not received any advice or opinions that are contradictory to the client's support for the tax accrual.

AU section 9326, Evidential Matter: Auditing Interpretations of Section 326, paragraph 2.22. (Emphasis supplied.) Professional standards adopted by the Public Company Accounting Oversight Board ("PCAOB") require registered accounting firms to comply with the revised interpretation set forth in AU section 9326.

In response to the revised interpretation, over the past several months, there has been a dramatic increase in requests for privileged materials, particularly legal opinions and litigation assessments relied upon by companies in formulating contingency reserves and for oral assessments of loss contingency ranges and other client confidences.

These queries are at odds with the standards developed by the American Bar Association (the "Association") and the AICPA thirty years ago and embodied in ABA Statement of Policy Regarding Lawyers' Response to Auditors' Requests for Information (December 1975). That policy was aimed at providing clients with appropriate advice concerning public disclosures on contingencies and providing responses to auditors in a form intended to preserve the client's ability to assert applicable privileges with respect to both communications with counsel and advice received concerning those communications. Until recently, that policy formed the basis of practice for both accountants and lawyers with respect to responses to auditors' letters.

By requesting copies of the opinions and assessments themselves rather than seeking assurance that advice on appropriate disclosures has been given, the new practice by auditors raises risks that the attorney-client and other privileges may be waived to the substantial detriment of public companies and their shareholders. The

auditors apparently believe that the PCAOB rules and rules contemplated by other accounting bodies give them little choice but to make such demands.

As an initial matter, we believe that the Task Force should assess the probable consequences of widespread auditor demands for privileged materials, formulate ways that the Association might make auditors and their regulatory bodies aware of the risks posed by such demands, and suggest alternative means by which auditor concerns might be addressed. We believe that there is a significant risk that such demands may actually be counterproductive to the goal of increasing the transparency of corporate financial statements. The serious threat over time is to the advice-seeking process itself: if a discussion with a lawyer cannot be conducted with the assurance of confidentiality provided by the attorney-client and other privileges, the risk is that consultation will be deferred or forgone altogether. It is difficult to perceive how advocates of transparency, compliance and enforcement could regard such a result as ultimately advancing any of their goals. Moreover, if a company's inquiry to its counsel and counsel's response must be disclosed to auditors and that disclosure results in a broad "subject matter" waiver, opening up the company and its attorneys to inquiry not only from the auditor, but also from government agencies and actual and potential adversaries in a wide range of controversies, about communications with counsel, the prejudice to the company and to its shareholders is obvious: it must litigate in a fishbowl while its antagonists labor under no such burden.

Waiver or Forfeiture of Privilege by Disclosure

The consequences of disclosure of an opinion or litigation assessment to an auditor on the attorney-client privilege are uncertain under current case law.¹ The broadest, most unfavorable outcome is that the disclosure to the auditor constitutes a "subject matter" waiver not only of the document or documents disclosed to the auditors but of all related communications and advice on the "subject matter" of the disclosure.² While cases holding that a "subject matter" waiver has occurred frequently do not articulate all of the distinctions, a "subject matter" waiver raises many potential issues.

¹ While we recognize that the Task Force is focused on the attorney-client privilege, waiver is also a concern with respect to the work-product privilege. Some courts hold that disclosures to an auditor do not waive the work-product privilege. *See, e.g., Merrill Lynch & Co. v. Allegheny Energy, Inc.*, No. 02 Civ. 7689(HB), 2004 WL 2389822 (S.D.N.Y. Oct. 26, 2004); *In re Pfizer Inc. Sec. Litig.*, No. 90 Civ. 1260(SS), 1993 WL 561125 (S.D.N.Y. Dec. 23, 1993). In contrast, others have found disclosure to financial auditors to waive the work-product privilege as well. *See, e.g., Medinol Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (S.D.N.Y. 2002)(disclosure to financial auditors); *United States v. Mass. Inst. of Tech.*, 129 F.3d 681 (1st Cir. 1997)(disclosure to government auditors). *See also First Fed. Sav. Bank of Hegewisch v. United States*, 55 Fed. Cl. 263 (Ct. Fed. Cl. 2003) (disclosure of privileged minutes to financial auditor waived attorney-client privilege); *Long-Term Capital Holdings v. United States*, 2003 WL 1548770, at *8 (D. Conn. Feb. 14, 2003) (a corporation's disclosure to its accountant of the level of a tax opinion received from its counsel, *e.g.* "more likely than not," "waived the attorney-client privilege to the limited portion of the opinion that confirms what was actually disclosed").

In addition, section 7525 of the Internal Revenue Code provides a statutory privilege for tax professionals that may be affected by the issues addressed in this testimony.

² *In re Pioneer Hi-Bred Int'l, Inc.*, 238 F.3d 1370, 1374-75 (Fed. Cir. 2001) (holding that the disclosure in a proxy statement of advice rendered by legal counsel concerning the tax consequences of a merger constituted a waiver of the attorney-client privilege with respect to "all documents which formed the basis for the advice, all documents considered by counsel in rendering that advice, and all reasonably contemporaneous documents reflecting discussions by counsel or others concerning that advice"); *United States v. Jones*, 696 F.2d 1069, 1073 (privilege did not attach to tax law opinions published in part in promotional materials for a tax shelter transaction).

For example, how broad is the "subject matter"?³ Does the waiver reach only advice by the attorney or law firm whose advice is disclosed or must advice by other counsel on the subject matter also be disclosed?⁴ Does the waiver cover a specific period of time or does it reach any future communication with any counsel on the subject matter?⁵

The articulated rationale for a broad "waiver" or "forfeiture" of privilege has been that a litigant should not be permitted to engage in "selective" disclosure and thereby use the privilege as both sword and shield. Thus, for example, a defendant who proposed to offer testimony based on a reliance-on-advice-of-counsel defense in a securities law case was required to elect between the defense and a full waiver of privilege if testimony concerning reliance on counsel were introduced at trial. *See United States v. Bilzerian*, 926 F.2d 1285 (2d Cir. 1991).

In contrast to cases reaching a broad "subject matter" waiver result, other cases have held waivers to be limited to the actual disclosures made, particularly where

³ *See Long-Term Capital Holdings*, 2003 WL 1548770, at *5 (production to the IRS of a tax opinion relating to one aspect of a transaction did not result in a waiver of the attorney-client privilege with respect to a tax opinion relating to a subsequent portion of the transaction).

⁴ *Diotima Shipping Corp. v. Chase, Leavitt & Co.*, 102 F.R.D. 532, 537 (D. Me. 1984) (waiver of a privileged communication passing between a client and a certain attorney and discussing a certain subject operates to waive the privilege only as to communications between the same attorney and the same client on the same subject). *See also Bower v. Weisman*, 669 F. Supp. 602 (S.D.N.Y. 1987); *Champion Int'l Corp. v. Int'l Paper Co.*, 486 F. Supp. 1328 (N.D. Ga. 1980). *But see, e.g., Technitrol, Inc. v. Digital Equip. Corp.*, 1974 U.S. Dist. LEXIS 12129 (N.D. Ill. 1974) (waiver reached communications with other counsel).

⁵ In *XYZ Corp. v. United States*, 348 F.3d 16, 25 (1st Cir. 2003), the First Circuit stated that "a prospective waiver will very rarely be warranted in extrajudicial disclosure cases. Courts have generally allowed prospective waivers in discrete and limited situations, almost invariably involving advice-of-counsel defenses."

the disclosure occurs in an extrajudicial context. Thus, the Second Circuit in *von Bulow v. von Bulow*, 828 F.2d 94, 102 (2d Cir. 1987) found that a "subject matter" waiver did not occur where a criminal defendant's counsel disclosed certain confidences of the client in a book about the client's judicial proceedings. Specifically, the Second Circuit held:

[T]he extrajudicial disclosure of an attorney-client communication – one not subsequently used by the client in a judicial proceeding to his adversary's prejudice – does not waive the privilege as to the undisclosed portions of the communication.

Id. This partial waiver approach has been followed in situations involving disclosures to a business associate,⁶ a proffer to a prosecutor,⁷ disclosures in securities offering materials,⁸ and disclosures included in an income tax return.⁹

⁶ *XYZ Corp. v. United States*, 348 F.3d 16 (1st Cir. 2003) (disclosure of a legal position to a co-venturer did not result in a broad subject matter waiver of the attorney-client privilege as to confidential communications between client and attorney underlying that legal position).

⁷ *John Doe Co. v. United States*, 350 F.3d 299, 304-05 (2d Cir. 2003) (letter submitted to the U.S. Attorney's office describing why the defendant's operations complied with U.S. firearms laws did not waive the defendant's "work product privilege" applicable to notes made by the defendant's attorneys of meetings and conversations with officials of the Bureau of Alcohol, Tobacco, and Firearms).

⁸ *Apex Mun. Fund v. N-Group Sec.*, 841 F. Supp. 1423, 1427-28 (S.D. Tex. 1993) (documents reflecting information conveyed by the client to the attorney to prepare a public offering statement are protected by the attorney-client privilege, except to the extent that the information in them actually appears in the public document); *Schenet v. Anderson*, 678 F. Supp. 1280 (E.D. Mich. 1988) (drafts of securities offering materials were privileged). *But see In re Pioneer Hi-Bred Int'l.*, 238 F.3d 1370 (Fed. Cir. 2001) (disclosure of outside counsel's advice regarding the tax consequences of the transaction in an SEC filing resulted in broad waiver of the attorney-client privilege).

⁹ *United States v. Schlegel*, 313 F. Supp. 177, 179-80 (D. Neb. 1970) ("In the present case, therefore, aside from the information incorporated in the income tax return which was sent to the government, the oral conversations between the defendant and his attorney regarding preparation of the return and any written materials prepared by

Disclosures to auditors are by their nature extrajudicial and involve none of the "fair litigation" issues cited by courts to require broad "subject matter" waivers.¹⁰ We believe that an appropriate judicial response to disclosures of privileged materials to auditors would be to limit the waiver to the disclosure and not to apply the "subject matter" waiver concept in these circumstances.

Policy Issues

Even if, however, the consequence of disclosures to auditors can be limited to act as a waiver of the attorney-client privilege only as to the documents actually disclosed, the adverse consequences to reporting companies and their shareholders will be severe. Disclosure of a company's internal assessment of its odds of prevailing in tax litigation, for example, affords its government opponents an advantage in the settlement process that will certainly not be reciprocated. This advantage is magnified when it is realized that relatively few tax disputes are litigated and that the overwhelming majority are settled. Moreover, if mandatory disclosures to auditors result in broad "subject matter" waivers, such disclosures must over time constrain the

the defendant solely for the purpose of delivery to his attorney for the preparation of his return are within the privilege."). *But see United States v. Cote*, 456 F.2d 142 (8th Cir. 1972) (attorney-client privilege attaching to information contained in accountant's workpapers waived by publishing the substance of that information in amended tax returns).

¹⁰ Moreover, in circumstances where disclosure to an auditor is the first disclosure outside the circle of those entitled to access to the privileged materials, the concerns about materials prepared for public disclosure discussed in *In re Grand Jury Proceedings*, 727 F.2d 1352 (4th Cir. 1984) and *In re Grand Jury (Under Seal)*, 748 F.2d 871 (4th Cir. 1984) should not be operative.

information that clients are willing to share with their attorneys. As the Supreme Court observed in the context of the work-product privilege,

Were such materials open to opposing counsel on mere demand, much of what is now put down in writing would remain unwritten. An attorney's thoughts, heretofore inviolate, would not be his own. Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial. The effect on the legal profession would be demoralizing. And the interests of the clients and the cause of justice would be poorly served.

Hickman v. Taylor, 329 U.S. 495, 511 (1947).

For these reasons, we believe that these issues require consultation by the Association with the accounting regulatory and standard setting bodies as well as with organizations of the accounting profession to create awareness of the issues posed by accounting rules mandating disclosures of privileged materials. In such consultations, the Association should emphasize the critical role of the privilege in securing informed legal representation and the likely consequences of its erosion. Given audit firms' expertise in the tax matters and ability to assess virtually all tax issues independently, we question in particular whether access to privileged tax materials is needed. Second, we urge the Task Force to analyze the conflicting case law on waiver with a view toward articulating a more coherent framework than now exists for determining when waivers (or forfeitures) of privilege occur and the extent of such waivers. Such consultation and analysis may identify areas which might usefully be changed or clarified by legislation or appropriate rule-making.